

PAPER
3

**FINAL COURSE
STUDY MATERIAL
GROUP-I**

**ADVANCED AUDITING,
ASSURANCE &
PROFESSIONAL ETHICS
MODULE 1 OF 3**



Board of Studies (Academic)
**The Institute of Chartered
Accountants of India**

(Set up by an Act of Parliament)

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BEFORE WE BEGIN.....

Evolving Role of a CA. - Shift Towards Strategic Decision Making

The role of a chartered accountant is evolving continually to assume newer responsibilities in a dynamic environment. There has been a notable shift towards strategic decision making and entrepreneurial roles that add value beyond traditional accounting and auditing. The causative factors for the change include globalisation leading to increase in cross border transactions and consequent business complexities, significant developments in information and technology and financial scams underlining the need for a stringent regulatory set up. These factors necessitate an increase in the competence level of chartered accountants to bridge the gap in competence acquired and competence expected from stakeholders. Towards this end, the scheme of education and training is being continuously reviewed so that it is in sync with the requisites of the dynamic global business environment; the competence requirements are being stepped up to enable aspiring chartered accountants to acquire the requisite professional competence to take on new roles.

Skill Requirements at Final Level

Under the Revised Scheme of Education and Training, at the Final Level, you are expected to apply the professional knowledge acquired through academic education and the practical exposure gained during articleship training in addressing issues and solving practical problems. The integrated process of learning through academic education and practical training should also help you inculcate the requisite technical competence, professional skills and professional values, ethics and attitudes necessary for achieving the desired level of professional competence.

Auditing – Core and Practical Subject

Auditing has been conceived of to provide a highly useful technical service to the economy to know performances in financial and other appropriate terms in a reliable manner. It is needless to say that multitudes of significant decisions in the economic society are taken based on the financial information and, therefore, ensuring reliability of such information is an imperative necessity. Audit is a subject that requires a lot of quick and logical application of mind to answer practical problems. It is one of the most practical-oriented subjects in the C.A. curriculum. This paper aims to provide knowledge of generally accepted auditing procedures and of techniques and skills needed to apply them in audit engagements. A good knowledge of the subject would provide a strong foundation to

students while pursuing the Chartered Accountancy course. A good understanding of the theoretical concepts, particularly, in the context of auditing standards would make practical training an enriching and enjoying experience. While studying this paper, students are advised to integrate the knowledge acquired in other subjects in a meaningful manner along with practical training. Such learning would only help a student to become a better professional.

Know your syllabus and Study Material

The Study Material of Advanced Auditing, Assurance and Professional Ethics subject has been designed having regard to the needs of home study and distance learning students. The study material deals with the conceptual theoretical framework in detail. In each chapter, the topic has been covered in a step by step approach. The text has been explained, where appropriate, through illustrations, diagrams, tables, flowcharts, screenshots etc. You should go through the chapter carefully ensuring that you understand the topic and then test your knowledge by attempting question.

The Study Material has been divided into nineteen chapters in line with the syllabus and further bifurcated into three modules for the easy handling and convenience of students. For bare text of Guidance Notes and Auditing Standards, the students are advised to refer the “Auditing Pronouncements” which has been webhosted on the BOS Knowledge Portal by the Board of Studies. For understanding the coverage of the syllabus, it is important to read the study material along with the Study Guidelines.

Framework of Chapters – Uniform Structure Comprising of Specific Components

Efforts have been made to present each topic of the syllabus in a lucid manner. Care has been taken to present the chapters in a logical sequence to facilitate easy understanding by the students.

Structure of the Study Material

The content for each chapter/unit at the Final level has been structured in the following manner –

S. No.	Components of Each Chapter	About the Component
1.	Learning Outcomes	Learning outcomes which you need to demonstrate after learning each topic have been detailed in the first page of each chapter/unit. Demonstration of these learning outcomes would help you to achieve the desired level of technical competence.
2.	Chapter Overview	As the name suggests, this chart/table would give a broad outline of the contents covered in the chapter.

3.	Beginning with a Story	After Chapter Overview in flowchart, importance of the Chapter and key points to make the Chapter interesting are explained in the form of Story.
4.	Introduction	A brief introduction is given at the beginning of each chapter/unit which would help you get a feel of the topic.
5.	Content	The concepts and provisions of law/standard are explained in student-friendly manner with the aid of Examples / illustrations/diagrams/flow charts. These value additions would help you develop conceptual clarity and get a good grasp of the topic. Diagrams and Flow charts would help you understand the concept/provision in a better manner. Illustrations would help you understand the application of concepts/provisions.
6.	Test Your Understanding	Test your Understanding feature is also newly added feature. With the help of this feature student can test their understanding and refer the answer given after the end of the Chapter.
7.	Key Takeaways	This feature summarise the Key Takeaways for revision purpose.
8.	Exercise Questions with Case Study/ Case Scenario / Test Your Knowledge	Exercising questions and answers alongwith Integrated Case Scenario based MCQs would help you to apply what you have learnt in problem solving. In effect, it would sharpen your application skills and test your understanding as well as your application of concepts/provisions.

Though all efforts have been taken in developing this Study Material, the possibilities of errors / omissions cannot be ruled out. You may bring such errors / omissions, if any, to our notice so that the necessary corrective action can be taken.

We hope that the student-friendly features in the Study Material makes your learning process more enjoyable, enriches your knowledge and sharpens your application skills.

Happy Reading and Best Wishes!

SYLLABUS

PAPER 3: ADVANCED AUDITING, ASSURANCE AND PROFESSIONAL ETHICS

(One Paper – Three hours 100 Marks)

Objective:

- (a) To gain the ability to analyse current auditing practices and procedures and apply them in auditing engagements.
- (b) To develop the ability to solve cases relating to audit engagements.

Contents:

1. Quality Control

SQC 1 Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information and Other Assurance and Related Services Engagements

SA 220 Quality Control for an Audit of Financial Statements

2. General Auditing Principles and Auditors Responsibilities

SA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

SA 250 Consideration of Laws and Regulations in an Audit of Financial Statements

SA 260 Communication with Those Charged with Governance

SA 299 Joint Audit of Financial Statements

SA 402 Audit Considerations Relating to an Entity Using a Service Organisation.

(Note: Content of SA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing; SA 210 Agreeing the Terms of Audit Engagements and SA 230 Audit Documentation is covered in depth at Intermediate level. Thus, application part of above SAs may be discussed in the form of Case Study at Final level.)

3. Audit Planning, Strategy, and Execution

SA 300 Planning an Audit of Financial Statements; (Content is covered in depth at Intermediate level, therefore, application part of SA 300 may be discussed in the form of Case Study at Final level.)

SA 450 Evaluation of Misstatements identified During the Audit

SA 520 Analytical Procedures

SA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures

SA 610 Using the Work of Internal Auditors

SA 620 Using the Work of an Auditor's Expert

4. Materiality, Risk Assessment and Internal Control

Evaluation of Internal Control Procedures; Components of Internal Controls; Internal Control and Risk Assessment; auditor's response to assessed risks; Risk-Based Audit- Audit Risk Analysis; Reporting on Internal Control Weaknesses, Framework on Reporting of Internal Controls.

SA 265 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management.

SA 330 The Auditor's Responses to Assessed Risks

(Note : Content of SA 315 Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment and SA 320 Materiality in Planning and Performing an Audit is covered in depth at Intermediate level. Thus, application part of above SAs may be discussed in the form of Case Study at Final level.)

5. Audit Evidence

(Note : Content of SA 500 Audit Evidence; SA 501 Audit Evidence - Specific Considerations for Selected Items; SA 505 External Confirmations; SA 510 Initial Audit Engagements – Opening Balances; SA 530 Audit Sampling & SA 550 Related Parties is covered in depth at Intermediate level. Thus, application part of above SAs may be discussed in the form of Case Study at Final level.)

6. Completion and Review

(Note: Content of SA 560 Subsequent Event; SA 570 Going Concern and SA 580 Written Representation is covered in depth at Intermediate level. Thus, application part of above SAs may be discussed in the form of Case Study at Final level.)

7. Reporting

SA 700 Forming an Opinion and Reporting on Financial Statements

SA 701 Communicating Key Audit Matters in the Independent Auditor's Report

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

SA 706 Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

SA 710 Comparative Information – Corresponding Figures and Comparative Financial Statements

SA 720 The Auditor's Responsibility in Relation to Other Information

8. Specialised Areas

Basic and Overview of SA 800 Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks

Basic and Overview of SA 805 Special Considerations-Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement

Basic and Overview of SA 810 Engagements to Report on Summary Financial Statements

9. Related Services : Basic and Overview of SRS 4400 Engagements to Perform Agreed-upon Procedures Regarding Financial Information

Basic and Overview of SRS 4410 Compilation Engagements

10. Review of Financial Information

Basic and Overview of SRE 2400 Engagements to Review Historical Financial Statements

Basic and Overview of SRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity

11. Prospective Financial Information and Other Assurance Services

Basic and Overview of SAE 3400 The Examination of Prospective Financial Information

Basic and Overview of SAE 3402 Assurance Reports on Controls at a Service Organisation

Basic and Overview of SAE 3420 Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus

12. Digital Auditing and Assurance

Auditing digitally and Digital auditing, Usage of Automated Tools such as CAAT, Data Analytics, Artificial Intelligence, etc., Remote Auditing.

13. Group Audits

Audit of Consolidated Financial Statements - Responsibility of Parent Company, Auditor of the Consolidated Financial Statements; Audit Considerations - Permanent Consolidation, Current Period Consolidation; Reporting.

Audit of Group Financial Statements including the work of Component Auditors,

SA 600 Using the Work of Another Auditor

14. **Special Features of Audit of Banks & Non-Banking Financial Companies**
15. **Overview of Audit of Public Sector Undertakings:** Concept of Propriety Audit; Performance Audit; Comprehensive Audit.
16. **Internal Audit :** Provisions of Internal Audit as per Companies Act, 2013; Scope of Internal Auditing; Relationship between Internal and External Auditor; Basics of Internal Audit Standards issued by the ICAI; Drafting of Internal Audit Report; Audit Trail, Internal Audit as a Management Function.
17. **Due Diligence, Investigation and Forensic Accounting:** Due Diligence Review; Audit versus Investigation; Steps for Investigation; Types of Investigation; Procedure, Powers, etc. of Investigator; Types of Fraud, Indicators of Fraud, Follow-up thereof; Forensic Accounting-meaning, difference between Statutory Audit and Forensic Accounting, Forensic Accounting and Investigation Report, Introduction of Forensic Accounting and Investigation Standards
18. **Emerging Areas: Sustainable Development Goals (SDG) & Environment, Social and Governance (ESG) Assurance etc.**
19. **Professional Ethics and Liabilities of Auditors:** Introduction of Code of Ethics as per IESBA and Code of Ethics with special reference to the relevant provisions of the Chartered Accountants Act, 1949 and the Regulations thereunder; Application of Fundamental Principles; Application of Threats, Evaluation of Threats; Addressing Threats and Safeguards; Conceptual Framework; Important Provisions of Chartered Accountants Act, 1949 and Chartered Accountants Regulations 1988.

Note: *If any new legislations / Engagement and Quality Control Standards/ Guidance Notes/ Statements are enacted in place of the existing legislations / Engagement and Quality Control Standards / Guidance Notes / Statements, the syllabus will accordingly include the corresponding provisions of such new legislations / Engagement and Quality Control Standards / Guidance Notes /Statements, with effect from the date to be notified by the Institute.*

Similarly, if any existing legislations / Engagement and Quality Control Standards/ Guidance Notes /Statements ceases to be in force, the syllabus will accordingly exclude such legislations/ Engagement and Quality Control Standards/ Guidance Notes / Statements with effect from the date to be notified by the Institute.

Further, the specific inclusions/exclusions in any topic covered in the syllabus will be effected by way of Study Guidelines every year, if required.

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QUALITY CONTROL

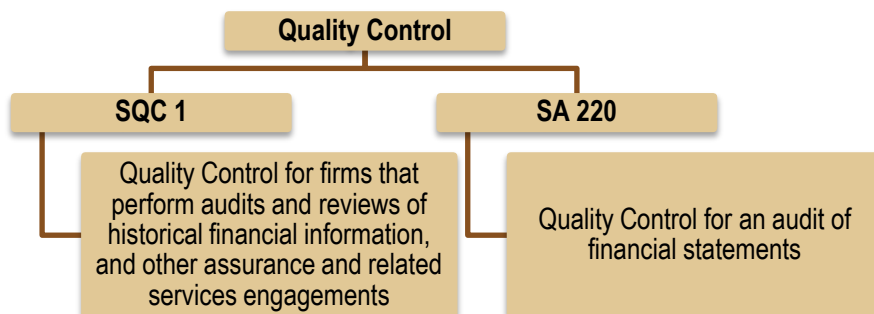


LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ☐ Gain the knowledge about importance of audit quality.
- ☐ Understand the importance of quality control system in a firm.
- ☐ Clearly grasp import of SQC 1 and SA 220.
- ☐ Apply requirements of SQC 1 and SA 220 in practical situations.
- ☐ Understand importance of ethics in engagements.
- ☐ Differentiate between SQC 1 and SA 220.
- ☐ Understand relationship between SQC 1 and SA 220.
- ☐ Know briefly about mechanisms for review of audit quality.

CHAPTER OVERVIEW



CA Jagriti is working in a firm of Chartered Accountants in capacity of a paid employee. The firm consists of 7 partners and is handling varied type of professional work including audits. There is heavy load of professional work on her and she handles few audit clients also. The firm's business is growing rapidly and many new clients have been added to the client base of firm in past 2-3 years. In the hindsight, she is thinking whether it was proper on part of the firm to accept new clients without checking and verifying about their backgrounds.

Besides, she also feels that firm is accepting audits of some companies which are engaged in technical and complex operations. The firm has no past experience for audits of such clients. The partners also seemed to be stingy in hiring experienced and capable staff to handle such work. In her mind, she always lamented about the same. Are commercial considerations deciding and overriding factors? She was brooding.

Increase in volume of professional work without commensurate hiring of capable and qualified staff is leading to many lapses. She had handled audit of a listed company. The audit was completed, report issued, and annual report published. She found to her horror that audit report issued under Companies Act, 2013 referred to "profit" in financial statements. However, audited financial statements reflected a "loss." She developed cold feet and cursed lack of a proper quality control system in the firm.

Similarly, in another case, she found that issued audit report of the company referred to "cash flow statement" whereas audited financial statements didn't comprise of a cash flow statement as it was a "small company" within meaning of Companies Act, 2013.

She had made up her mind to make senior partner listen to her. Inviting attention to such serious lapses in reporting, she politely told her that firm was inviting troubles from regulators. She underlined need for a proper and effective quality control system in the firm to ensure that work was carried out in accordance with professional standards and applicable legal and regulatory framework so that audit report that is appropriate is issued.



1. AUDIT QUALITY

High audit quality is central to auditing profession. It helps in creating trust in users of financial information. Industry, government and public at large who are the stake holders who relies upon assurance given by auditors. It is, therefore, necessary to ensure high audit quality throughout the audit process. Audit quality involves application of a rigorous audit process by auditors and quality control procedures that comply with laws, regulations and applicable professional standards.

SQC 1- Quality Control for firms that perform audits and reviews of historical financial information, and other assurance and related services engagements and SA 220- Quality Control for an audit of financial statements deal with issue of establishing quality control systems and responsibilities of auditors in this regard. Both the standards deal with framework of audit quality. SQC 1 applies to all engagements and deals with quality at level of firm. SA 220 deals with audit quality at individual audit engagement level.

Besides above two standards, other Standards on auditing, code of ethics issued by ICAI and certain provisions of Companies Act, 2013 facilitate quality control process. There also exists mechanism for review of quality control through Peer review Board, Quality review Board and NFRA (National financial reporting authority).



2. SQC 1 - QUALITY CONTROL FOR FIRMS THAT PERFORM AUDITS AND REVIEWS OF HISTORICAL FINANCIAL INFORMATION, AND OTHER ASSURANCE AND RELATED SERVICES ENGAGEMENTS

SQC 1 requires that the firm should establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements and that reports issued by the firm or engagement partners are appropriate in the circumstances. Firm's system of quality control should consist of policies designed to achieve these objectives. This quality control standard applies to all firms irrespective of their constitution.

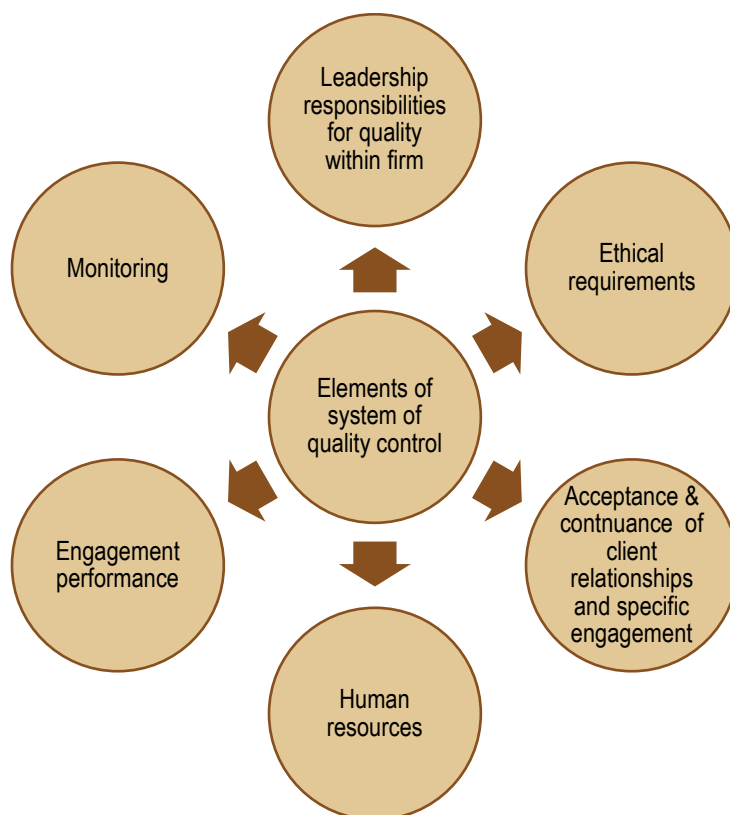
2.1 Elements of System of Quality Control

The firm's system of quality control should include policies and procedures addressing each of the following elements: -

- (a) Leadership responsibilities for quality within the firm

- (b) Ethical requirements
- (c) Acceptance and continuance of client relationships and specific engagements
- (d) Human resources
- (e) Engagement performance
- (f) Monitoring

Quality control policies and procedures should be documented and communicated to the firm's personnel. By communicating, the firm recognizes the importance of obtaining feedback on its quality control system from its personnel. Therefore, the firm encourages its personnel to communicate their views or concerns on quality control matters.



2.1.1 Leadership Responsibilities for Quality within the Firm

SQC 1 requires firms to establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements. Such policies and procedures should require the firm's chief executive officer or the firm's managing partners to

assume ultimate responsibility for the firm's system of quality control. The example set by firm's leadership encourages an inner culture that recognizes high quality audit work. Further, persons assigned operational responsibilities for the firm's quality control system by the firm's chief executive officer or managing partners should have sufficient and appropriate experience, ability, and the necessary authority to assume that responsibility.

It has been laid down clearly that firm's business strategy is subject to the overriding requirement for the firm to achieve quality in all the engagements that the firm performs. Essentially, it implies that audit quality is paramount in all engagements. It is non-negotiable. In this regard, it should be ensured that: -

- (a) The firm assigns its management responsibilities so that commercial considerations do not override the quality of work performed.
- (b) The firm's policies and procedures addressing performance evaluation, compensation, and promotion (including incentive systems) with regard to its personnel are designed to demonstrate the firm's overriding commitment to quality and
- (c) The firm devotes sufficient resources for the development, documentation and support of its quality control policies and procedures.

TEST YOUR UNDERSTANDING 1:

ABC & Associates, Chartered Accountants has a policy to accept the clients wherein the risk evaluation is conducted with respect to the Company and the promoter. XYZ Limited approached ABC & Associates. Promoter of XYZ Limited is a close associate and family friend of Mr. A, Managing Partner of ABC & Associates. XYZ Limited is in news in the previous year for certain inquiries from the regulatory authorities in relation to certain matters. The existing auditor of XYZ Limited has resigned and has created a casual vacancy. XYZ Limited is ready to offer 25% more than the existing fees and has approached ABC & Associates for appointment as Auditor. Mr. A has strong recommendation to the Firm to accept the audit.

What is your understanding of the functioning of the tone at the top of the Firm ABC & Associates, Chartered Accountants.? What are the considerations one should exercise to uphold Quality of the Firm?

2.1.2. Ethical Requirements

The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements contained in the Code of ethics issued by ICAI.

The Code establishes the fundamental principles of professional ethics which include integrity, objectivity, professional competence and due care, confidentiality and professional behaviour. Fundamental principles should be emphasized by

- ◆ Actions of the leadership of the firm
- ◆ spreading awareness and training
- ◆ Monitoring
- ◆ A process for dealing with non-compliance.

Observance of “Independence” in all engagements is the founding requirement. The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and (including experts contracted by the firm and network firm personnel) maintain independence where required by the Code. Such policies and procedures should enable the firm to: -

- (a) Communicate its independence requirements to its personnel
- (b) Identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to *withdraw from the engagement*.

There should exist a mechanism in the firm by which engagement partners provide the firm with relevant information about client engagements and personnel of firm promptly notify firm of circumstances and relationships that create a threat to independence. All breaches of independence should be promptly notified to firm for appropriate action. Its objective is to ensure that independence requirements are satisfied.

At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent in terms of the requirements of the Code.

SQC 1 lays special emphasis on familiarity threat. Using the same senior personnel on assurance engagements over a prolonged period may impair the quality of performance of the engagement. Therefore, the firm should establish criteria for determining the need for safeguards to address this threat. In determining appropriate criteria, the firm considers such matters as-

- (a) the nature of the engagement, including the extent to which it involves a matter of public interest and
- (b) the length of service of the senior personnel on the engagement.

Examples of safeguards include rotating the senior personnel or requiring an engagement quality control review. The familiarity threat is particularly relevant in the context of financial statement audits of listed entities. For these audits, the engagement partner should be rotated after a pre-defined period, normally not more than seven years (except in cases where audit of listed entities is conducted by a sole practitioner). However, to ensure quality control exists in such firms and appropriate reports are issued, there is a process for mandatory peer review of such firms.

TEST YOUR UNDERSTANDING 2

MNP & Co., a firm of auditors, is appointed by a bank to conduct stock audit of a borrower. It deputes one of its paid Chartered accountant employees, Sudhanshu, to conduct above said stock audit. He leverages it as an opportunity to prevail upon the client to get the accounts audited from their firm. He also assures the client of a clean stock audit report without adverse comments as a *quid pro quo*. Is approach of Sudhanshu proper? How does it reflect upon quality control system of firm?

2.1.3. Acceptance and Continuance of Client Relationships and Specific Engagements

A firm before accepting an engagement should acquire vital information about the client. Such an information should help firm to decide about: -

- ◆ Integrity of Client, promoters and key managerial personnel.
- ◆ Competence (including capabilities, time and resources) to perform engagement.
- ◆ Compliance with ethical requirements.

The firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Where issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, it should document how the issues were resolved.

With regard to the integrity of a client, matters that the firm considers include, for example:

- The identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance.
- The nature of the client's operations, including its business practices.

- Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
- Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.
- Indications of an inappropriate limitation in the scope of work.
- Indications that the client might be involved in money laundering or other criminal activities.
- The reasons for the proposed appointment of the firm and non-reappointment of the previous firm. The extent of knowledge a firm will have regarding the integrity of a client will generally grow within the context of an ongoing relationship with that client.

In considering whether the firm has the capabilities, competence, time and resources to undertake an engagement, following matters have to be taken into consideration: -

- Firm personnel have knowledge of relevant industries or subject matters;
- Firm personnel have experience with relevant regulatory or reporting requirements, or the ability to gain the necessary skills and knowledge effectively;
- The firm has sufficient personnel with the necessary capabilities and competence;
- Experts are available, if needed;
- Individuals meeting the criteria and eligibility requirements to perform engagement quality control review are available, where applicable; and
- The firm would be able to complete the engagement within the reporting deadline.

If there is any conflict of interest between the firm and client, it should be properly resolved before accepting the engagement. Where the firm obtains information that would have caused it to decline an engagement if that information had been obtainable earlier, policies and procedures on the continuance of the engagement and the client relationship should include consideration of:

- (a) The professional and legal responsibilities that apply to the circumstances, including whether there is a requirement for the firm to report to the person or persons who made the appointment or, in some cases, to regulatory authorities; and
- (b) The possibility of withdrawing from the engagement or from both the engagement and the client relationship.

Policies and procedures on withdrawal from an engagement or from both the engagement and the client relationship address issues that include the following:

- Discussing with the appropriate level of the client's management and those charged with its governance regarding the appropriate action that the firm might take based on the relevant facts and circumstances.
- If the firm determines that it is appropriate to withdraw, discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement or from both the engagement and the client relationship, and the reasons for the withdrawal.
- Considering whether there is a professional, regulatory or legal requirement for the firm to remain in place, or for the firm to report the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities.
- Documenting significant issues, consultations, conclusions and the basis for the conclusions.

TEST YOUR UNDERSTANDING 3

CA M is introduced to a prospective client in a social function. He assures to visit office of CA M very soon in relation to professional work. During discussions over a cup of coffee next week, it transpires that there was a search by Enforcement Directorate in his premises about a month back resulting in recovery of huge sum of cash. The income tax department had also searched his premises in relation to bogus capital gains on penny stocks. Lamenting poor quality of services provided by his present auditor, he offers appointment as tax auditor of his five family-owned firms to CA M in lieu of handsome fees. What are the factors to be evaluated by CA M if he wants to take up the engagement?

2.1.4. Human Resources

The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances. Such policies and procedures should address relevant HR issues including recruitment, compensation, training, career development, performance evaluation etc. There should be emphasis on the continuing professional development of firm's personnel.

The firm should assign responsibility for each engagement to an engagement partner.

The firm should establish policies and procedures requiring that:

- (a) The identity and role of the engagement partner are communicated to key members of the client's management and those charged with governance;
- (b) The engagement partner has the appropriate capabilities, competence, authority and time to perform the role; and
- (c) The responsibilities of the engagement partner are clearly defined and communicated to that partner

Each engagement team should be able to carry out its responsibilities with necessary competence and skill. Therefore, the firm should ensure suitable people are available and also groom them for their role. The firm should assess performance of their partners and team members keeping in mind their commitment towards quality.

2.1.5. Engagement Performance

Consistency in quality of engagement performance is achieved through briefing of engagement teams of their objectives, processes for complying with engagement standards, processes of engagement supervision and training, methods of reviewing performance of work, appropriate documentation of work performed.

Consultation in difficult or contentious matters: Consultation should take place in difficult or contentious matters pertaining to an engagement.

Consultation includes discussion, at the appropriate professional level, with individuals within or outside the firm who have specialized expertise, to resolve a difficult or contentious matter. It helps to promote quality and improves the application of professional judgment. Consultation procedures require consultation with those having appropriate knowledge, seniority and experience within the firm (or outside the firm) on significant technical, ethical and other matters and appropriate documentation and implementation of conclusions resulting from consultations.

A firm needing to consult externally, for example, a firm without appropriate internal resources, may take advantage of advisory services provided by other firms or professional and regulatory bodies. Complete and proper documentation should be maintained on issues involved and results of consultation.

Engagement quality control review: Significant judgments made in an engagement should be reviewed by an engagement quality control reviewer for taking an objective view before the report is issued.

The extent of the review depends on the complexity of the engagement and the risk that the report might not be appropriate in the circumstances. The review does not reduce the responsibilities of the engagement partner.

Engagement quality control review is mandatory for all audits of financial statements of listed entities. In respect of other engagements, firm should devise criteria to determine cases requiring performance of engagement quality control review.

An engagement quality control review for audits of financial statements of listed entities includes considering the following: -

- The engagement team's evaluation of the firm's independence in relation to the specific engagement.
- Significant risks identified during the engagement and the responses to those risks.
- Judgments made, particularly with respect to materiality and significant risks.
- Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations.
- The significance and disposition of corrected and uncorrected misstatements identified during the engagement.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.
- 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.

Engagement quality control reviewer is a partner, other person in the firm (who should be member of ICAI), suitably qualified external person, or a team made up of such individuals. In this regard, suitably qualified external person refers to an individual outside the firm with the capabilities and competence to act as an engagement partner, for example a partner or an employee (with appropriate experience) of another firm. In addition, the engagement quality control reviewer for an audit of the financial statements of a listed entity is an individual with sufficient and appropriate experience and authority to act as an audit engagement partner on audits of financial statements of listed entities. It is necessary to maintain objectivity of such reviewer. Therefore, participation in

engagement or making decisions for engagement team is to be avoided at all costs. However, engagement partner may consult engagement quality control reviewer during the engagement so as not to compromise his objectivity and 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 should provide for the replacement of the engagement quality control reviewer where the ability to perform an objective review may be impaired.

Differences of Opinion: There might be difference of opinion within engagement team, with those consulted and between engagement partner and engagement quality control reviewer. The report should only be issued after resolution of such differences. In case, recommendations of engagement quality control reviewer are not accepted by engagement partner and matter is not resolved to reviewer's satisfaction, the matter should be resolved by following established procedures of firm like by consulting with another practitioner or firm, or a professional or regulatory body.

Engagement documentation: The firm should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been finalized. Engagement files should be completed in not more than 60 days after date of auditor's report in case of audit engagements and in other cases within the limits appropriate to engagements.

Where two or more different reports are issued in respect of the same subject matter information of an entity, the firm's policies and procedures relating to time limits for the assembly of final engagement files should be considered for each report as if it were for a separate engagement. This may, for example, be the case when the firm issues an auditor's report on a component's financial information for group consolidation purposes and, at a subsequent date, an auditor's report on the same financial information for statutory purposes.

Policies and procedures should be designed to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation.

Care should be taken that policies and procedures on documentation of the engagement quality control review should require documentation that: -

- (a) The procedures required by the firm's policies on engagement quality control review have been performed.

- (b) The engagement quality control review has been completed before the report is issued and
- (c) 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.

Unless otherwise specified by law or regulation, engagement documentation is the property of the firm. The firm may, at its discretion, make portions of, or extracts from, engagement documentation available to clients, provided such 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.

Engagement documentation has to be retained for a period of time sufficient to permit those performing monitoring procedures to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.

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.

2.1.6. Monitoring

The firm should ensure that policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements. Quality control of engagements has to be monitored taking into account following factors:

- ◆ Deciding whether quality control system of the firm has been appropriately designed and effectively implemented.
- ◆ Examining whether new developments in the professional standards, legal and regulatory requirements have been reflected in the quality control policies.
- ◆ Conducting monitoring by entrusting responsibility of monitoring process to a partner or other persons with sufficient and appropriate experience and authority in the firm.
- ◆ Dealing with complaints and allegations against the firm or any employees of it of non-compliance with professional standards or appropriate regulatory requirements by a person within or outside the firm.
- ◆ Taking appropriate remedial actions against the personnel who did not conform to quality control policies.

- ◆ Taking action when deficiencies in the design or operation of the firm's quality control policies and procedures, or non-compliance with the firm's system of quality control are identified.



3. SA 220 - QUALITY CONTROL FOR AN AUDIT OF FINANCIAL STATEMENTS:

Based upon quality control system of firm, quality control policies pertaining to audit engagements are decided by engagement teams. Engagement partner of a team is responsible for quality control procedures of a particular audit engagement in accordance with SA 220.

Therefore, SA 220 is premised on the basis that the firm is subject to SQC 1. Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement and provide the firm with relevant information to enable the functioning of that part of the firm's system of quality control relating to independence. Engagement teams are entitled to rely on the firm's system of quality control, unless information provided by the firm or other parties suggests otherwise.

As per SA 220, the objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that: -

- (a) The audit complies with professional standards and regulatory and legal requirements and
- (b) The auditor's report issued is appropriate in the circumstances.

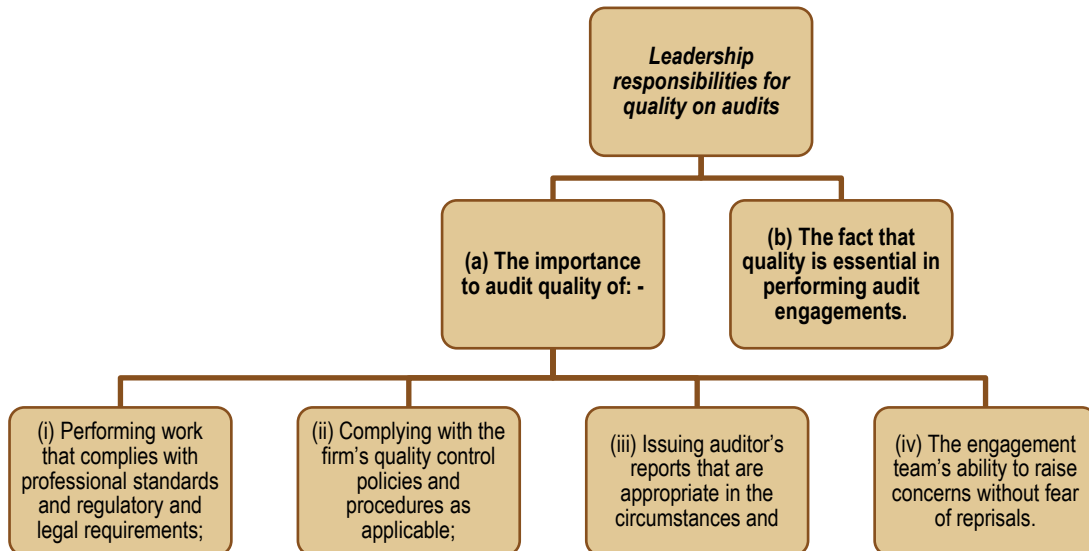
SA 220 is modelled on lines of SQC 1. It describes responsibilities of engagement partner in relation to following matters: -

- (a) Leadership responsibilities for quality on audits.
- (b) Relevant ethical requirements.
- (c) Acceptance and continuance of client relationships and audit engagements.
- (d) Assignment of engagement teams.
- (e) Engagement performance.
- (f) Monitoring.

3.1 Leadership Responsibilities for Quality on Audits

Leadership responsibility of an engagement partner is to take responsibility for the overall quality on each audit engagement. The actions of the engagement partner and appropriate messages to the

other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasis:



(a) The importance to audit quality of: -

- (i) Performing work that complies with professional standards and regulatory and legal requirements;
- (ii) Complying with the firm's quality control policies and procedures as applicable.
- (iii) Issuing auditor's reports that are appropriate in the circumstances and
- (iv) The engagement team's ability to raise concerns without fear of reprisals.

(b) The fact that quality is essential in performing audit engagements.

3.2 Relevant Ethical Requirements

The responsibilities of an engagement partner in relation to ethical requirements in an audit engagement are as under: -

- ◆ Identifying a threat to independence regarding the audit engagement that safeguards may not be able to eliminate or reduce to an acceptable level.
- ◆ Reporting by engagement partner to the relevant persons within the firm to determine appropriate action, which may include eliminating the activity or interest that creates the threat, or withdrawing from the audit engagement, where withdrawal is legally permitted.

3.3 Acceptance and Continuance of Client Relationships and Audit Engagements

The responsibility of an engagement partner in this regard in an audit engagement is on lines of SQC 1 which requires the firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.

Information like integrity of principal owners, competence of engagement team and consideration of necessary capabilities including time and resources, compliance with relevant ethical requirements and significant matters arisen during current or previous audit engagement and their implications assist the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate.

3.4 Assignment of Engagement Teams

It should be ensured by engagement partner that the engagement team and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to perform the engagement in accordance with professional standards and regulatory and legal requirements.

3.5 Engagement Performance

Engagement partner has the responsibility for direction, supervision and performance of audit engagement in accordance with professional standards and regulatory and legal requirements. He is responsible for auditor's report being appropriate in circumstances. Further, review of audit documentation before issue of audit report is his responsibility. It has to be ensured that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for issuance of auditor's report.

Engagement partner is also responsible for ensuring undertaking appropriate consultation on difficult or contentious matters by engagement team not only within the team but also with others at appropriate level within or outside the firm.

3.6 Engagement Quality Control Review

For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall:

- (a) Determine that an engagement quality control reviewer has been appointed
- (b) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer
- (c) Not date the auditor's report until the completion of the engagement quality control review.

The engagement quality control reviewer shall perform an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached in formulating the auditor's report. This evaluation shall involve:

- (a) Discussion of significant matters with the engagement partner**
- (b) Review of the financial statements and the proposed auditor's report**
- (c) Review of selected audit documentation relating to the significant judgments the engagement team made and the conclusions it reached and**
- (d) Evaluation of the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's report is appropriate**

For audits of financial statements of listed entities, the engagement quality control reviewer, on performing an engagement quality control review, shall also consider the following:

- (a) The engagement team's evaluation of the firm's independence in relation to the audit engagement;
- (b) Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations;
- (c) Whether audit documentation selected for review reflects the work performed in relation to the significant judgments made and supports the conclusions reached.

Differences of Opinion

If differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm's policies and procedures for dealing with and resolving differences of opinion.

TEST YOUR UNDERSTANDING 4

GVN & Associates are auditors of a listed company involved in “fin-tech” sector. The engagement team is stuck up with some issue pertaining to a particular Ind-AS applicable to the company. They have framed a query and sent to ICAI for expert opinion on the matter. The issue was resolved upon receipt of expert opinion. Since expert opinion was provided by ICAI, engagement team was of the view that appointment of engagement quality control reviewer has lost its relevance. Do you agree?

3.7 Monitoring

An effective system of quality control includes a monitoring process designed to provide the firm with reasonable assurance that its policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. The engagement partner shall consider the results of the firm’s monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the audit engagement.

3.8 Documentation

The engagement partner should document following matters pertaining to an audit engagement: -

(a) Issues identified with respect to compliance with relevant ethical requirements and how they were resolved.

(b) Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.

(c) Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements.

(d) The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement.

Besides, the engagement quality control reviewer shall document, for the audit engagement reviewed, that:

(a) The procedures required by the firm's policies on engagement quality control review have been performed.

(b) The engagement quality control review has been completed on or before the date of the auditor's report.

(c) 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.



4. SQC 1 VS. SA 220- KEY DIFFERENCES IN NATURE, SCOPE AND APPLICABILITY

S.N.	SQC 1	SA 220
1	It applies to entire firm and fixes the responsibility of firm to be assumed by CEO or managing partners.	It applies to a particular audit engagement and engagement partner takes responsibility of the same.
2	It is applicable to audits, reviews of historical financial information, and other assurance and related services engagements.	It is applicable to audit engagements only.
3	It relates to setting up of a quality control system consisting of policies and procedures for firm as a whole.	It deals with responsibilities of engagement teams to implement quality control procedures that are applicable to audit engagements.
4	It pertains to establishing a system of quality control designed to provide firm with a reasonable assurance that a firm and its personnel comply with professional standards and regulatory and legal requirements so that reports issued by firm or engagement partners are appropriate in circumstances.	It is premised on the basis that firm is subject to SQC 1. Therefore, SQC 1 is a <i>sine qua non</i> for applicability of SA 220. It is within overall context of a firm's system of quality control, engagement teams implement quality control procedures applicable to audit engagements.

TEST YOUR UNDERSTANDING 5

RST & Co., a firm of Chartered accountants, are auditors of a listed company engaged in manufacturing of heavy machinery components. The audit report for year 2021-22 also included report on matters listed in CARO, 2020. While reporting under clause vii(a) of the said order relating to regularity of undisputed statutory dues by the company, the auditors have commented that

company is “generally regular” in depositing statutory dues to appropriate authorities. Is above reporting qualitative and in line with requirements of SA 220?

5. MECHANISMS FOR REVIEW OF QUALITY CONTROL

5.1 Peer Review Board

Peer review Board is constituted by Council of ICAI. The main objective of Peer review Board is to ensure that, in carrying out assurance assignments: -

- ◆ Technical, professional and ethical standards including regulatory requirements are complied with by members of ICAI.
- ◆ Proper systems are in place including documentation thereof which amply demonstrate quality of assurance services provided by members.

The peer review is meant for purpose of enhancing quality of professional work resulting in more reliable and useful audit reports.

Peer review means an examination and review of the systems and procedures to determine whether the same have been put in place by the Practice Unit for ensuring the quality of assurance services as envisaged by the technical, professional and ethical Standards or any other regulatory requirements.

Once a Practice Unit is subjected to Peer review, its assurance engagement records pertaining to the Peer review period are subject to examination and review by the Peer Reviewer. On completion of this exercise, a “peer review certificate” is issued in case of unqualified report issued by Peer Reviewer. In case of a qualified report, it is informed to the Practice Unit that same cannot be issued along with the reasons therefor as well as inform about the due date for conducting a follow-on review as may be decided by the Board.

5.2 Quality Review Board

Quality review Board has been set up by Central government. It consists of members nominated by Central govt and Council of ICAI. The functions of QRB are: -

- (a) To make recommendations to the Council regarding the quality of services provided by the members of the Institute;

- (b) To review the quality of services provided by the members of the Institute including audit services and
- (c) To guide the members of the Institute to improve the quality of services and adherence to the various statutory and other regulatory requirements;

The statutory auditors in respect of the companies are identified for their audit quality review based upon risk-based approach. The review is carried out by technical reviewers who are empanelled by QRB on engagement basis from across the country.

5.3 National Financial Reporting Authority (NFRA)

NFRA has been constituted in terms of Section 132(1) of Companies Act, 2013. Duties of NFRA also include the following: -

- ◆ Monitor and enforce compliance with accounting standards and auditing standards
- ◆ Oversee the quality of service of the professions associated with ensuring compliance with such standards and suggest measures for improvement in the quality of service

It has power to monitor and enforce compliance with accounting standards and auditing standards and oversee the quality of service under section 132(2) or undertake investigation under section 132(4) of the auditors of certain class of companies. Such companies include listed companies, insurance companies, banking companies and other companies as provided for in rule 3 of NFRA Rules, 2018.

Therefore, overseeing quality of audit services of listed companies falls under the purview of NFRA. QRB can review quality of audit services provided by the members of the Institute only in respect of entities other than those specified under Rule 3 of NFRA Rules, 2018 and those referred to QRB by NFRA under relevant rules.

Integrated Case Scenario

CA Mritunjay is statutory auditor of a listed company engaged in providing services relating to "tourism sector". He is practicing in sole-proprietorship capacity. The audit of abovesaid listed company was conducted by his proprietary firm and report was issued for year 2021-22. Subsequently, audit report was selected by NFRA to oversee quality of service and compliance with Standards. Necessary information was called from auditor towards above objective.

It was required of him to produce audit working papers to show that audit was carried out in accordance with Standards on auditing. Details of the audit plan and details of risk assessment

procedures carried out to identify and assess risk of material misstatement in financial statements were called. It was also required to show how response to assessed risks was designed and implemented and communicated with those charged with governance.

Audit working papers sent by him through email included procedures on how some balances in financial statements were verified. Also included in working papers were procedures performed by him relating to verification of inventories, trade receivables and trade payables.

The working papers sent by him to the authority did not include details on audit plan and manner of identifying and assessing risks of material misstatement. On being asked to respond, it was reasoned by him that audit was properly planned and required procedures were carried out in relation to material items on test check basis.

It has been further clarified by him to the authority that audit was carried out in accordance with Standards and it was practically not feasible for a firm of small size to make a detailed audit plan. It was also put on record with authority that he had assessed risk of material misstatement to be low based upon his understanding of the company. He has further reasoned that assessing risks is a matter of professional judgment. Representation has also been made by him stating that communications as necessary were made orally with those charged with governance.

It was also pointed out to him that engagement quality control review was not carried out. He has answered that no contentious matter arose during the course of audit and therefore, no need was felt to carry out this exercise.

Attention was also drawn to the fact that financial statements of company were required to be prepared on basis of Ind-AS. However, at some places in notes to accounts, reference is made to accounting standards which are not applicable to the company. These errors have been attributed to data feeding entry errors by junior staff.

Based upon above, answer the following questions: -

- (1) It has been contended by auditor that audit was properly planned. He has further stated that it was practically not feasible for firm of small size to prepare a detailed audit plan.

Which of the following views is most appropriate in this regard?

- (a) Audit was, in fact, planned as evidenced by auditor's submissions.
- (b) Although auditor has no record of audit plan, it does not affect compliance with SA 220.

- (c) Since auditor has no record of audit plan, it goes on to show non-compliance with SA 220.
 - (d) Audit was, in fact, planned as evidenced by auditor's submissions. However, there is an exemption for small CA firms doing away with cumbersome documentation in relation to audit plan.
- (2) The auditor has reasoned that risk of material misstatement has been assessed to be low based upon his understanding of the company and it is a matter of professional judgment. Identify the most appropriate statement from below in this regard.
- (a) Assessing risks of material statement is a matter of professional judgment. It cannot be demanded from him how his judgment was arrived at.
 - (b) Although auditor has not submitted record of how risk of material misstatement was arrived at, it does not affect compliance with SA 220.
 - (c) Since auditor has no record of how risk of material misstatement was arrived at, it goes on to show non-compliance with SA 220.
 - (d) Such a query, itself, is outside the mandate of authority.
- (3) Considering auditor's point of view regarding engagement quality control review, identify the most appropriate statement from below: -
- (a) Engagement quality control review is mandatory in such type of engagement. It was not proper for auditor to bypass such review. He has violated mandatory requirement of SA 220.
 - (b) Engagement quality control review is optional in such type of engagement. Therefore, question of not following SA 220 does not arise.
 - (c) No contentious matter arose during the course of engagement. Therefore, question of not following SA 220 does not arise in respect of engagement quality control review.
 - (d) Engagement quality control review is dependent upon benchmarks established under SQC 1. If those bench marks are satisfied, such a review is necessary.
- (4) Considering auditor's reply regarding errors in data feeding entry by junior staff in relation to accounting standards, which of the following statements is proper?
- (a) Such are examples of clerical errors encountered during preparation of reports. There is no question of non-compliance with SA 220.

- (b) Such are examples of clerical errors encountered during preparation of reports. There is no effect on auditor's opinion and consequently question of non-compliance with SA 220 does not arise.
- (c) Such are examples of serious lapses on part of auditor showing non-compliance with SA 220.
- (d) Such are examples of serious lapses on part of auditor. However, these are not related to compliance with SA 220.
- (5) On your overall reading of the case study, which of the following statements appears to be true?
- (a) The firm has an effective system of quality control described in SQC 1. Audit engagement has also been performed in accordance with SA 220.
- (b) The firm does not have effective system of quality control described in SQC 1. Audit engagement has also not been performed in accordance with SA 220.
- (c) SQC 1 is not applicable in the case. Audit engagement has not been performed in accordance with SA 220.
- (d) SQC 1 is not applicable in the case. Audit engagement has been performed in accordance with SA 220.

Key Takeaways

- SQC 1 requires that the firm should establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements and that reports issued by the firm or engagement partners are appropriate in the circumstances.
- SQC 1 is applicable to audits, reviews of historical financial information, and other assurance and related services engagements. It is applicable to all firms irrespective of their constitution.
- Elements of system of quality control envisaged in SQC 1 include establishing leadership responsibilities for quality within the firm, complying with ethical requirements, acceptance and continuance of client relationships and specific engagements, establishing policies and procedures addressing issues of capabilities, competence, and commitment of human resources in firm to carry out engagements, engagement performance and monitoring.
- In respect of difficult or contentious matters, consultation may be required at the appropriate professional level, with individuals within or outside the firm who have specialized expertise, to resolve a difficult or contentious matter.

- Significant judgments made in an engagement should be reviewed by an engagement quality control reviewer for taking an objective view before the report is issued. The review does not reduce the responsibilities of the engagement partner.
- Engagement quality control review is mandatory in respect of listed entities.
- The firm should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been finalized. Engagement files should be completed in not more than 60 days after date of auditor's report in case of audit engagements and in other cases within the limits appropriate to engagements.
- Engagement documentation has to be retained for a period of time sufficient to permit those performing monitoring procedures to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.
- 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.
- SA 220 is applicable to audit engagements only. It deals with responsibilities of engagement teams to implement quality control procedures that are applicable to audit engagements.
- SA 220 is premised on the basis that firm is subject to SQC 1. It is within overall context of a firm's system of quality control, engagement teams implement quality control procedures applicable to audit engagements.
- Besides SQC 1 and SA 220, other Standards on auditing, code of ethics issued by ICAI and certain provisions in Companies Act, 2013 facilitate quality control process. There also exists mechanism for review of quality control through Peer review Board, Quality review Board and NFRA (National Financial Reporting Authority).

FOR SHORTCUT TO ENGAGEMENT & QUALITY CONTROLS STANDARDS WISDOM: SCAN ME !



TEST YOUR KNOWLEDGE

Theoretical Questions

- 1 *PQR & Associates are statutory auditors of a listed company. There arose an issue during the course of audit relating to related party transactions. The engagement partner wants to consult engagement quality control reviewer on this matter during the course of audit process itself. Can he consult with engagement quality control reviewer? Discuss.*
- 2 *Beta Private Limited has approached a firm of Chartered accountants to assist them in preparation of financial statements and issue a compilation report in this regard. Does CA firm have responsibility in relation to quality control for above said engagement? Discuss with reasons.*
- 3 *Ramanujan, a CA final student, feels that engagement file in audit engagement should be ready prior to issue of audit report. Discuss whether Ramanujan's view is in order.*
- 4 *BNE & Co. are in midst of audit process of a listed company. During the course of audit, an issue arose relating to revenues from contracts with customers in terms of Ind AS 115. The engagement partner took a certain stand. However, engagement quality control reviewer recommended otherwise after review. The engagement partner is not willing to accept recommendations of reviewer. How can the stalemate be ended?*
- 5 *MB & Associates is a partnership firm of Chartered Accountants which was established seven years back. The firm is getting new clients and has also, been offered new engagement services with existing clients. The firm is concerned about obtaining such information as it considers necessary in the circumstances before accepting an engagement with a new client and acceptance of a new engagement with an existing client. The firm is looking to work with only select clients to adhere to the Quality Control Standards. Guide MB & Associates about the matters to be considered with regard to the integrity of a client, as per the requirements of SQC 1.*

Answers to Test your Understanding

1. The given situation indicates that proposed client is a new one whose promoter is close associate and family friend of managing partner of M/s ABC & Associates. However, previous auditor of proposed client has resigned and company is offering hike in audit fees in comparison to audit fees paid to previous auditor. Besides, there are also regulatory inquiries

against the company. In spite of all this, managing partner of firm Mr. A has recommended for acceptance of offered audit of the company.

It reflects poorly regarding functioning at top of the firm as regards to quality control. SQC 1 requires that firm should establish a system of quality control designed to provide it with reasonable assurance that firm and its personnel comply with professional standards and legal and regulatory requirements. It further requires that firm's business strategy is subject to overriding requirement of firm to achieve quality in all engagements. However, in the given situation, commercial considerations seem to be overriding factor.

The managing partner of firm is close associate and family friend of promoter. The matter should have been brought to knowledge of firm in accordance with requirements of SQC 1 as it involves issue of independence of managing partner of the firm with respect to proposed audit engagement. Further, matters of inquiries from regulators and resignation of previous auditor raise question about integrity of the proposed client. SQC 1 further requires firm to consider before acceptance of an engagement that client does not lack integrity. All these factors need to be taken into consideration before accepting engagement.

Overall, such a situation reflects lack of proper establishment of quality control framework at top of the firm. Following considerations should be taken into account while upholding quality of firm: -

- (i) The firm assigns its management responsibilities so that commercial considerations do not override quality of work performed
 - (ii) The firm's policies and procedures in relation to its personnel are designed to demonstrate its overriding commitment to quality.
 - (iii) The firm devotes sufficient resources for development and documentation of its quality control policies and procedures
 - (iv) A firm before accepting an engagement should acquire vital information about the client. Such an information should help firm to decide about integrity of Client, promoters and key managerial personnel, competence (including capabilities, time and resources) to perform engagement and compliance with ethical requirements.
2. Approach of Sudhanshu is not proper. Such practices blatantly violate code of ethics and its spirit. It reflects poorly upon quality control system of firm envisaged in SQC 1 which requires that quality control policies and procedures should be documented and communicated to the firm's personnel. It shows that firm's personnel are not properly sensitized regarding requirements of SQC 1.

3. As per SQC 1, before accepting a new engagement, integrity of client should be considered including matters that indicate involvement in money laundering or criminal activities. There has been search of ED on the said party leading to recovery of huge amount of cash. The above coupled with actions of income tax department relating to bogus capital gains on penny stocks indicates that client might be involved in money laundering activities. Therefore, offer should not be accepted.
4. Engagement quality control review in listed entities is a mandatory requirement. Expert opinion of ICAI pertains to issue of interpretation. The appointment of reviewer is a separate and mandatory requirement in audits of listed companies.
5. Such type of reporting is not qualitative. It is not in accordance with SA 220. One of the objectives of the auditor, as per SA 220, is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that the audit complies with professional standards and regulatory and legal requirements. The reporting under CARO, 2020 is not proper. Hence, the audit does not comply with regulatory and legal requirements.

Answers to Integrated Case Scenario

1. (c)
2. (c)
3. (a)
4. (c)
5. (b)

Hints /Answers to Theoretical Questions

1. It is necessary to maintain objectivity of reviewer. Therefore, participation in engagement or making decisions for engagement team is to be avoided at all costs. However, engagement partner may consult engagement quality control reviewer during the engagement so as not to compromise his objectivity and eligibility to perform the role.
2. Such kind of services fall in category of “related services”. SQC 1 is applicable to all type of engagements including engagement pertaining to “related services”.
3. The firm should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been

finalized. Engagement files should be completed in not more than 60 days after date of auditor's report in case of audit engagements. Thus, view of Ramanujam is not in order.

4. In case, recommendations of engagement quality control reviewer are not accepted by engagement partner and matter is not resolved to reviewer's satisfaction, the matter should be resolved by following established procedures of firm like by consulting with another practitioner or firm, or a professional or regulatory body. The audit report should be issued only after resolution of matter.
5. As per SQC 1, the firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Where issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, it should document how the issues were resolved.

With regard to the integrity of a client, matters that the firm considers include, for example:

- The identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance.
- The nature of the client's operations, including its business practices.
- Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
- Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.
- Indications of an inappropriate limitation in the scope of work.
- Indications that the client might be involved in money laundering or other criminal activities.
- The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.

The extent of knowledge a firm will have regarding the integrity of a client will generally grow within the context of an ongoing relationship with that client.

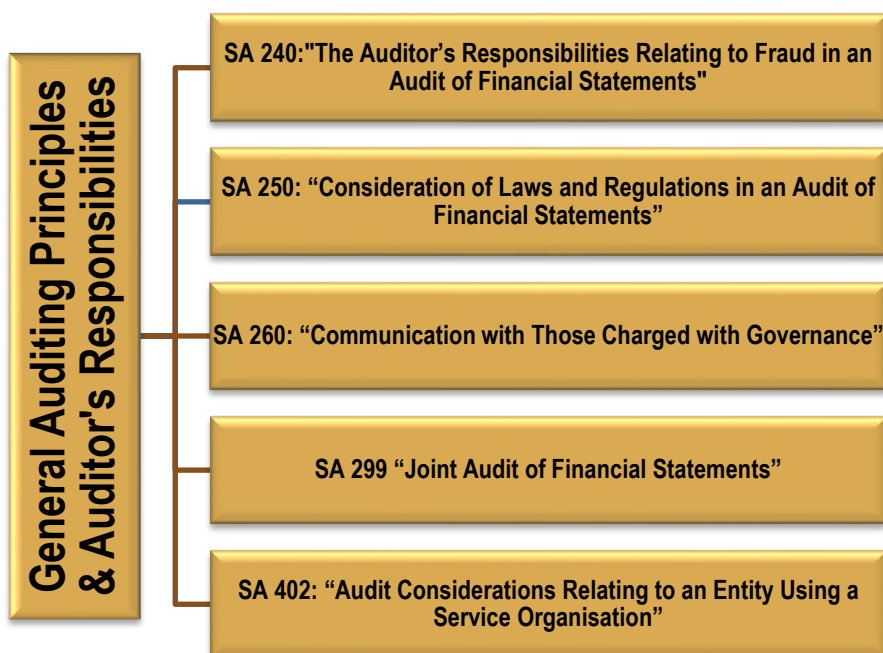
GENERAL AUDITING PRINCIPLES AND AUDITOR'S RESPONSIBILITIES



LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ❑ Understand meaning of fraud and its characteristics, fraud risk factors with examples etc.
- ❑ Gain knowledge about SA 240 “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”.
- ❑ Gain knowledge about SA 250 “Consideration of Laws and Regulations in an Audit of Financial Statements”.
- ❑ Learn about significance of communication with those charged with governance and gain knowledge about SA 260 “Communication with Those Charged with Governance”.
- ❑ Gain knowledge about SA 299 “Joint Audit of Financial Statements”.
- ❑ Gain knowledge about SA 402 “Audit Considerations Relating to an Entity Using a Service Organisation”.

CHAPTER OVERVIEW

CA. Bijoy is auditor of a listed company since last three years. Of late, the company is in news in financial circles for all the wrong reasons. There have been allegations of flouting of Securities Contracts (Regulation) Rules by clandestinely controlling more than required percentage of shares than mandated in rules. Besides, the said company has been accused of violating other provisions of securities laws.

There have also been allegations of manipulating share prices, of artificially keeping share prices high and failure to disclose all related party transactions. The company is a highly leveraged one. However, there has been no default and company has kept its commitments. SEBI is also seized of the matter on its own.

Ever since the above allegations were hurled through media, auditor of the company is in a fix. What do such allegations reflect? How he should proceed in audit of ensuing year? The regulatory report would take time and audit has to be completed within timelines. Audits of last years were conducted in accordance with Standards on auditing and no wrongdoings were noticed and unmodified opinion was expressed in audit reports. However, given the current scenario, there seemed to be a heightened level of audit risk. It would be foolish of him not to take notice of such developments.

The allegations of violations of securities laws, manipulating share prices and failure to disclose all related party transactions could be fraud risk factors. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred. Hence, there are increased risks of material misstatement due to fraud. Due to assessment of increased risks of material misstatement due to fraud, audit procedures need to be designed and performed accordingly.

Besides above, suspected non-compliance with laws and regulations may have material effect on financial statements. It could involve hefty penalties and other issues. If management is not forthcoming in providing information relating to compliance with laws and regulations, does he need to obtain legal advice? Whether it would also lead to any impact on his opinion? Such questions were staring him in the face in current year of his tenure.

If he suspects fraud involving management, should he communicate these suspicions to audit committee and discuss with them nature, timing, and extent of audit procedures necessary to complete the audit?

1. GENERAL AUDITING PRINCIPLES AND AUDITOR'S RESPONSIBILITIES

SA 200 establishes the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with SAs. Audit has to be planned and performed with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. Misstatements can arise from errors or frauds. SA 240 deals with the auditor's responsibilities relating to fraud in an audit of financial statements. The auditor has to remain alert throughout the audit recognizing the possibility that material misstatement due to fraud could exist.

Entities are subject to various laws and regulations. Non-compliance with laws and regulations may result in fines, litigation or other consequences for the entity leading to material effect on financial statements. SA 250 deals with auditor's responsibilities in this regard while performing an audit of financial statements. Since many laws and regulations affect entities, auditor has to remain alert to the possibility of non-compliance with laws and regulations.

Communication with those charged with governance on a timely basis during audit serves many useful purposes and SA 260 deals with auditor's responsibilities in this regard. SA 299 details special consideration relating to responsibilities of auditors in a joint audit.

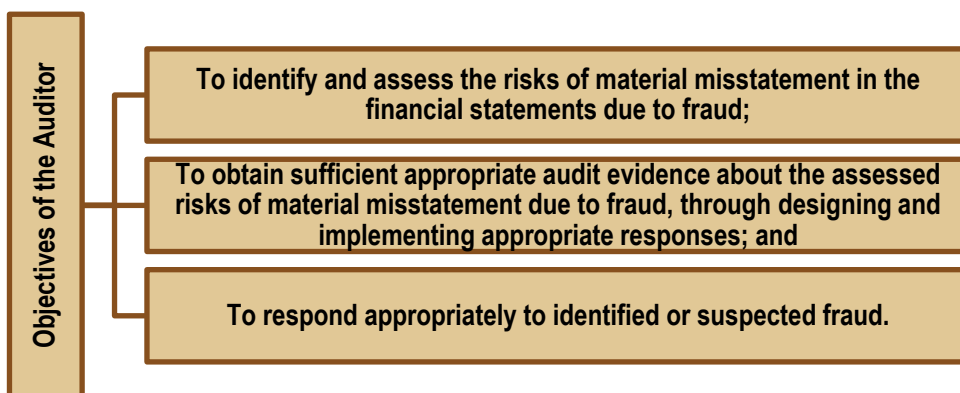
It is very common for user entities these days to outsource activities from a third-party service organization. SA 402 dwells upon the user auditor's responsibility to obtain sufficient appropriate audit evidence in this respect.

2. SA 240 “THE AUDITOR’S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS”

SA 240 deals with the auditor's responsibilities relating to fraud in an audit of financial statements. Its requirements assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

2.1 The objectives of the auditor in accordance with SA 240 are: -

- (a) To identify and assess the risks of material misstatement in the financial statements due to fraud;
- (b) To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
- (c) To respond appropriately to identified or suspected fraud.

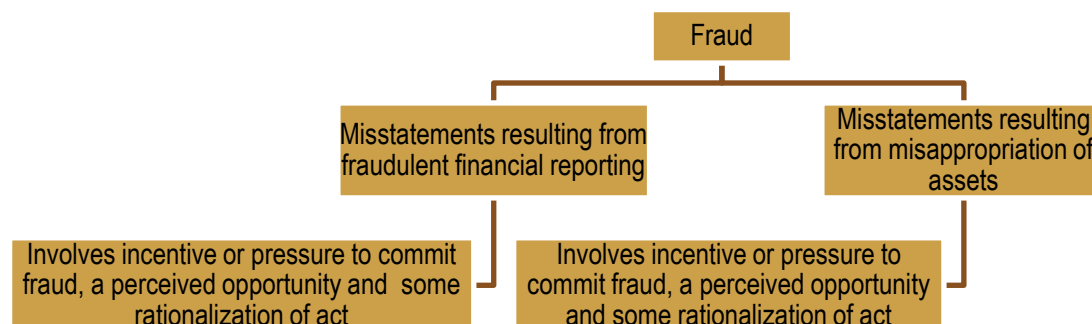


Meaning of Fraud and its Characteristics

Fraud is 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.

Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

Although fraud is a broad legal concept, the auditor is concerned with fraud that causes a material misstatement in the financial statements.



Two types of intentional misstatements are relevant to the auditor: -

- **Misstatements resulting from fraudulent financial reporting**
- **Misstatements resulting from misappropriation of assets**

Fraud, whether due to misstatements resulting from fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. **For example: -**

Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome – particularly since the consequences to management for failing to meet financial goals can be significant.

Similarly, individuals may have an incentive to misappropriate assets, for example, because the individuals are living beyond their means.

A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.

Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

2.2 How Fraudulent Financial Reporting may be caused by entities?

Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. It can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.

Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting. Such a situation could occur when, due to pressures to meet market expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.

Fraudulent financial reporting may be accomplished by the following: -

- Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.
- Misrepresentation in or intentional omission from, the financial statements of events, transactions or other significant information.
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as: -

- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- Inappropriately adjusting assumptions and changing judgments used to estimate account balances.
- Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
- Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.
- Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
- Altering records and terms related to significant and unusual transactions.

2.3 How misappropriation of assets may be accomplished by entities?

Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect.

Misappropriation of assets can be accomplished in a variety of ways including: -

- Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).
- Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).
- Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).
- Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

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.

2.4 Whose primary responsibility is to prevent and detect fraud?

The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on *fraud prevention*, which may reduce opportunities for fraud to take place, and *fraud deterrence*, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behaviour which can be reinforced by an active oversight by those charged with governance.

2.5 Responsibilities of the Auditor

An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

The potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false.

The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.

When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.

What are fraud risk factors?

Fraud risk factors are events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud. For example: -

- The need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud;

- The granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; and
- A control environment that is not effective may create an opportunity to commit fraud.

Examples of fraud risk factors : Following are examples of fraud risk factors relating to misstatements arising from fraudulent financial reporting and from misappropriation of assets respectively : -

[A] Risk factors relating to misstatements arising from fraudulent financial reporting

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting: -

Incentives/Pressures
Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by): -
➤ High degree of competition or market saturation, accompanied by declining margins.
➤ High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
➤ Significant declines in customer demand and increasing business failures in either the industry or overall economy.
➤ Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent.
➤ Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.
➤ Rapid growth or unusual profitability especially compared to that of other companies in the same industry.
➤ New accounting, statutory, or regulatory requirements.

Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following: -

- Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages.
- Need to obtain additional debt or equity financing to stay competitive— including financing of major research and development or capital expenditures.

- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements.
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.

Information available indicates that the personal financial situation of management or those charged with governance is threatened by the entity's financial performance arising from the following: -

- **Significant financial interests in the entity.**
- **Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow.**
- **Personal guarantees of debts of the entity.**
- **There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.**

Opportunities: The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following: -

- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.
- Use of business intermediaries for which there appears to be no clear business justification.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

The monitoring of management is not effective as a result of the following: -

Domination of management by a single person or small group (in a non owner-managed business) without compensating controls.

Oversight by those charged with governance over the financial reporting process and internal control is not effective.

There is a complex or unstable organizational structure, as evidenced by following: -

- Difficulty in determining the organization or individuals that have controlling interest in the entity.
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority.
- High turnover of senior management, legal counsel, or those charged with governance.

Internal control components are deficient as a result of the following: -

- **Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required).**
- **High turnover rates or employment of accounting, internal audit, or information technology staff that are not effective.**
- **Accounting and information systems that are not effective, including situations involving significant deficiencies in internal control.**

Attitudes/Rationalizations

- Communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective.
- Non-financial management's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates.
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations.
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
- The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.

- Management failing to remedy known significant deficiencies in internal control on a timely basis.
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
- Low morale among senior management.
- The owner-manager makes no distinction between personal and business transactions.
- Dispute between shareholders in a closely held entity.
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following: -

- Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.

- Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report.

- Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.

- Domineering management behaviour in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

[B] Risk factors relating to misstatements arising from misappropriation of assets

The following are examples of risk factors relating to misstatements arising from misappropriation of assets: -

Incentives/Pressures

Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets. Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following: -

- **Known or anticipated future employee layoffs**
- **Recent or anticipated changes to employee compensation or benefit plans**
- **Promotions, compensation, or other rewards inconsistent with expectations**

Opportunities

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following: -

- Large amounts of cash on hand
- Inventory items that are small in size, of high value, or in high demand.
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips.
- Fixed assets which are small in size, marketable, or lacking observable identification of ownership.

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

- **Inadequate segregation of duties or independent checks.**
- **Inadequate oversight of senior management expenditures, such as travel and other reimbursements.**
- **Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations.**
- **Inadequate job applicant screening of employees with access to assets.**
- **Inadequate record keeping with respect to assets.**
- **Inadequate system of authorization and approval of transactions (for example, in purchasing).**
- **Inadequate physical safeguards over cash, investments, inventory, or fixed assets.**
- **Lack of complete and timely reconciliations of assets.**
- **Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.**
- **Lack of mandatory vacations for employees performing key control functions.**
- **Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.**
- **Inadequate access controls over automated records, including controls over and review of computer systems event logs.**

Attitudes/Rationalizations

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.
- Behaviour indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
- Changes in behaviour or lifestyle that may indicate assets have been misappropriated.
- Tolerance of petty theft.

Why evaluation of fraud risk factors by auditor is necessary?

The auditor shall evaluate whether one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud.

The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, the auditor may identify fraud risk factors. Fraud risk factors cannot easily be ranked in order of importance. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present risks of material misstatement. Accordingly, the determination of whether a fraud risk factor is present and whether it is to be considered in assessing the risks of material misstatement of the financial statements due to fraud requires the exercise of professional judgment.

2.6 Maintaining Professional Skepticism

The auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance.

Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further.

Where responses to inquiries of management or those charged with governance are inconsistent, the auditor shall investigate the inconsistencies.

2.7 Discussion among the engagement team

The discussion among the engagement team shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur notwithstanding the engagement team members' beliefs that management and those charged with governance are honest and have integrity.

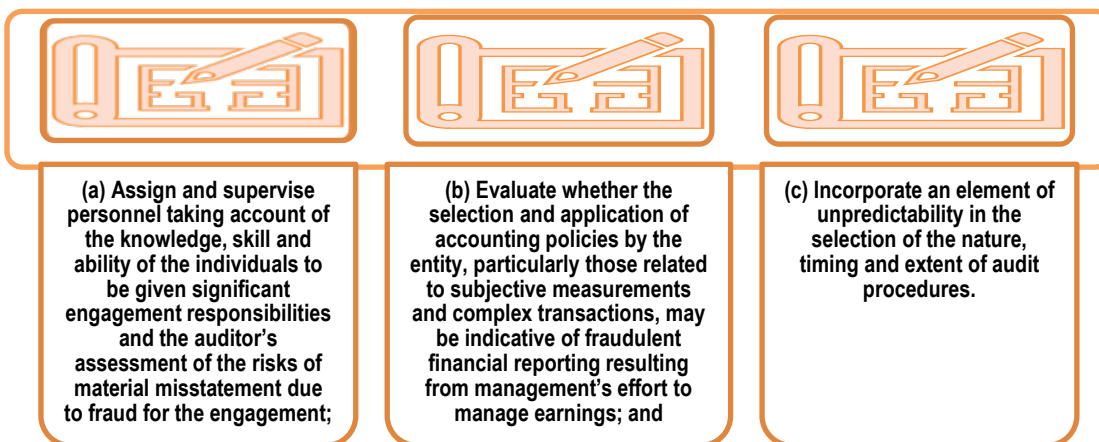
2.8 Risk assessment procedures and related activities be geared towards obtaining information for use in identifying risk of material misstatement due to fraud

When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, the auditor shall perform the procedures to obtain information for use in identifying the risks of material misstatement due to fraud like inquiries of management and others within the entity, obtaining understanding as to how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks and evaluation of unexpected relationships identified in performing analytical procedures which may indicate risks of material misstatement due to fraud.

Besides, as discussed already, the auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present.

2.9 Responses to the assessed risks of material misstatement due to fraud at the financial statement level

In determining overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor shall: -



2.10 Audit procedures responsive to assessed risks of material misstatement due to fraud at the assertion level

The auditor shall design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level. In doing so, the auditor may change nature, timing and extent of audit procedures to obtain audit evidence that is more reliable and relevant or to obtain additional corroborative information.

For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a related risk that management is inflating sales by entering into sales agreements that include terms that preclude revenue recognition or by invoicing sales before delivery. In these circumstances, the auditor may, for example, design external confirmations not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor might find it effective to supplement such external confirmations with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.

2.11 Audit procedures responsive to risks related to management override of controls

Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. This risk is present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk.

Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to: -

- (a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.**
- (b) Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud.**
- (c) For significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit, the auditor shall evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.**

The auditor shall determine whether, in order to respond to the identified risks of management override of controls, the auditor needs to perform other audit procedures in addition to those specifically referred to above.

2.12 Evaluation of Audit Evidence

The auditor shall evaluate whether analytical procedures that are performed when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity and its environment indicate a previously unrecognized risk of material misstatement due to fraud.

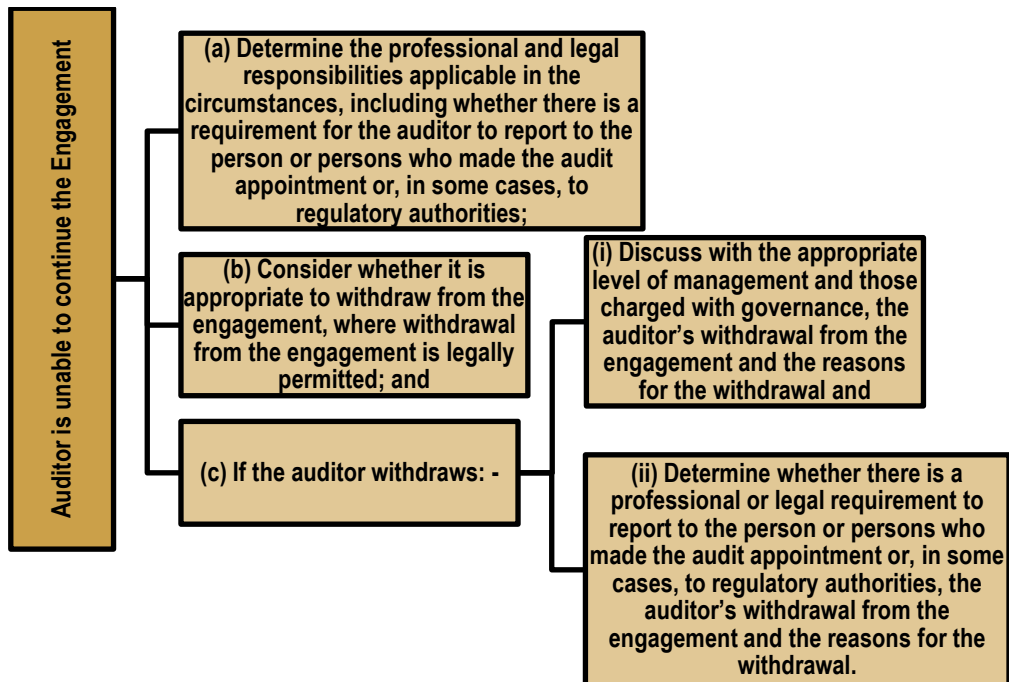
When the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence.

If the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor shall re-evaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained.

When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud, the auditor shall evaluate the implications for the audit.

2.13 Circumstances in which auditor is unable to continue the engagement

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



2.14 Management Representations

The auditor shall obtain written representations from management and, where applicable, those charged with governance that: -

(a) They acknowledge their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;

(b) They have disclosed to the auditor the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud;

(c) They have disclosed to the auditor 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 financial statements; and

(d) They have disclosed to the auditor their knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.

2.15 Communications to Management and with Those Charged With Governance

If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities.

Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving management, employees who have significant roles in internal control or others where the fraud results in a material misstatement in the financial statements, the auditor shall communicate these matters to those charged with governance on a timely basis.

If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit.

The auditor shall communicate with those charged with governance any other matters related to fraud that are, in the auditor's judgment, relevant to their responsibilities.

2.16 Communications to Regulatory and Enforcement Authorities

If the auditor has identified or suspects a fraud, the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances. For example, in case of audit of banks, the auditor has a statutory duty to report the occurrence of fraud to the supervisory authorities, i.e. RBI.

Also, in some entities the auditor may have a duty to report misstatements to authorities in those cases where management and those charged with governance fail to take corrective action. In some clients, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related legislation or regulation.

2.17 Documentation

The auditor's documentation of the understanding of the entity and its environment and the assessment of the risks of material misstatement required shall include: -

(a) 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

(b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.

The auditor's documentation of the responses to the assessed risks of material misstatement required shall include: -

(a) 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

(b) The results of the audit procedures, including those designed to address the risk of management override of controls.

The auditor shall document communications about fraud made to management, those charged with governance, regulators and others.

When the auditor has concluded that 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, the auditor shall document the reasons for that conclusion.

TEST YOUR UNDERSTANDING 1

My Décor Limited, presently engaged in manufacturing of fabrics, wants to set up a new plant for manufacturing of special kind of fabric providing an altogether different texture and feel. This kind of fabric has become a hit with retail customers. The company needs to set up plant for manufacturing the above kind of fabric involving huge capital outlays to stay competitive in the market.

You are auditor of the company and find that company's revenue has increased in financial year 2022-23 to ₹ 1000 crore from ₹ 750 crore in last year. By the time, you started the audit, there was no change in plant capacity and information regarding need to set up new plant has become known to you during inquiry of company's personnel.

Discuss, how you should proceed to deal with above situation, as auditor of the company, paying special attention to risk of material misstatement due to fraudulent financial reporting?

TEST YOUR UNDERSTANDING 2

CA. Ridhima, internal auditor of Track Store Limited, has pointed out following deficiencies in internal control of the company, in her reports: -

- [i] Receivables are not reconciled at stipulated intervals.
- [ii] Customers are provided a credit limit based upon their track record. However, no review of customer credit limits is undertaken at required intervals.

The statutory auditor of the company finds that no action has been taken by the company on the said deficiencies pointed out in reports of internal auditor.

What does above situation allude to statutory auditor of company?



3. SA 250 “CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS”

SA 250 deals with auditor's responsibility to consider laws and regulations when performing an audit of financial statements. However, it does not apply to other assurance engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.

The requirements in this SA are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with laws and regulations.

3.1 Effect of Laws and Regulations on Financial Statements of an Entity

The effect on the financial statements of laws and regulations varies considerably. Those laws and regulations to which an entity is subject constitute the legal and regulatory framework. The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity's financial statements. 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 financial statements.

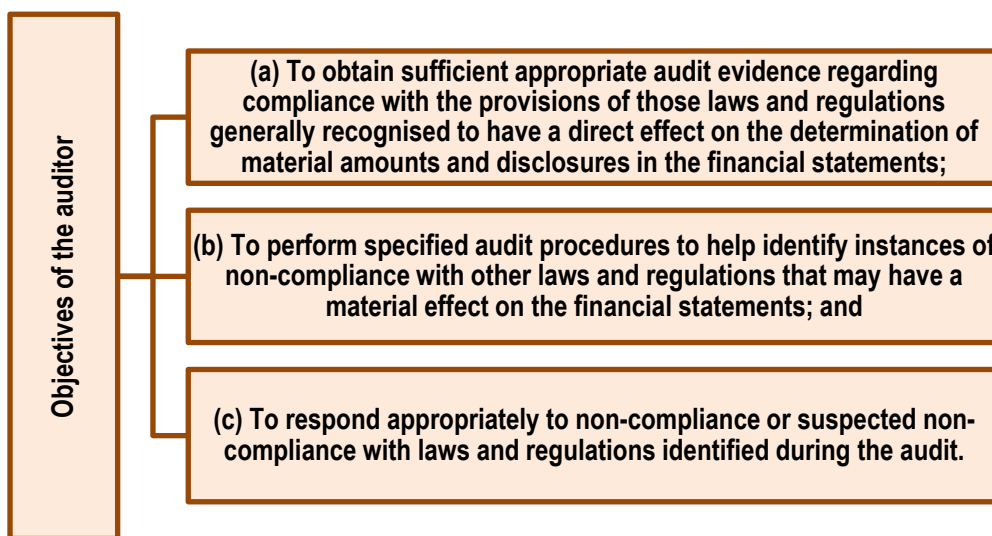
Some entities operate in heavily regulated industries (such as banks and chemical companies). Others are subject only to the many laws and regulations that relate generally to the operating aspects of the business (such as those related to occupational safety and health). Non-compliance

with laws and regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements.

3.2. Objectives of auditor in accordance with SA 250

The objectives of the auditor in accordance with SA 250 are: -

- (a) To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements;
- (b) To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and
- (c) To respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit.



3.3 Responsibility of Management for Compliance with Laws and Regulations

It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements.

The following are examples of the types of policies and procedures an entity may implement to assist in the prevention and detection of non-compliance with laws and regulations: -

- Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
- Instituting and operating appropriate systems of internal control.
- Developing, publicising and following a code of conduct.
- Ensuring employees are properly trained and understand the code of conduct.
- Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it.
- Engaging legal advisors to assist in monitoring legal requirements.
- Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints.

In larger entities, these policies and procedures may be supplemented by assigning appropriate responsibilities to an internal audit function, an audit committee, a compliance function.

3.4 Responsibility of the Auditor

The auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following: -

There are many laws and regulations, relating principally to the operating aspects of an entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.

Non-compliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls or intentional misrepresentations being made to the auditor.

Whether an act constitutes non-compliance is ultimately a matter for legal determination by a court of law.

Ordinarily, the further removed non-compliance is from the events and transactions reflected in the financial statements, the less likely the auditor is to become aware of it or to recognise the non-compliance.

SA 250 distinguishes the auditor's responsibilities in relation to compliance with two different categories of laws and regulations as follows: -

- (a) The provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and labour laws and
- (b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties (for example, compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations). Non-compliance with such laws and regulations may, therefore, have a material effect on the financial statements.

Auditor's responsibilities in relation to compliance with laws and regulations

Responsibilities relating to compliance with those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in FS

Responsibilities relating to those laws and regulations that do not have a direct effect on the determination of amounts and disclosures in FS but their compliance may be fundamental to operating aspects of business

For the compliance with provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements, the auditor's responsibility is to obtain sufficient appropriate audit evidence about compliance with the provisions of those laws and regulations.

For other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements but compliance with which may be fundamental to the operating aspects of the business, the auditor's responsibility is limited to undertaking specified audit

procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

The auditor is to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on financial statements may bring instances of identified or suspected non-compliance to the auditor's attention. Maintaining professional skepticism throughout the audit, is important in this context, given the extent of laws and regulations that affect the entity.

The Auditor's consideration of compliance with laws and regulations

As part of obtaining an understanding of the entity and its environment, the auditor shall obtain a general understanding of: -

(a) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and

(b) How the entity is complying with that framework.

The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements. Such laws, for example, could relate to form and content of financial statements or industry- specific financial reporting issues.

The auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements:

- (a) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and**
- (b) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.**

Certain other laws and regulations may need particular attention by the auditor because they have a fundamental effect on the operations of the entity. Non-compliance with laws and regulations that have a fundamental effect on the operations of the entity may cause the entity to cease operations, or call into question the entity's continuance as a going concern.

For example: Non-compliance with the requirements of the entity's license or other entitlement to perform its operations could have such an impact (for example, for a bank, non-compliance with

capital or investment requirements). An NBFC might have to cease to carry on the business of a non-banking financial institution if it fails to obtain a certificate of registration issued under RBI Act and if its Net Owned Funds are less than the amount specified by the RBI in this regard.

There are also many laws and regulations relating principally to the operating aspects of the entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting. As the financial reporting consequences of other laws and regulations can vary depending on the entity's operations, the audit procedures as stated above are directed to bringing to the auditor's attention instances of non-compliance with laws and regulations that may have a material effect on the financial statements.

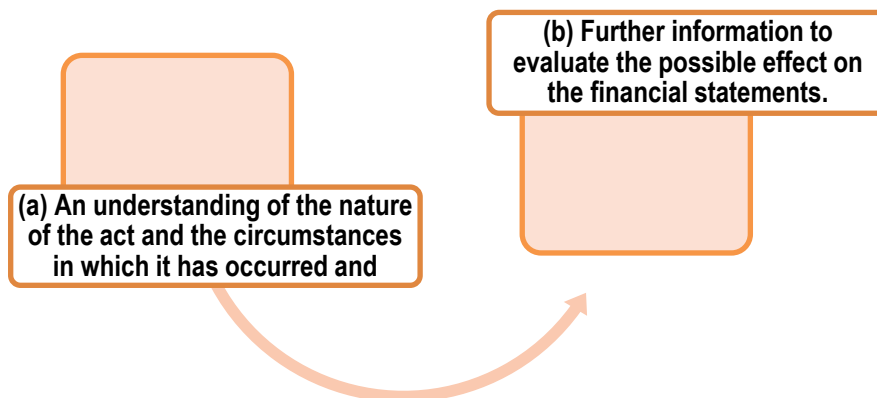
Audit procedures applied to form an opinion on the financial statements may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention.

During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention.

The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor.

3.5 Audit Procedures when Non-Compliance is Identified or Suspected

If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain:



If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice.

If sufficient information about suspected non-compliance cannot be obtained, the auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion.

The auditor shall evaluate the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations, and take appropriate action.

3.6 Reporting of Identified or Suspected Non-Compliance

(A) Reporting Non-Compliance to Those Charged with Governance

Unless all of those charged with governance are involved in management of the entity, and therefore are aware of matters involving identified or suspected non-compliance already communicated by the auditor, the auditor shall communicate with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor's attention during the course of the audit, other than when the matters are clearly inconsequential.

If, in the auditor's judgment, the non-compliance referred to above is believed to be intentional and material, the auditor shall communicate the matter to those charged with governance as soon as practicable.

If the auditor suspects that management or those charged with governance are involved in non-compliance, the auditor shall communicate the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or supervisory board. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor shall consider the need to obtain legal advice.

(B) Reporting non-compliance in the auditor's report on the financial statements

If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall, in accordance with SA 705, express a qualified or adverse opinion on the financial statements.

If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified

opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with SA 705.

If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance, the auditor shall evaluate the effect on the auditor's opinion in accordance with SA 705.

(C) Reporting non-compliance to regulatory and enforcement authorities

If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity.

3.7 Documentation

The auditor shall document identified or suspected non-compliance with laws and regulations and the results of discussion with management and, where applicable, those charged with governance and other parties outside the entity.

TEST YOUR UNDERSTANDING 3

FAS Insurance Brokers Limited is a leading online insurance intermediary. During the year, Director General of GST Intelligence (DGGI) has issued notice to the company for allegedly creating fictitious invoices for "marketing and sales services" amounting to ₹ 50 crores in favour of non-life insurance companies. The premises of company were also searched during the year by DGGI officials. The matter was also informed to IRDAI by DGGI for violation of norms and regulations in this regard.

Does above situation has any bearing on your responsibilities as statutory auditor of the company? Outline briefly in context of possible non-compliance with laws by the company.



4. SA 260 "COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE"

SA 260 deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements.

Who are "Those charged with governance"?

"Those charged with governance" denote the person(s) or organization(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes those overseeing the financial reporting process. For some

entities, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.

Governance structures vary by entities, reflecting influences such as different cultural and legal backgrounds, size and ownership characteristics. For example, in some entities, a supervisory board exists that is separate from executive board. In other entities, both supervisory and executive functions are performed by a single board. In some entities, those charged with governance hold positions that are an integral part of the entity's legal structure. For example, company directors. In some cases, some or all of those charged with governance are involved in managing the entity. In others, those charged with governance and management comprise different persons.

In most entities, governance is the collective responsibility of a governing body, such as a board of directors, a supervisory board, partners, proprietors, a committee of management, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, for example, the owner-manager where there are no other owners, or a sole trustee.

Such diversity means that it is not possible to specify for all audits the persons with whom the auditor is to communicate particular matters. Also, in some cases, the appropriate persons with whom to communicate may not be clearly identifiable from the applicable legal framework or other engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities and some not-for-profit organizations.

In such cases, the auditor may need to discuss and agree with the engaging party the relevant persons with whom to communicate. In deciding with whom to communicate, the auditor's understanding of an entity's governance structure and processes obtained in accordance with SA 315 is relevant. The appropriate persons with whom to communicate may vary depending on the matter to be communicated.

Significance of Communication with Those charged with governance

Communication from auditor is important with those charged with governance. An effective two-way communication is important in assisting:

[a] The auditor and those charged with governance in understanding matters related to the audit in context, and in developing a constructive working relationship. This relationship is developed while maintaining the auditor's independence and objectivity.

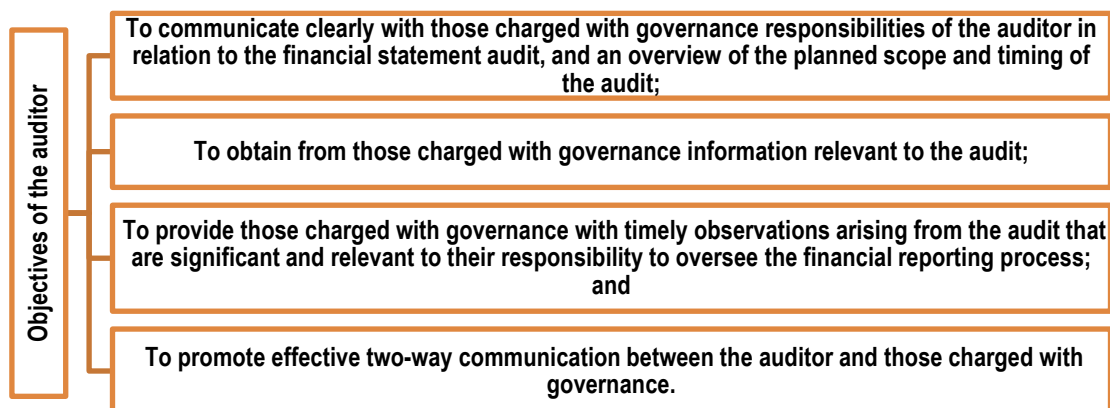
[b] The auditor in obtaining from those charged with governance information relevant to the audit. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events and

[c] Those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements.

4.1 Objectives of Auditor in Accordance with SA 260

The objectives of the auditor are: -

- (a) To communicate clearly with those charged with governance responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;
- (b) To obtain from those charged with governance information relevant to the audit;
- (c) To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and
- (d) To promote effective two-way communication between the auditor and those charged with governance.



Determining appropriate persons with whom to communicate : The auditor shall determine the appropriate person(s) within the entity's governance structure with whom to communicate.

4.2 Matters to be Communicated by the Auditor

Following matters are required to be communicated by auditor with those charged with governance:-

[a] The auditor's responsibilities in relation to the financial statement audit

The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that:

- (a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance and
- (b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

The auditor's responsibilities in relation to the financial statement audit are often included in the engagement letter or other suitable form of written agreement that records the agreed terms of the engagement. Law, regulation or the governance structure of the entity may require those charged with governance to agree the terms of the engagement with the auditor. When this is not the case, providing those charged with governance with a copy of that engagement letter or other suitable form of written agreement may be an appropriate way to communicate with them.

[b] Planned scope and timing of the audit

Communication regarding the planned scope and timing of the audit may: -

- Assist those charged with governance to understand better the consequences of the auditor's work, to discuss issues of risk and the concept of materiality with the auditor, and to identify any areas in which they may request the auditor to undertake additional procedures and
- Assist the auditor to understand better the entity and its environment.

The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit, which includes communicating about the significant risks identified by the auditor.

Communicating significant risks identified by the auditor helps those charged with governance understand those matters and why they require special audit consideration. The communication about significant risks may assist those charged with governance in fulfilling their responsibility to oversee the financial reporting process.

While communication with those charged with governance may assist the auditor to plan the scope and timing of the audit, it does not change the auditor's sole responsibility to establish the overall audit strategy and the audit plan, including the nature, timing and extent of procedures necessary to obtain sufficient appropriate audit evidence.

Care is necessary when communicating with those charged with governance about the planned scope and timing of the audit so as not to compromise the effectiveness of the audit, particularly where some or all of those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable.

[c] Significant findings from the audit

The auditor shall communicate with those charged with governance: -

- (i) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.

When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;

- (ii) Significant difficulties, if any, encountered during the audit;
- (iii) Unless all of those charged with governance are involved in managing the entity: -

(1) Significant matters arising during the audit that were discussed, or subject to correspondence, with management;

(2) Written representations the auditor is requesting

- (iv) Circumstances that affect the form and content of the auditor's report, if any and
- (v) Any other significant matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process.

The communication of findings from the audit may include requesting further information from those charged with governance in order to complete the audit evidence obtained. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.

Significant difficulties encountered during the audit may include such matters as: -

Significant delays by management, the unavailability of entity personnel, or an unwillingness by management to provide information necessary for the auditor to perform the auditor's procedures.

An unreasonably 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 the entity's ability to continue as a going concern when requested.

In some circumstances, such difficulties may constitute a scope limitation that leads to a modification of the auditor's opinion.

Significant matters that were discussed, or subject to correspondence with management may include such matters as: -

- **Significant events or transactions that occurred during the year.**
- **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.**
- **Significant matters on which there was disagreement with management, except for initial differences of opinion because of incomplete facts or preliminary information that are later resolved by the auditor obtaining additional relevant facts or information.**

The agreed terms of the audit engagement are required to be recorded in an audit engagement letter or other suitable form of written agreement and include, among other things, reference to the expected form and content of the auditor's report. Communication in this respect is intended to inform those charged with governance about circumstances in which the auditor's report may differ from its expected form and content or may include additional information about the audit that was performed.

Circumstances in which the auditor is required or may otherwise consider it necessary to include additional information in the auditor's report in accordance with the SAs, and for which communication with those charged with governance is required, include when: -

- The auditor expects to modify the opinion in the auditor's report in accordance with SA 705. • A material uncertainty related to going concern is reported in accordance with SA 570.
- Key audit matters are communicated in accordance with SA 701.
- The auditor considers it necessary to include an Emphasis of Matter paragraph or Other Matter paragraph in accordance with SA 706 or is required to do so by other SAs.
- The auditor has concluded that there is an uncorrected material misstatement of the other information in accordance with SA 720.

In such circumstances, the auditor may consider it useful to provide those charged with governance with a draft of the auditor's report to facilitate a discussion of how such matters will be addressed in the auditor's report.

4.3 Communication of Auditor's Independence in Case of Listed Entities

In the case of listed entities, the auditor shall communicate with those charged with governance: -

- (a) A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with relevant ethical requirements regarding independence; and
- (b)
 - i. All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor; and
 - ii. The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

The Communication process

The auditor shall communicate with those charged with governance the form, timing and expected general content of communications.

The auditor shall communicate in writing with those charged with governance regarding significant findings from the audit if, in the auditor's professional judgment, oral communication would not be adequate. Written communications need not include all matters that arose during the course of the audit. The auditor shall communicate in writing with those charged with governance regarding auditor independence when required in case of listed entities.

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

Adequacy of the communication process

The auditor shall evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor shall evaluate the effect, if any, on the auditor's assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence, and shall take appropriate action.

4.4 Documentation

Where matters required by SA 260 to be communicated are communicated orally, the auditor shall include them in the audit documentation, and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the audit documentation.

TEST YOUR UNDERSTANDING 4

CA. Vallabh Sundar is auditor of a leading private sector bank. “IT Systems and controls” is under his consideration to be reported as “Key audit matter” in audit report of the bank due to high level of automation and complexity of the IT architecture and its impact on the financial reporting system.

At what time he should communicate such identified “Key audit matter”? What are relevant considerations in this regard and their usefulness?

5. SA 299 “JOINT AUDIT OF FINANCIAL STATEMENTS”

SA 299 lays down the principles for effective conduct of joint audit to achieve the overall objectives of the auditor as laid down in SA 200. It deals with the special considerations in carrying out audit by joint auditors.

However, it does not deal with the relationship between a principal auditor who is appointed to report on the financial statements of an entity and another auditor who is appointed to report on the financial statements of one or more component (divisions, branches, subsidiary, joint venture, associates, other entity) included in the financial statements of the entity.

What is joint audit of financial statements?

A joint audit is an audit of financial statements of an entity by two or more auditors appointed with the objective of issuing the audit report. Such auditors are described as joint auditors.

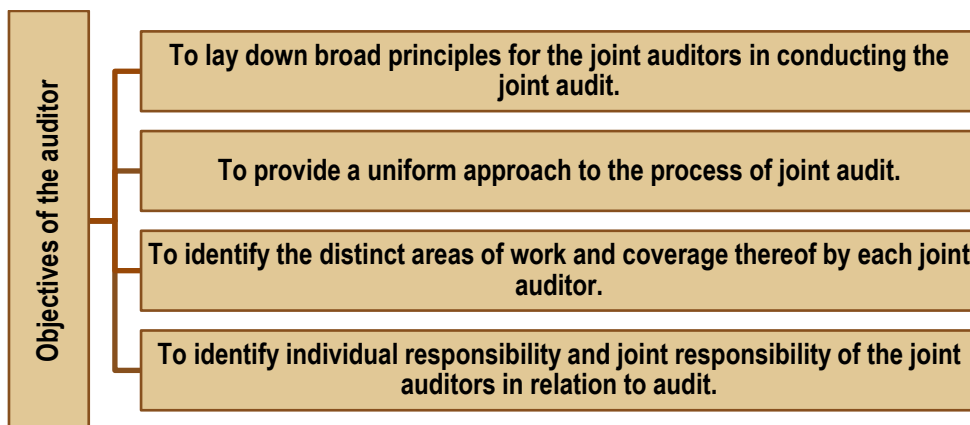
The practice of appointing more than one auditor to conduct the audit of large entities has been in vogue for a long time, sometimes voluntarily by the shareholders or sometimes due to the requirements of laws or regulations. Such auditors, known as joint auditors, conduct the audit jointly and report on the financial statements of the entity.

For example, section 139(3) of Companies Act, 2013 provides that members of a company may resolve to provide that the audit shall be conducted by more than one auditor.

5.1 Objectives in accordance with SA 299

The objectives in accordance with SA 299 are as under: -

- (a) To lay down broad principles for the joint auditors in conducting the joint audit.
- (b) To provide a uniform approach to the process of joint audit.
- (c) To identify the distinct areas of work and coverage thereof by each joint auditor.
- (d) To identify individual responsibility and joint responsibility of the joint auditors in relation to audit.



5.2 Audit planning, Risk Assessment and Allocation of Work

The engagement partner and other key members of the engagement team from each of the joint auditors shall be involved in planning the audit. Overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan shall be established jointly.

Prior to the commencement of the audit, the joint auditors shall discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors shall: -

(a) Identify division of audit areas and common audit areas amongst the joint auditors that define the scope of the work of each joint auditor. Where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure. 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.

- (b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required
- (c) Consider and communicate among all joint auditors the factors that, in their professional judgment, are significant in directing the engagement team's efforts
- (d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other or similar engagements performed earlier by the respective engagement partner for the entity is relevant.
- (e) Ascertain the nature, timing and extent of resources necessary to perform the engagement.

At this stage, risks of material misstatement need to be considered and assessed by each of the joint auditors and shall be communicated to other joint auditors, and documented, whether pertaining to the overall financial statements level or to the area of allocation among the other joint auditors.

The joint auditors shall discuss and document the nature, timing, and the extent of the audit procedures for common and specific allotted areas of audit to be performed by each of the joint auditors and the same shall be communicated to those charged with governance.

The joint auditors shall obtain common engagement letter and common management representation letter.

After identification and allocation of work among the joint auditors, the work allocation document shall be signed by all the joint auditors and the same shall be communicated to those charged with governance of the entity.

The documentation of allocation of work helps in avoiding any dispute or confusion which may arise among the joint auditors regarding the scope of work to be carried out by them. Further, the communication of allocation of work to the entity helps in avoiding any dispute or confusion which may arise between the entity and the joint auditors.

5.3 Responsibility and Co-ordination among Joint Auditors

The audit process involves obtaining and evaluating information and explanations from the management. This responsibility is shared by all the joint auditors unless they agree upon a specific pattern of distribution of this responsibility.

In respect of *audit work divided* among the joint auditors, each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures. In cases where specific divisions, zones or units are allocated to different joint auditors, it is the

separate and specific responsibility of each joint auditor to obtain information and explanations from the management in respect of such divisions/zones/units and to evaluate the information and explanations so obtained by said joint auditor. The joint auditors shall have proper coordination and rationality wherever required.

All the joint auditors shall be jointly and severally responsible for: -

(a) the audit work which is not divided among the joint auditors and is carried out by all joint auditors

(b) decisions taken by all the joint auditors under audit planning in respect of common audit areas concerning the nature, timing and extent of the audit procedures to be performed by each of the joint auditors.

(c) matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors

(d) examining that the financial statements of the entity comply with the requirements of the relevant statutes

(e) presentation and disclosure of the financial statements as required by the applicable financial reporting framework

(f) ensuring that the audit report complies with the requirements of the relevant statutes, the applicable Standards on Auditing and the other relevant pronouncements issued by ICAI.

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

It shall be the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the areas of work allocated to said joint auditor. It is the individual responsibility of each joint auditor to study and evaluate the prevailing system of internal control and assessment of risk relating to the areas of work allocated to said joint auditor.

As regards decisions taken by all the joint auditors under audit planning in respect of common audit areas concerning the nature, timing and extent of the audit procedures to be performed by each of the joint auditors, all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing and extent of the audit procedures agreed upon among them, proper execution of these audit procedures is the individual responsibility of the joint auditor concerned.

5.4 Audit Conclusion and Reporting

The joint auditors are required to issue common audit report, however, where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report. A joint auditor is not bound by the views of the majority of the joint auditors regarding the opinion or matters to be covered in the audit report and shall express opinion formed by the said joint auditor in separate audit report in case of disagreement. In such circumstances, the audit report(s) issued by the joint auditor(s) shall make a reference to the separate audit report(s) issued by the other joint auditor(s). Further, separate audit report shall also make reference to the audit report issued by other joint auditors. Such reference shall be made under the heading "Other Matter Paragraph" as per SA 706.

Each Joint Auditor is entitled to assume that: -

(a) The other joint auditors have carried out their part of the audit work and the work has actually been performed in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in such a manner.

(b) The other joint auditors have brought to said joint auditor's notice any departure from applicable financial reporting framework or significant observations that are relevant to their responsibilities noticed in the course of the audit.

Where financial statements of a division/branch are audited by one of the joint auditors, the other joint auditors are entitled to proceed on the basis that such financial statements comply with all the legal and regulatory requirements and present a true and fair view of the state of affairs and of the results of operations of the division/branch concerned.

Before finalizing their audit report, the joint auditors shall discuss and communicate with each other their respective conclusions that would form the content of the audit report.

5.5 Communication with Those Charged with Governance

When the joint auditors expect to modify the opinion in the auditor's report, the joint auditors shall communicate with those charged with governance the circumstances that led to the expected modification and the proposed wording of the modification to ensure compliance with SA 705. If the joint auditors expect to include an Emphasis of Matter or an Other Matter paragraph in the auditor's report, the joint auditors shall communicate with those charged with governance regarding this expectation and the proposed wording of this paragraph to ensure compliance with SA 706.

TEST YOUR UNDERSTANDING 5

Four audit firms viz. GPR & Co., MKS & Co., CY & Associates and DES & Associates have been appointed for conducting statutory audit of KNB Bank, a public sector bank in accordance with regulatory guidelines. The professional work was divided by audit firms on the basis of zones of bank. However, work relating to “IT Systems and controls” was not allocated by them due to its very nature.

While planning for the above common work area, it was decided to test IT general controls, application controls and IT dependent manual controls. Planned key audit procedures relating to this common area also included testing design and operating effectiveness of controls over “computer operations including back-up, batch-processing and data centre security”.

The actual audit procedures pertaining to “testing controls over batch processing” were performed by team of DES & Associates. In case work in relation to above audit procedures is not performed professionally by DES & Associates, discuss where responsibility for such lapses would lie in line with SA 299?

6. SA 402 “AUDIT CONSIDERATIONS RELATING TO AN ENTITY USING A SERVICE ORGANISATION”

SA 402 deals with the user auditor’s responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organisations. Specifically, it expands on how the user auditor applies SA 315 and SA 330 in obtaining an understanding of the user entity, including internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.

What is a Service organization?

- Service organisation is a third-party organisation (or segment of a third-party organisation) that provides services to user entities that are part of those entities’ information systems relevant to financial reporting. User entity is an entity that uses a service organisation and whose financial statements are being audited.

Who is a service auditor?

- Service auditor is an auditor who, at the request of the service organisation, provides an assurance report on the controls of a service organisation. User auditor is an auditor who audits and reports on the financial statements of a user entity.

Many entities outsource aspects of their business to organisations that provide services ranging from performing a specific task under the direction of an entity to replacing an entity's entire business units or functions, such as the tax compliance function. Many of the services provided by such organisations are integral to the entity's business operations; however, not all those services are relevant to the audit.

When services provided by a service organization are relevant to the audit of a user entity's financial statements?

Services provided by a service organisation are relevant to the audit of a user entity's financial statements when those services, and the controls over them, are part of the user entity's information system, including related business processes, relevant to financial reporting. Although most controls at the service organisation are likely to relate to financial reporting, there may be other controls that may also be relevant to the audit, such as controls over the safeguarding of assets.

A service organisation's services are part of a user entity's information system, including related business processes, relevant to financial reporting if these services affect any of the following: -

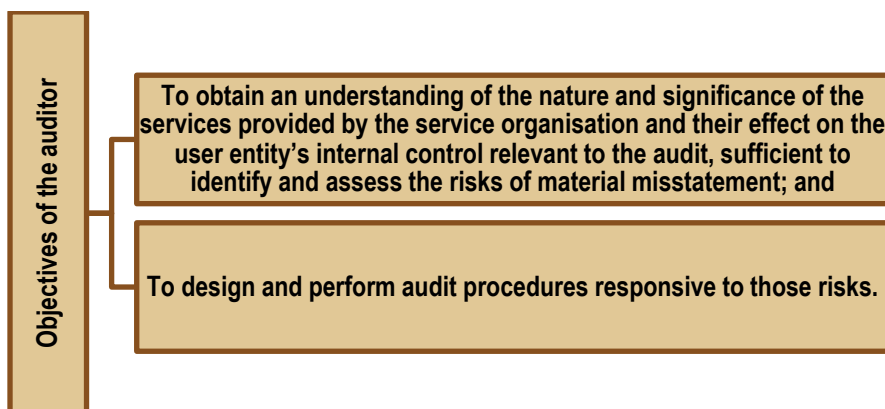
- (a) The classes of transactions in the user entity's operations that are significant to the user entity's financial statements
- (b) The procedures, within both information technology (IT) and manual systems, by which the user entity's transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements
- (c) The related accounting records, either in electronic or manual form, supporting information and specific accounts in the user entity's financial statements that are used to initiate, record, process and report the user entity's transactions
- (d) How the user entity's information system captures events and conditions, other than transactions, that are significant to the financial statements
- (e) The financial reporting process used to prepare the user entity's financial statements, including significant accounting estimates and disclosures and
- (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments

The nature and extent of work to be performed by the user auditor regarding the services provided by a service organisation depend on the nature and significance of those services to the user entity and the relevance of those services to the audit.

6.1 Objectives of user auditor in accordance with SA 402

The objectives of the user auditor, when the user entity uses the services of a service organisation, are:-

- (a) To obtain an understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement; and
- (b) To design and perform audit procedures responsive to those risks.



6.2 Type 1 report and Type 2 report

Type 1 report is a report that comprises: -

(i) A description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls that have been designed and implemented as at a specified date; and

(ii) A report by the service auditor with the objective of conveying reasonable assurance that includes the service auditor's opinion on the description of the service organisation's system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives.

Type 2 report is a report that comprises: -

(i) A description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls, their design and implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period; and

(ii) A report by the service auditor with the objective of conveying reasonable assurance that includes: -

a. The service auditor's opinion on the description of the service organisation's system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; and

b. A description of the service auditor's tests of the controls and the results thereof.

6.3 Obtaining an Understanding of the Services

1. **Obtaining an understanding of the services provided by a service organisation, including internal control:** When obtaining an understanding of the user entity in accordance with SA 315, the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity's operations, including: -

(a) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control. Information on nature of services provided by a user organization may be available from sources such as user manuals, contract between the user entity and service organization, reports by service auditors etc.

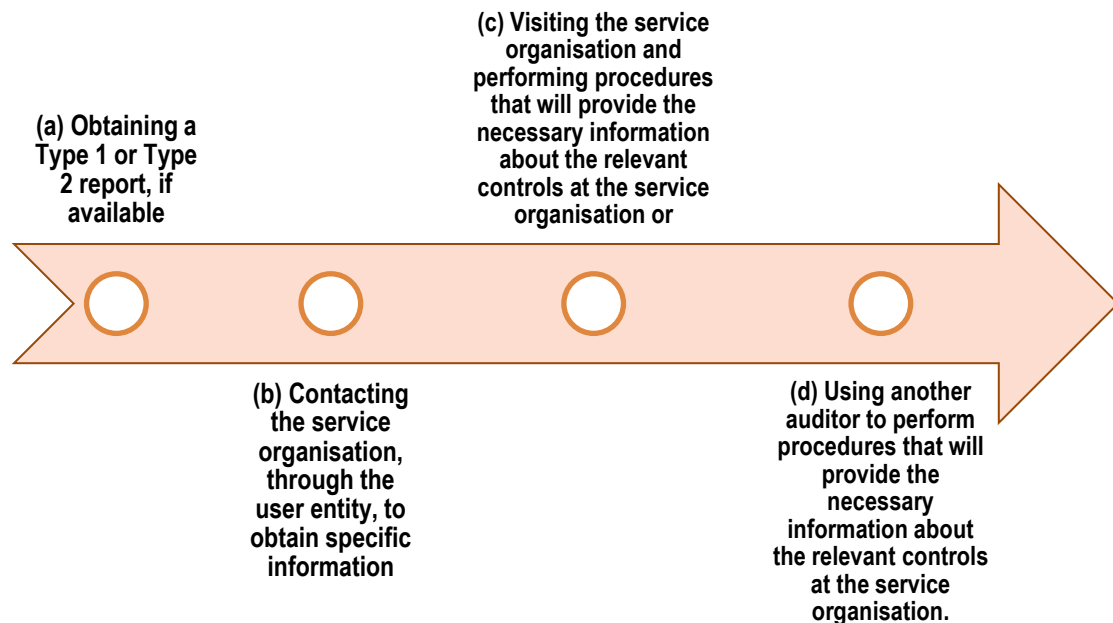
(b) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation. In certain situations, the transactions processed and the accounts affected by the service organisation may not appear to be material to the user entity's financial statements, but the nature of the transactions processed may be significant and the user auditor may determine that an understanding of those controls is necessary in the circumstances.

(c) The degree of interaction between the activities of the service organisation and those of the user entity. The degree of interaction refers to the extent to which a user entity is able to and elects to

implement effective controls over the processing performed by the service organisation. For example, a high degree of interaction exists between the activities of the user entity and those at the service organisation when the user entity authorises transactions and the service organisation processes and does the accounting for those transactions

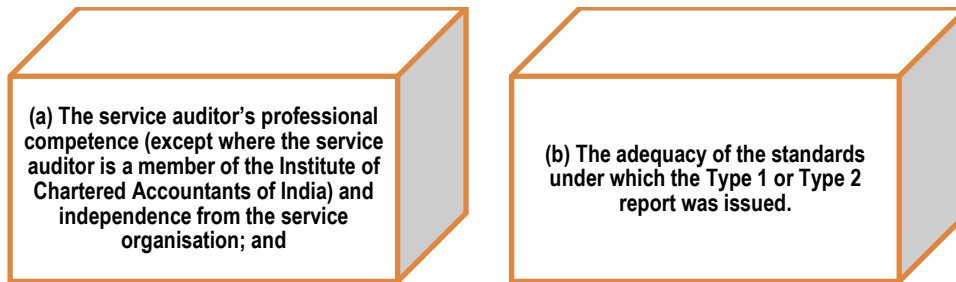
(d) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organisation.

2. **When obtaining an understanding of internal control relevant to the audit in accordance with SA 315, the user auditor shall evaluate the design and implementation of relevant controls** at the user entity that relate to the services provided by the service organisation, including those that are applied to the transactions processed by the service organisation.
3. **The user auditor shall determine whether a sufficient understanding of the nature and significance of the services** provided by the service organisation and their effect on the user entity's internal control relevant to the audit has been obtained to provide a basis for the identification and assessment of risks of material misstatement.
4. **If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor shall obtain that understanding from one or more of the following procedures: -**



6.4 Using Type 1 or Type 2 Report

Using A Type 1 Or Type 2 Report to Support the User Auditor's Understanding of The Service Organisation : In determining the sufficiency and appropriateness of the audit evidence provided by a Type 1 or Type 2 report, the user auditor shall be satisfied as to: -



If the user auditor plans to use a Type 1 or Type 2 report as audit evidence to support the user auditor's understanding about the design and implementation of controls at the service organisation, the user auditor shall:

(a) Evaluate whether the description and design of controls at the service organisation is at a date or for a period that is appropriate for the user auditor's purposes;

(b) Evaluate the sufficiency and appropriateness of the evidence provided by the report for the understanding of the user entity's internal control relevant to the audit; and

(c) Determine whether complementary user entity controls identified by service organisation are relevant to the user entity and, if so, obtain an understanding of whether the user entity has designed and implemented such controls.

Complementary user entity controls refer to controls that the service organisation assumes, in the design of its service, will be implemented by user entities, and which, if necessary to achieve control objectives, are identified in the description of its system.

6.5 Responding to the Assessed Risks of Material Misstatement

In responding to assessed risks in accordance with SA 330, the user auditor shall: -

- (a) Determine whether sufficient appropriate audit evidence concerning the relevant financial statement assertions is available from records held at the user entity; and, if not,**

- (b) Perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organisation on the user auditor's behalf.

6.6 Tests of Controls

When the user auditor's risk assessment includes an expectation that controls at the service organisation are operating effectively, the user auditor shall obtain audit evidence about the operating effectiveness of those controls from one or more of the following procedures: -

(a) Obtaining a Type 2 report, if available;

(b) Performing appropriate tests of controls at the service organisation; or

(c) Using another auditor to perform tests of controls at the service organisation on behalf of the user auditor.

Using a Type 2 report as audit evidence that controls at the service organisation are operating effectively

If, the user auditor plans to use a Type 2 report as audit evidence that controls at the service organisation are operating effectively, the user auditor shall determine whether the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment by:

(a) Evaluating whether the description, design and operating effectiveness of controls at the service organisation is at a date or for a period that is appropriate for the user auditor's purposes ;

(b) Determining whether complementary user entity controls identified by the service organisation are relevant to the user entity and, if so, obtaining an understanding of whether the user entity has designed and implemented such controls and, if so, testing their operating effectiveness;

(c) Evaluating the adequacy of the time period covered by the tests of controls and the time elapsed since the performance of the tests of controls; and

(d) Evaluating whether the tests of controls performed by the service auditor and the results thereof, as described in the service auditor's report, are relevant to the assertions in the user entity's financial statements and provide sufficient appropriate audit evidence to support the user auditor's risk assessment.

6.7 Fraud, non-compliance with laws and regulations and uncorrected misstatements in relation to activities at the service organisation

The user auditor shall inquire of management of the user entity whether the service organisation has reported to the user entity, or whether the user entity is otherwise aware of, any fraud, non-compliance with laws and regulations or uncorrected misstatements affecting the financial statements of the user entity. The user auditor shall evaluate how such matters affect the nature, timing and extent of the user auditor's further audit procedures, including the effect on the user auditor's conclusions and user auditor's report.

6.8 Reporting by the user auditor

The user auditor shall modify the opinion in the user auditor's report in accordance with SA 705 if the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation relevant to the audit of the user entity's financial statements.

The user auditor shall not refer to the work of a service auditor in the user auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the user auditor's report shall indicate that the reference does not diminish the user auditor's responsibility for the audit opinion.

If reference to the work of a service auditor is relevant to an understanding of a modification to the user auditor's opinion, the user auditor's report shall indicate that such reference does not diminish the user auditor's responsibility for that opinion.

Integrated Case Scenario:

CA. Biswajit is conducting audit of "*Have More Limited*". He is auditor of the company since last three years and has found nothing unusual in operations and financial statements of the company. The company has many locations where substantial inventories are stored and lying. During his fourth year stint, he finds that inventory quantities have risen disproportionately as compared to past few years trends. He has assessed existence of risk of material misstatement due to fraud.

The company has revenue of ₹ 750 crore during the year. He has deeply verified all aspects pertaining to revenue recognition of the company and has concluded that there is no risk of material misstatement due to fraud related to revenue recognition.

During the course of audit, it has come to his knowledge that company is also required to install online air pollution control monitoring systems in its plant as mandated in state pollution control

legislation and regulations. Non-installation of such online air pollution control monitoring systems may lead to fines and even sealing of plant.

While verifying payroll data of the company, it has come to notice that provisions of law preventing employment of child labour are not being adhered to and company is employing child labour in flagrant violation of rules in this regard. The company also exports part of its turnover and matter has gone unnoticed in compliance audits carried out by agencies of overseas buyers.

On the basis of above, answer the following questions: -

1. Considering description of disproportionate rise in inventory quantities, which of the following is not likely to be an appropriate response to outlined assessed risk of material misstatement due to fraud?

- (a) Observing inventory counts at all locations at same date by employing necessary resources.
- (b) Observing inventory counts at certain locations after prior intimation.
- (c) More rigorous examination of packed items during observing inventory count process.
- (d) Observing inventory count at end of reporting period to minimize risk of manipulation.

2. It has been concluded by auditor that there is no risk of material misstatement due to fraud related to revenue recognition. Which of the following statements is most appropriate in this respect?

- (a) The auditor needs to document reasons for arriving at conclusion that there is no risk of material misstatement due to fraud related to revenue recognition.
- (b) Identified and assessed risks of material misstatement due to fraud need to be documented. Since no risk of material misstatement due to fraud pertaining to revenue recognition was identified, separate documentation in this respect is not needed.
- (c) The auditor needs only to document that no risk of material misstatement due to fraud relating to revenue recognition was identified.
- (d) The auditor needs to give reference to discussion among engagement team members to document that no risk of material misstatement due to fraud relating to revenue recognition was identified.

3. Which of the following statements most appropriately describes responsibilities of auditor in relation to compliance with state pollution control legislation and regulations?

- (a) Sufficient appropriate evidence needs to be obtained by auditor to verify compliance.

- (b) Physical verification of workability of such systems is required from an auditor.
- (c) Only inquiry of company management personnel and review of correspondence with regulatory authorities are suffice to verify compliance.
- (d) Only physical verification of workability of such systems and review of correspondence with regulatory authorities are suffice to verify compliance.

4. The auditor has observed non-compliance of law prohibiting employment of child labour. Which is the most appropriate course of action for him to proceed in this matter?

- (a) He should obtain further information to evaluate the possible effect on financial statements.
- (b) He must report the matter to concerned government department.
- (c) He should obtain further information to evaluate the possible effect on financial statements. Besides, he should evaluate implications of non-compliance for audit risk assessment.
- (d) He should express a modified opinion in audit report.

5. Which of the following statements is most appropriate about documentation of non-compliance with laws and regulations by an auditor in context of SA 250?

- (a) Instances of identified non-compliance with laws and regulations need to be documented.
- (b) Instances of suspected non-compliance with laws and regulations need to be documented.
- (c) Instances of non-compliance with laws and regulations finally determined by Courts of law need to be documented.
- (d) Instances of identified as well as suspected non-compliance with laws and regulations need to be documented.

Key Takeaways

- Fraud is 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.
- SA 240 deals with the auditor's responsibilities relating to fraud in an audit of financial statements. Its requirements assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.
- Fraud risk factors are events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

- The effect on the financial statements of laws and regulations varies considerably. The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity's financial statements. 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 financial statements.
- 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 financial statements.
- SA 250 deals with auditor's responsibility to consider laws and regulations when performing an audit of financial statements.
- Communication from auditor is important with those charged with governance. SA 260 deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements.
- A joint audit is an audit of financial statements of an entity by two or more auditors appointed with the objective of issuing the audit report. Such auditors are described as joint auditors.
- SA 299 lays down the principles for effective conduct of joint audit to achieve the overall objectives of the auditor as laid down in SA 200. It deals with the special considerations in carrying out audit by joint auditors.
- Service organisation is a third-party organisation (or segment of a third-party organisation) that provides services to user entities that are part of those entities' information systems relevant to financial reporting. User entity is an entity that uses a service organisation and whose financial statements are being audited.
- SA 402 deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organisations.

**FOR SHORTCUT TO ENGAGEMENT & QUALITY CONTROLS STANDARDS WISDOM:
SCAN ME !**



TEST YOUR KNOWLEDGE

Theoretical Questions

1. *A, B and C are joint auditors of a company. B is of the opinion that there are material misstatements in financial statements of a company which, if accounted for, would turn profit reflected in financial statements for ₹ 25 crore to a loss of ₹ 5 crore. He, therefore, wants an adverse opinion to be expressed in audit report. However, A and C do not concur with his views and are inclined to accept management's version. Is B required to go by majority opinion of 2-1?*
2. *CA. Shelly Goel is offered appointment as auditor of RUTE Limited, a listed company. The audit committee of the company wants her to justify independence in relation to company through proper communication. Although she has ensured that there are no threats to her independence, she feels requirement of audit committee to be beyond its purview. What is your opinion in this regard?*
3. *You are auditor of a social media company. Of late, government has tightened noose around companies operating in this segment by bringing in a maze of regulatory legislations to protect interests of users. How you can proceed to verify that company is compliant with new regulatory requirements? Besides, what does above situation underscore to you as an auditor?*
4. *Discuss why the potential effects of inherent limitations of an auditor's ability to detect material misstatements described in SA 200 are far greater in respect of non-compliance with laws and regulations?*
5. *MN & Associates are the statutory auditors of ABC Ltd. for the FY 2021-22. During the course of audit, the engagement partner, Mr. Manohar notices a misstatement resulting from a suspected fraud that brings into question the audit team's ability to continue performing the audit. How should the audit team deal with the situation?*
6. *CA Anand is the engagement partner for the audit assignment of NHT Ltd. engaged in manufacture of Iron and Steel bars. The company has its plants in the state of Sikkim. While verifying the wages record of the company, CA Anand found that maximum of the labour employed in the plants of the company was child labour. He questioned the management of the company about the same to which the management replied that looking into the*

compliance of such law is outside his scope of financial audit. Give your comments with respect to such situation.

7. *Magnet Interiors Ltd. is a listed company engaged in the manufacture of office furniture. The company has its activities divided into four geographic regions. The company has appointed two joint auditors, namely, AB & Co. and CD & Co. to conduct the joint audit of the financial statements of the company for the year ending 31.03.2023. The engagement partners from both the firms, CA Amar and CA Chetanya along with their audit teams had a meeting to discuss the areas of the work to be divided and their respective responsibilities. Explain the responsibilities of the joint auditors with respect to such joint audit.*
8. *MNO Ltd. gets its accounting data processed by a service organisation. CA Riya is the statutory auditor of MNO Ltd. CA Riya wants to obtain an understanding as to how MNO Ltd. is using the services of the service organisation. What all understanding should she obtain?*
9. *UVW & Associates are the statutory auditors of Moon Ltd., a listed company, for the financial year 2022-23. CA Udhav is the engagement partner for the audit assignment. He was of the understanding that as per the requirement of one of the SAs he has a responsibility to communicate following matters to those charged with governance:*
 - (a) The auditor's responsibilities in relation to the financial statement audit.
 - (b) Planned scope and timing of the audit.
 - (c) Auditor independence

Which of the matters is not included in the list prepared by CA Udhav. Discuss such matter in detail.

Answers to Test your Understanding:

1. The given situation highlights need for the company to set up new plant for manufacturing of special kind of fabric to stay competitive in the market. Setting up of such plant involves huge capital outlays which could entail financing arrangements. Therefore, excessive pressure exists for management to be involved in fraudulent financial reporting. In such a situation, management may be tempted to inflate its revenues to show rosy picture. It is a fraud risk factor and needs to be evaluated by the auditor.

The revenues of company have jumped from ₹ 750 crore in last year to ₹ 1000 crore in year 2022-23 without any change in plant capacity. The auditor may consider abovesaid fraud risk factor for assessing risk of material misstatement due to fraud.

In case of auditor assessing risk of material misstatement due to fraudulent financial reporting, audit procedures to address such risk like performing substantive analytical procedures relating to revenue, use of computer assisted audit techniques to identify unusual revenue transactions and testing controls pertaining to revenue transactions need to be performed.

2. Management failing to remedy known significant deficiencies in internal control on a timely basis is a fraud risk factor for misstatements arising from fraudulent financial reporting.

When management does not correct significant deficiencies in internal control on a timely basis, it reflects an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act.

Failure to rectify known control deficiencies pertaining to reconciliation of receivables and review of customer credit limits has the potential to fraud. Lack of timely reconciliation of receivables may lead to intentional misstatements. Further, non-reviewing customer limit may lead to grant of credit beyond creditworthiness of customers. It may result in intentional tying up of company's funds with risky customers due to collusion.

The above situation is a fraud risk factor for fraudulent financial reporting.

3. When the auditor becomes aware of the existence of or has information about investigations by government departments and regulatory organizations, it may be an indication of non-compliance with laws and regulations.

In the instant case, notice has been served upon the company by DGGI for allegedly creating fictitious invoices in guise of providing "*marketing and sales services*" for ₹ 50 crores. Issuing an invoice without supply of services is a serious offence under GST laws and it could involve penalties and imprisonment. Such suspected non-compliance may have a direct effect on financial statements.

The matter has also been informed to regulator i.e. IRDAI. Violation of IRDAI regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements.

If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain: -

- (a) An understanding of the nature of the act and the circumstances in which it has occurred and
- (b) Further information to evaluate the possible effect on the financial statements.

If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice.

If sufficient information about suspected non-compliance cannot be obtained, the auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion.

4. SA 260 requires the auditor to communicate with those charged with governance on a timely basis.

SA 701 states that the appropriate timing for communications about key audit matters will vary with the circumstances of the engagement. However, the auditor may communicate preliminary views about key audit matters when discussing the planned scope and timing of the audit, and may further discuss such matters when communicating about audit findings. Doing so may help to alleviate the practical challenges of attempting to have a robust two-way dialogue about key audit matters at the time the financial statements are being finalized for issuance.

Communication with those charged with governance enables them to be made aware of the key audit matters that the auditor intends to communicate in the auditor's report, and provides them with an opportunity to obtain further clarification where necessary. The auditor may consider it useful to provide those charged with governance with a draft of the auditor's report to facilitate this discussion.

Communication with those charged with governance recognizes their important role in overseeing the financial reporting process, and provides the opportunity for those charged with governance to understand the basis for the auditor's decisions in relation to key audit matters and how these matters will be described in the auditor's report. It also enables those charged with governance to consider whether new or enhanced disclosures may be useful in light of the fact that these matters will be communicated in the auditor's report.

5. In respect of common areas, the joint auditors are only responsible for appropriateness of nature, timing and extent of planned audit procedures agreed among them. The responsibility of individual execution lies with concerned joint auditor.

In the instant case, audit procedures relating to testing design and operating effectiveness of controls over computer operations including back-up, batch-processing and data center security have been planned jointly as it is a common area.

However, audit procedures relating to testing controls over batch processing were actually performed by team of DES & Associates although these were planned jointly. In case of any lapses in performing such procedures, DES & Associates would be responsible.

Answers to Integrated Case Scenario:

1. (b)
2. (a)
3. (c)
4. (c)
5. (d)

Hints /Answers to Theoretical Questions:

1. Where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report. A joint auditor is not bound by the views of the majority of the joint auditors regarding the opinion or matters to be covered in the audit report and shall express opinion formed by the said joint auditor in separate audit report in case of disagreement. Therefore, B is not required to go by majority opinion of 2-1.

In such circumstances, the audit report issued by the joint auditors shall make a reference to the separate audit report issued by the other joint auditor. Further, separate audit report shall also make reference to the audit report issued by other joint auditors. Such reference shall be made under the heading "Other Matter Paragraph" as per SA 706.

2. As required in SA 260, in the case of listed entities, the auditor shall communicate with those charged with governance: -
 - (a) A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with relevant ethical requirements regarding independence and
 - i. All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on

independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor and

- ii. The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

Further, as per the Companies Act, 2013 requires audit committee to review and monitor auditor's independence. Therefore, audit committee requiring auditor to justify her independence is well within its purview.

3. It needs to be verified that the company has put in place systems and procedures to meet with new regulatory requirements. The same can be verified by examining policies and procedures developed by company in this regard like devising appropriate system of internal control, sensitizing employees regarding new rules, engaging legal advisors etc.

Further, financial stability of the company may be threatened due to new regulatory requirements. The management may be under pressure. It is also a fraud risk factor and may need to be evaluated by auditor.

4. In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following: -

- There are many laws and regulations, relating principally to the operating aspects of an entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.
- Non-compliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls or intentional misrepresentations being made to the auditor.
- Whether an act constitutes non-compliance is ultimately a matter for legal determination by a court of law.

5. During the course of audit, the engagement partner, Mr. Manohar notices a misstatement resulting from a suspected fraud that brings into question the audit team's ability to continue performing the audit. In such a situation the audit team should:

- (a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
 - (b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and
 - (c) If the auditor withdraws: -
 - (i) Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal and
 - (ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.
6. As per SA 250 "Considerations of Laws and Regulations in an Audit of Financial Statements", the auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework.

For the compliance with provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements, the auditor's responsibility is to obtain sufficient appropriate audit evidence about compliance with the provisions of those laws and regulations.

For other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements but compliance with which may be fundamental to the operating aspects of the business, the auditor's responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

In the instant case, maximum of the labour employed in the plants of the company was child labour. When CA Anand questioned the management of the company about the same, the management replied that looking into the compliance of such law is outside his scope of financial audit. Such reply by the management is not acceptable as such situation may have a material effect on the financial statements. Therefore, CA Anand should ensure as to

whether any penal provisions will be there for non-compliance of such law and also whether the same has been duly disclosed by the company. If CA Anand concludes that such non-compliance has a material effect on the financial statements and the same has not been adequately reflected in the financial statements by the company, he shall express an adverse or a qualified opinion on the financial statements.

7. As per SA 299 “Joint Audit of Financial Statements”, in respect of *audit work divided* among the joint auditors, each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures. In cases where specific divisions, zones or units are allocated to different joint auditors, it is the separate and specific responsibility of each joint auditor to obtain information and explanations from the management in respect of such divisions/zones/units and to evaluate the information and explanations so obtained by said joint auditor. The joint auditors shall have proper coordination and rationality wherever required.

All the joint auditors shall be jointly and severally responsible for: -

- a. the audit work which is not divided among the joint auditors and is carried out by all joint auditors
- b. decisions taken by all the joint auditors under audit planning in respect of common audit areas concerning the nature, timing and extent of the audit procedures to be performed by each of the joint auditors.
- c. matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors
- d. examining that the financial statements of the entity comply with the requirements of the relevant statutes
- e. presentation and disclosure of the financial statements as required by the applicable financial reporting framework
- f. ensuring that the audit report complies with the requirements of the relevant statutes, the applicable Standards on Auditing and the other relevant pronouncements issued by ICAI.

Where, in the course of the audit, a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or require discussion with, or application of judgment by other joint

auditors, the said joint auditor shall communicate the same to all the other joint auditors in writing prior to the completion of the audit.

It shall be the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the areas of work allocated to said joint auditor. It is the individual responsibility of each joint auditor to study and evaluate the prevailing system of internal control and assessment of risk relating to the areas of work allocated to said joint auditor.

As regards decisions taken by all the joint auditors under audit planning in respect of common audit areas concerning the nature, timing and extent of the audit procedures to be performed by each of the joint auditors, all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing and extent of the audit procedures agreed upon among them, proper execution of these audit procedures is the individual responsibility of the joint auditor concerned.

8. When obtaining an understanding of MNO Ltd. (user entity) in accordance with SA 315, CA Riya shall obtain an understanding of how MNO Ltd. uses the services of a service organisation in its operations, including: -
- (a) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control. Information on nature of services provided by a user organization may be available from sources such as user manuals, contract between the user entity and service organization, reports by service auditors etc.
 - (b) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation. In certain situations, the transactions processed and the accounts affected by the service organisation may not appear to be material to the user entity's financial statements, but the nature of the transactions processed may be significant and the user auditor may determine that an understanding of those controls is necessary in the circumstances.
 - (c) The degree of interaction between the activities of the service organisation and those of the user entity. The degree of interaction refers to the extent to which a user entity is able to and elects to implement effective controls over the processing performed by the service organisation. For example, a high degree of interaction exists between the activities of the user entity and those at the service organisation when the user entity authorises transactions and the service organisation processes and does the accounting for those transactions

- (d) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organisation.
9. SA 260 “Communication with Those Charged with Governance” deals with auditor’s responsibility to communicate with those charged with governance in relation to an audit of financial statements. Among various matters as included by CA Udhav in his list, one of the matters that is not mentioned in the list is Significant findings from the audit. With respect to such matter, the auditor shall communicate with those charged with governance: -
- (a) The auditor’s views about significant qualitative aspects of the entity’s accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;
 - (b) Significant difficulties, if any, encountered during the audit;
 - (c) Unless all of those charged with governance are involved in managing the entity: -
 - (i) Significant matters arising during the audit that were discussed, or subject to correspondence, with management;
 - (ii) Written representations the auditor is requesting
 - (d) Circumstances that affect the form and content of the auditor’s report, if any and
 - (e) Any other significant matters arising during the audit that, in the auditor’s professional judgment, are relevant to the oversight of the financial reporting process.

The communication of findings from the audit may include requesting further information from those charged with governance in order to complete the audit evidence obtained. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.

(Note: Content of SA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing; SA 210 Agreeing the Terms of Audit Engagements and SA 230 Audit Documentation is covered in depth at Intermediate level. Thus, application part of above SAs may be discussed in the form of Case Study at Final level.)

AUDIT PLANNING, STRATEGY & EXECUTION



LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ☐ Know factors, benefits and considerations for establishing overall audit strategy.
- ☐ Understand the nature and extent of planning.
- ☐ Analyse the responsibility of the auditor in audit strategy and audit plan.
- ☐ Understand the process of audit execution.

CHAPTER OVERVIEW



CA. B has qualified final Chartered Accountancy exams. Plunging into the field of auditing practice after setting up his own office, he accepted audit of a company engaged in emerging “*fintech*” sector. The company relies heavily on big data and artificial intelligence. It is also expected to lean upon Blockchain technology in coming years and is working in that direction. Company is also a participant in Regulatory sandbox i.e., of live testing of new products and services under controlled environment.

While planning audit, he felt need for involvement of an expert IT specialist for gaining an insight into various IT controls and IT laws & rules in heavily tech laden company. Is such consideration a factor to be considered in establishing overall audit strategy? In case he chose to involve an expert IT specialist, would his overall responsibility as an auditor be shared in some way? Would it be prudent for him to enter into a formal agreement with the expert detailing out nature, scope and objectives of his work? Besides, he had this nagging doubt in mind over confidentiality requirements pertaining to expert. Involving expert in exercise of understanding controls may split open company’s systems and sensitive data before him. Wouldn’t it tantamount to violation of confidentiality principle of professional ethics? He was keeping his fingers crossed.

As the company and its business-both were new to him, he was keen on gaining knowledge about business of the company. Vividly remembering that knowledge of client’s business is foremost requirement for developing an overall audit plan, he proceeded to gain broad regulatory requirements pertaining to *fintech* sector. Learning that not only RBI, but Ministry of Electronics and Information technology (MeitY) has also a role to play in this sector under flagship *Digital India* programme. He was also trying to understand revenue recognition practices of the industry. He also came to know that “Ombudsman scheme for digital

transactions” for filing consumer complaints was in existence. Would such knowledge be helpful to him in understanding about the company as far as audit was concerned?

The company also has an internal audit department. He finds that internal audit department of the company is scantily staffed and is headed by a banker retired from the post of Chief manager of a public sector bank. He didn't appear to be tech-savvy. On enquiry, he came to know that he got the job on recommendation of some government official. In these circumstances, would it be advisable for him to rely upon work performed by internal auditor? He needed to take a decision in this regard.

1. COMMENCING AN AUDIT

SA 200 “Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing” states that in order to achieve the overall objectives of the audit, the auditor shall use the objectives stated in relevant SAs in planning and performing the audit. Without a careful plan, the overall objective of an audit may not be achieved. The audit planning is necessary to conduct an effective audit, in an efficient and timely manner.

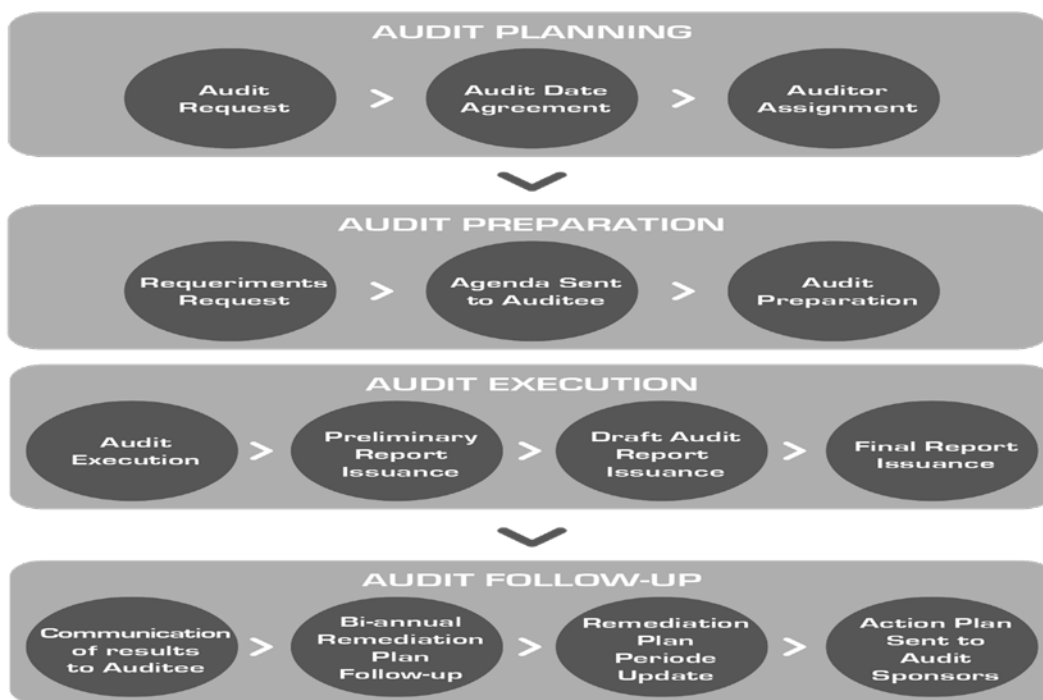


Image: Audit Planning, Preparation and Execution*

* Source : Forum Auditorías

1.1 Benefits/Advantages of Planning in an Audit of Financial Statements

Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways described hereunder-

- (i) Attention to Important areas
- (ii) Timely resolution of Potential Problems
- (iii) Proper Organisation and Management of Audit Engagement.
- (iv) Proper Selection of Engagement Team
- (v) Direction and Supervision of Engagement Team
- (vi) Easy Coordination in work done by auditors of components and experts.

1.2 Nature and Extent of Planning

So far as the nature of planning is concerned, it would vary according to-

(i) **Size and Complexity of the Auditee** - If the size and complexity of organization of which audit is to be conducted is large, then much more planning activities would be required as compared to an entity whose size and complexity is small.

(ii) **Past Experience & Expertise** - The key engagement team members' previous experience & expertise also contributes towards variation in planning activities.

(iii) **Change in Circumstances** - Another factor contributing towards variation in planning activities is change in circumstances.

1.3 Planning - A Continuous Process

Planning is not a discrete phase of an audit but rather a continual and iterative process. It often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning includes consideration of the timing of certain activities and audit procedures. It also involves forming audit programme.



1. Planning includes the need to consider such matters as:

- The analytical procedures to be applied as risk assessment procedures.

- Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
- The determination of materiality.
- The involvement of experts.
- The performance of other risk assessment procedures.

1.4 Overall Audit Strategy and Audit Plan - Responsibility of the Auditor

The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement. For example - to coordinate some of the planned audit procedures with the work of the entity's personnel.

Although these discussions often occur but the overall audit strategy and the audit plan remain the auditor's responsibility. When discussing matters about the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit to be taken to see there is no compromise in the effectiveness of the audit. For Example - discussing the nature and timing of detailed audit procedures with management may compromise the effectiveness of the audit by making the audit procedures too predictable.

The engagement partner and other key members of the engagement team should be involved in planning the audit. The involvement of the engagement partner and other key members of the engagement team in planning the audit draws on their experience, thereby, enhancing the effectiveness and efficiency of the planning process.

1.5 Acceptance and Continuance of Client Relationships and Audit Engagements

Acceptance and Continuance of Client Relationships and Audit Engagements are very important preliminary engagement activities. The engagement partner should be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and should determine that conclusions reached in this regard are appropriate.

The auditor shall undertake the following activities at the beginning of the current audit engagement-

- (i) Performing procedures required by SA 220, "Quality Control for an Audit of Financial Statements" regarding the continuance of the client relationship and the specific audit engagement. As per the combined reading of SA 220 and SQC 1, information and

procedures such as the following, assists the auditor in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate:

- The integrity of the principal owners, key management and those charged with governance of the entity;
- Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, expertise, including time and resources;
- Whether the firm and the engagement team 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.

In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), auditors may be appointed in accordance with statutory procedures.

- (ii) Evaluating compliance with ethical requirements, including independence, as required by SA 220; and
- (iii) Establishing an understanding of the terms of the engagement, as required by SA 210.

1.6 Contents of an Audit Plan

The auditor should develop an audit plan that shall include a description of-

- (i) The nature, timing and extent of planned risk assessment procedures, as determined under SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment".
- (ii) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330 "The Auditor's Responses to Assessed Risks".
- (iii) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops.



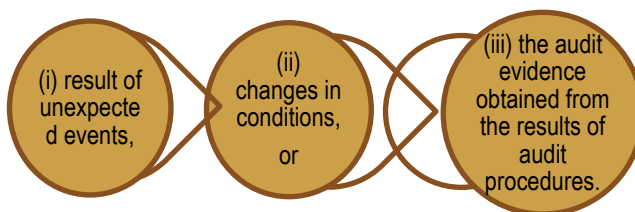
2. Planning of the auditor's risk assessment procedures occurs early in the audit process. However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures.

In addition, the 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.

1.7 Changes to Planning Decisions

The auditor should update and change the overall audit strategy and the audit plan as necessary during the course of the audit.

The auditor may need to modify the overall audit strategy and audit plan due to below mentioned factors-



Further, the auditor would also have to modify the nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks.

This may be the case when information coming to the auditor differs significantly from the information when he planned the audit procedures.



3. Audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls.

In addition to above, there may be a possibility of change in law, notifications, government policies which may warrant updating of overall audit strategy.

TEST YOUR UNDERSTANDING 1

XWL Limited was engaged in dealing in commodity futures trading based in Surat. CA P, based at Delhi, was auditor of the company. The auditor did not even once visit office of the company and failed to understand the nature of business of the company. All the papers and account books were received on emails and audit was concluded.

There were also included in his working papers checklists which had a requirement of test checking of cost of raw material consumed & cost of stores and spares. There was nothing in his working papers showing understanding of nature of business of company. What does it reflect upon planning of audit by CA P?

2. OVERALL AUDIT STRATEGY

The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

2.1 Factors while establishing Overall Audit Strategy

Overall audit strategy would involve-

- (i) **Determination of Characteristics of Audit:** Identify the characteristics of the engagement that defines its scope.
- (ii) **Reporting Objectives:** Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required.
- (iii) **Team's Efforts:** Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts.
- (iv) **Considering result of preliminary engagement activities:** Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant.
- (v) **Nature, timing and Extent of Resources:** Ascertain the nature, timing and extent of resources necessary to perform the engagement.

2.2 Benefits of Overall Audit Strategy

The process of establishing the overall audit strategy assists the auditor to determine such matters as-

- (i) **Employment of Qualitative Resources:** The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters like review of valuation, hedging transactions.
- (ii) **Allocation of Quantity of Resources:** The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count

at material locations, the extent of review of other auditors' work in the case of group audits, or the allocation of audit budgeted hours to high risk areas.

- (iii) **Timing of Deployment of Resources:** When these resources are to be deployed, such as whether at an interim audit stage or at or close to key cut-off dates.
- (iv) **Management of Resources:** How such resources shall be managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

2.3 Considerations in Establishing the Overall Audit Strategy

Some of the examples of matters that the auditor may consider in establishing the overall audit strategy are given hereunder. Many of these matters will also influence the auditor's detailed audit plan. All matters are not relevant to every audit engagement and the list is not necessarily complete.

(a) Characteristics of the Engagement

- (i) The financial reporting framework.
- (ii) Industry-specific reporting requirements such as reports mandated by industry regulators.
- (iii) The expected audit coverage, including the number and locations of components to be included.
- (iv) The nature of the control relationships between a parent and its components that determine how the group is to be consolidated.
- (v) The extent to which components are audited by other auditors.
- (vi) The entity's use of service organizations and how the auditor may obtain evidence concerning the design or operation of controls performed by them.
- (vii) The expected use of audit evidence obtained in previous audits, for example, audit evidence related to risk assessment procedures and tests of controls.
- (viii) The effect of information technology on the audit procedures.
- (ix) The availability of client personnel and data.

(b) Reporting Objectives, Timing of the Audit, and Nature of Communications

- (i) The entity's timetable for reporting.

- (ii) The organization of meetings with management regarding audit work (Nature, timing and extent).
- (iii) The discussion with management regarding type and timing of reports to be issued.
- (iv) The discussion with management regarding communications on the status of audit work.
- (v) Communication with auditors of components regarding types and timing of reports to be issued.
- (vi) The nature and timing of communications among engagement team members.
- (vii) Whether there are any other expected communications with third parties, including any statutory or contractual reporting responsibilities arising from the audit.

(c) Significant Factors, Preliminary Engagement Activities, and Knowledge Gained on Other Engagements

- (i) The determination of materiality in accordance with SA 320.
- (ii) Preliminary identification of areas where there may be a higher risk of material misstatement.
- (iii) The impact of the assessed risk of material misstatement at the overall financial statement level on direction, supervision and review.
- (iv) The manner in which engagement team members needs to maintain an inquisitive/questioning mind and exercise professional skepticism and unpredictability.
- (v) Results of previous audits including the identified deficiencies and action taken to address them.
- (vi) The discussion of matters that may affect the audit with firm personnel responsible for performing other services to the entity.
- (vii) Evidence of management's commitment to the design, implementation and maintenance of sound internal controls.
- (viii) Volume of transactions which may determine reliance on internal control.
- (ix) Importance attached to internal control.
- (x) Significant business developments affecting the entity.

- (xi) Significant industry specific developments and development in the economic environment.
- (xii) Significant changes in the financial reporting framework, such as changes in accounting standards.
- (xiii) Other significant relevant developments, such as changes in the legal and regulatory environment affecting the entity.

(d) Nature, Timing and Extent of Resources

- (i) The selection of the engagement team and the assignment of audit work to the team members.
- (ii) Engagement budgeting.

2.4 Documenting the Audit Plan

The auditor shall document-

- (i) The overall audit strategy;
- (ii) The audit plan; and
- (iii) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. Documentation of these matters assists auditor as under: -
 - (a) **Record of Key Decisions:** The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team
 - (b) **Record of Nature, Timing and Extent of Risk Assessment Procedures:** The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and additional audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.
 - (c) **Record of reasons for change in audit strategy and plan:** A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the

planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

2.5 Relationship between the Overall Audit Strategy and the Audit Plan



Fig 1: Audit Strategy and the Audit Plan are interrelated.*

The audit strategy is prepared before the audit plan. The audit plan is more detailed than the overall audit strategy. Audit strategy and audit plan are inter-related because change in one would result into change in the other. The audit strategy provides the guidelines for developing the audit plan. It establishes the scope and conduct of the audit procedures and thereby, works as basis for developing a detailed audit plan. Detailed audit plan would include the nature, timing and extent of the audit procedures so as to obtain sufficient appropriate audit evidence.



4. CA. Sam has already developed an audit strategy for Hitesh Ltd. While a detailed audit plan is being developed, she decided that materiality levels set earlier need to be lowered as weaknesses in the internal controls were highlighted in the internal audit report. Subsequently, a deviation from the audit strategy is felt necessary. Therefore, Sam would firstly modify the overall strategy and thereafter, prepare the audit plan in line with the strategy. This shows that the audit strategy and audit plan are closely inter-related as change in one is resulting into change in the other.

The overall audit strategy & audit plan should take into consideration the element of materiality and its relationship with Risks & procedures to be adopted.

* Source : msp-c.com

3. AUDIT PROGRAMME

An audit programme is commonly prepared to allocate work to team members which may include the list of audit procedures and instructions to be followed by the member. It also estimates the duration for completing an audit task.

3.1 Formulating an Audit Programme

It is very useful for you to know how to formulate an audit programme. The programme may contain audit objectives for each area and should have sufficient detail to serve as a set of instructions to the assistants involved in the audit and as means to control the proper execution of work. It may be emphasised that a clear spelling out of audit objectives for each area is important to link up the procedures with audit objectives and to ensure a purposeful audit.

The important matters which need to be considered in this regard are:

(a) **Nature of business in which the organisation is engaged:** On his first appointment, the auditor should examine in detail the financial and accounting organisation of the business by visiting the client's office; by observing different stages through which documents pass before each transaction is authorised and recorded; the record that is kept and the type of books maintained.

In the case of an industrial concern, he must also visit the factory to acquaint himself with the different processes of manufacture, the quantitative records maintained and the manner in which statistics are compiled in respect of losses in process.

The auditor, therefore, should draw up the audit programme after considering the technical, financial and accounting set-up of the company.

(b) **Overall plan:** Audit programme should be drawn up to ensure a systematic approach to the work. If in drawing the audit programme, any divergence from the overall plan becomes necessary, first the overall plan should be modified after due consideration and thereafter, only that specific matter may be taken in the audit programme. The framework provided under the overall plan should be strictly adhered to.

(c) **System of internal control and accounting procedures:** The existence of a system of internal control ensures that both financial and statistical records are checked continuously; it also unearths errors, both of omission and of commission. The auditor, in framing his opinion on financial statements needs reasonable assurance that transactions are properly authorised and recorded in the accounting records and that transactions have not been omitted. The study and evaluation of internal control helps the auditor to establish the reliance he can place on the internal controls in

determining the nature, timing and extent of his substantive auditing procedures.

The auditor's examination of the system of internal control should have three features - review and preliminary evaluation, testing of compliance and evaluation.

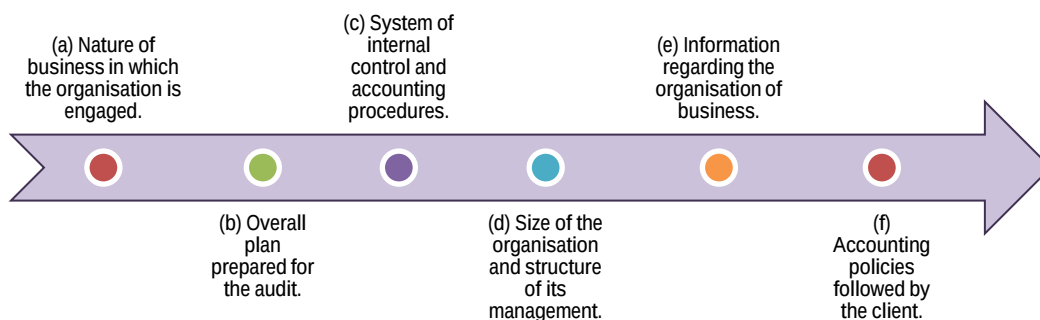
(d) **Size of the organisation and structure of its management:** An increase in the size of the organisation enhances the complexity of the examination of its accounting records specially when it has a number of branches, deals in several products or has a very large turnover.



5. The reports of the Comptroller and Auditor General on audit of accounts of Public Enterprises show that some of them have a very poor system of internal controls. In such cases, the magnitude of the tasks of the auditor increases considerably.

(e) **Information as regards organisation of the business:** To plan audit programme, it is necessary that the auditor should obtain from his client information as regards the client's history and business, purpose and nature of engagement and time schedule for the completion of audit.

(f) **Accounting and management policies:** The auditor should review the financial statements of the past several years, audited by his predecessors specially those of the immediately preceding previous year. This would reveal to him a great deal of information regarding accounting and management policies which have been followed in the past and whether these have been employed consistently.



3.2 Drawing up the audit programme:

After the auditor has collected the aforementioned information, he will be in a position to draw up the programme of audit. He can now decide the areas to be covered by audit, also those to be covered in detail and those which should be covered by the applications of the test checks. He will also be able to decide the specific audit procedures which should be applied in each case. These procedures vary widely because of the conditions under which each concern operates, its form of organisation, its nature of business and the condition of its accounts. On this account, it is not

practicable to draw up a typical audit programme. When an auditor is appointed to audit the accounts of an entity for the first time, the audit programme should be developed in three stages stated below:

- (i) To begin with, a broad outline of the audit programme should be drawn up.
- (ii) After the internal and accounting procedures have been reviewed, the details should be filled up on a consideration of the deficiencies in the system of internal control.
- (iii) After the detailed checking procedure is over, the extent to which the special procedures (first time/ opening balance audit procedures) that are required to be applied should be determined, e.g., independent verification of balances of debtors and creditors, physical inspection of fixed assets, personal inspection of various items of stock included in closing inventories and testing their values. At times, special procedures may have to be applied on a consideration of the nature of business e.g. verification of provision for tax liability in case of a shipping company regarding freight booked in different countries or for making a provision for unexpired liability in case of an insurance company, etc.

At each subsequent engagement, the programme should be reviewed and, if necessary, modified on account of:

(i) experience gained during the previous audits;

(ii) important changes that have taken place in the business specially in the system of internal control, accounting procedures or in the structure of management or of the scope of business; and

(iii) evaluation of internal control made for the current year.

Given below are a few circumstances where in the audit programme would have to be suitably altered:

(1)	If the audit procedures were designed for a certain volume of turnover and subsequently the volume have substantially increased. Also, when there have been significant changes in the accounting organisation, procedures and personnel subsequent to the audit procedures.
(2)	Where during the course of an audit, it has been discovered that internal control procedures were not as effective as assumed at the time the audit programme was framed.
(3)	Where there has been an extraordinary increase in the amount of book debts or that in the value of stocks as compared to that in the previous year.

- (4) When a suspicion has aroused during the course of audit or information has been received that assets of the company have been misappropriated.

It may be noted that the audit plan and related programme should be reconsidered as the audit progresses. Such re-consideration is based on the auditor's review of internal control, his preliminary evaluation thereof and the result of his compliance and substantive procedures

TEST YOUR UNDERSTANDING 2

CA. Pradyuman is planning for audit of a listed company headquartered in NOIDA. While doing this exercise, he has made a list of various procedures intended to be performed by him during the course of audit. He has further made up his mind to decide about sample size at time of performing various planned procedures. Is above approach proper?

TEST YOUR UNDERSTANDING 3

CA. Nikita is conducting audit of a leading society engaged in promoting awareness regarding usefulness of internet among the disadvantaged sections of society through easily understandable means and methods. The society is also registered under FCRA, 2010 for receipt of foreign contributions. During the course of audit, she embarked upon extensive procedures relating to verification of receipt of foreign contributions to rule out "round-tripping" in comparison to procedures originally thought of. She is documenting various procedures performed by her including relevant audit findings.

However, she doesn't not feel need for putting into writing about how she planned the whole exercise. Does she require refreshing of her knowledge?

4. AUDIT EXECUTION

Key phases in the audit execution stage are Execution Planning, Risk and Control Evaluation, Testing and Reporting.

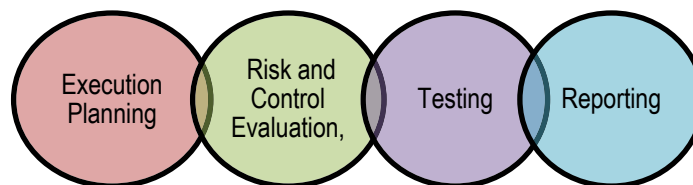


Image showing Stages of Audit Execution

4.1 Execution Planning

Prior to commencement of an audit engagement, it is important to lay down the roadmap for audit execution to ensure timely and quality audit results. The auditors need to plan their work in order to carry out the audit in an effective, efficient and timely manner. A detailed audit program is prepared laying down the audit objectives, scope and audit approach. The manpower requirement, audit team qualifications, and the time element, etc. are some of the important considerations during execution planning. In order to plan effectively, the auditor may need some more information about the audit area. A preliminary survey would help in gathering the required information.

4.2 Risk and Control Evaluation

For each segment of audit, the auditors should conduct a detailed risk and control assessment i.e. list the risks that must be reviewed in that segment, capture for each risk the controls that exist or those that are needed to protect against the risk and show for each control, the work steps required to test the effectiveness of the controls. While making Risk & Control assessment, it is necessary to bear in mind the Materiality levels as the same is linked to Audit Risks.

(Note: Students may refer Chapter 4 for understanding and evaluation of the Risk and Control for more details)

4.3 Testing

Once a comprehensive understanding is gained of the key risks and the controls to be evaluated in a given audit area, the auditors should test the operating effectiveness of the controls to determine whether controls are operating as designed. There are multiple test methods which can be used to arrive at the conclusions on the effectiveness of the controls.

4.4 Reporting

SA 700, "Forming an Opinion and Reporting on Financial Statements" establishes standards on the form and content of the auditor's report issued as a result of an audit performed by an auditor of the financial statements of an entity. The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements. This review and assessment involves considering whether the financial statements have been prepared in accordance with an acceptable financial reporting framework applicable to the entity under audit. It is also necessary to consider whether the financial statements comply with the relevant statutory requirements such as compliance of Provisions & Enactments of the Company Law, Accounting Standards framed by ICAI, latest Guidelines etc.

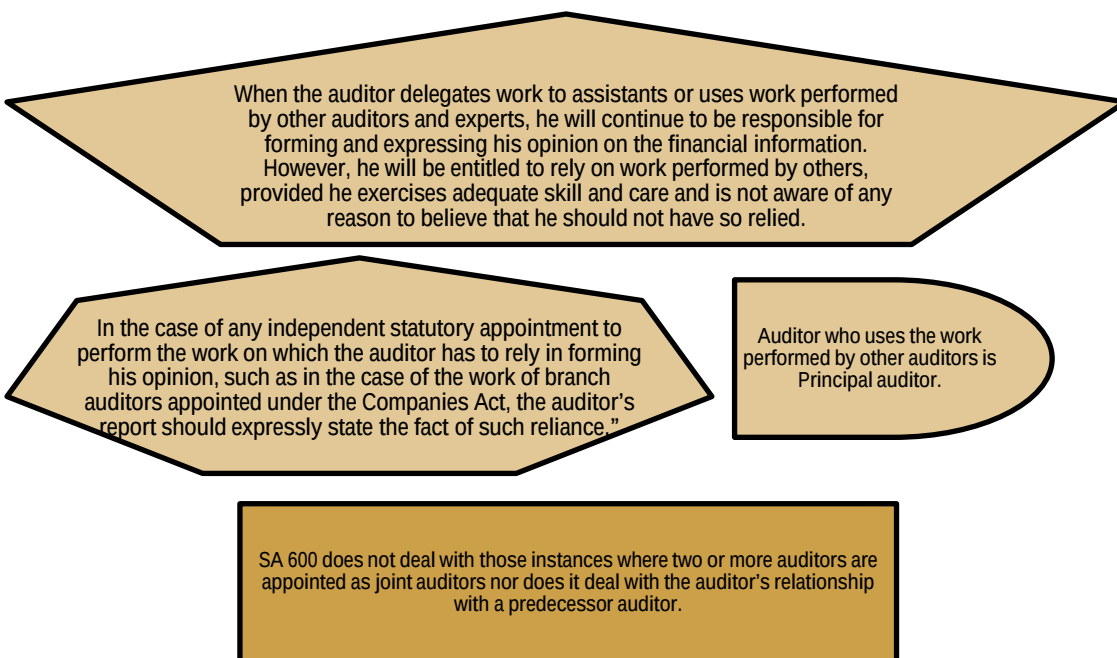
The auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole. A measure of uniformity in the form and content of the auditor's report is desirable because it helps to promote the reader's understanding of the auditor's report and to identify unusual circumstances when they occur. A statute governing the entity or a regulator may require the auditor to include certain matters in the audit report or prescribe the form in which the auditor should issue his report.

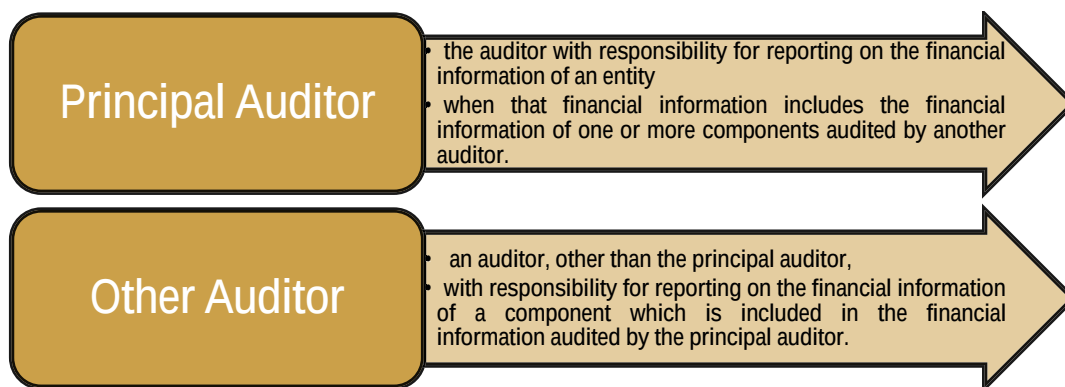
(Note: For details Students may refer SA 700 discussed in Chapter 7 of this study material)

4.5 Other Important Considerations

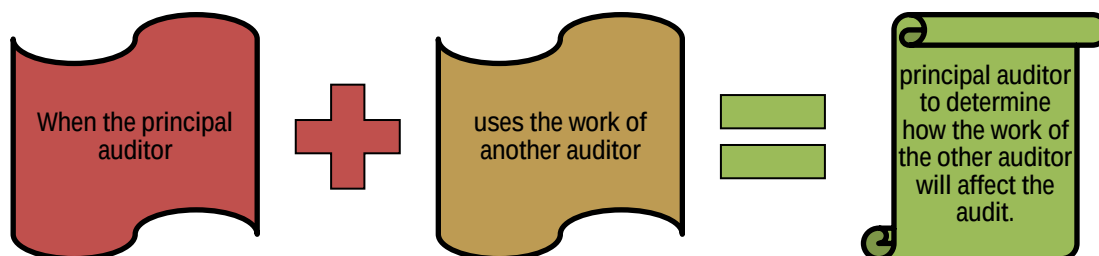
In addition to above, there are certain other considerations which auditor is required to take care while executing the audit, that are given below:

4.5.1 SA 600 - Using The Work of another Auditor





"Component" means a division, branch, subsidiary, joint venture, associated enterprises or other entity whose financial information is included in the financial information audited by the principal auditor.



The purpose of SA 600 (Using the work of another auditor) is to:

- establish standards to be applied in situations where Principal auditor,
- uses the work of other auditor
- with respect to the financial information of one or more components
- included in the financial information of the entity.

This Standard also discusses the principal auditor's responsibility in relation to his use of the work of the other auditor. In this Standard, the term 'financial information' encompasses 'financial statements'.

SA 600 does not deal with those instances where two or more auditors are appointed as joint auditors nor does it deal with the auditor's relationship with a predecessor auditor.

I. ACCEPTANCE AS PRINCIPAL AUDITOR

The auditor would consider the following before accepting his work as Principal auditor:

the materiality of the portion of the financial information which the principal auditor audits;

the principal auditor's degree of knowledge regarding the business of the components;

the risk of material misstatements in the financial information of the components audited by the other auditor(s); and

the performance of additional procedures as set out in this SA regarding the components audited by other auditor(s) resulting in the principal auditor having significant participation in such audit.

II. THE PRINCIPAL AUDITOR'S PROCEDURES

1. Right of Principal auditor to visit and examine books of accounts of a component



6. In certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of account and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component.

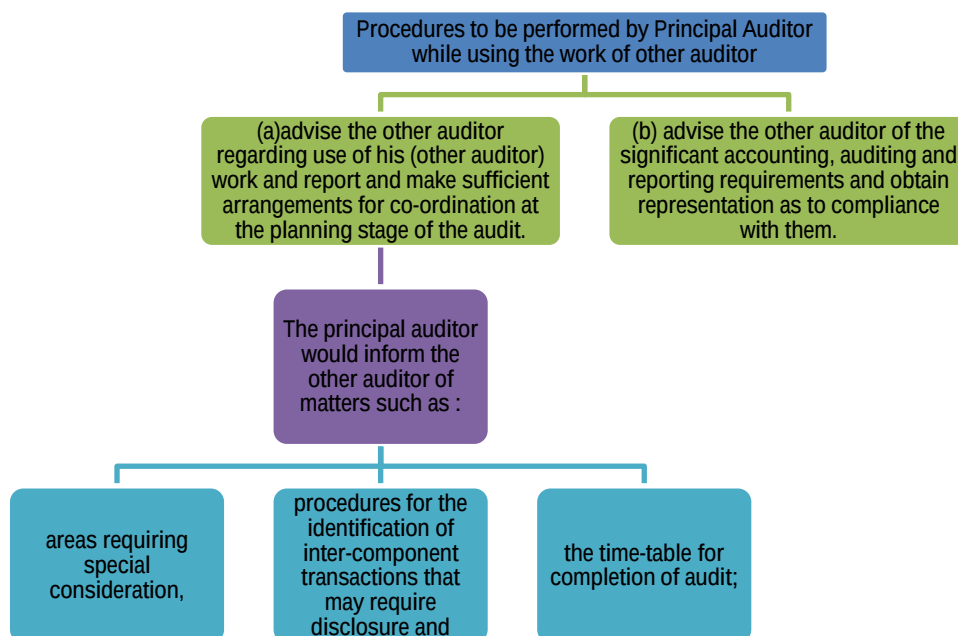
2. Principal auditor to consider the professional competence of other auditor



7. When planning to use the work of another auditor, the principal auditor should consider the professional competence of the other auditor in the context of specific assignment if the other auditor is not a member of the Institute of Chartered Accountants of India.

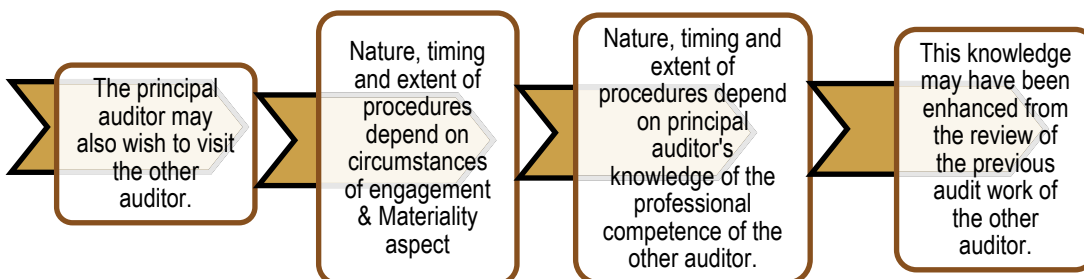
3. Procedures to be performed by principal auditor when using the work of other auditor

The principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinarily perform the procedures given in diagram above.



4. Principal auditor to review – written summary of other auditor's procedures

The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list.



5. The principal auditor should consider the significant findings of the other auditor.

The principal auditor may consider it appropriate to discuss with the other auditor and the management of the component, the audit findings or other matters affecting the financial information of the components.

He may also decide as to application of supplementary procedures that supplement tests of the records or the financial statements of the component, if deemed necessary. Such tests may, depending upon the circumstances, be performed by the principal auditor or the other auditor.

6. When other auditor is not a professionally qualified auditor.

In certain circumstances, the other auditor may happen to be a person other than a professionally qualified auditor.



8. For instance, where a component is situated in a foreign country and the applicable laws permit a person other than a professionally qualified auditor to audit the financial statements of such component.

7. Principal Auditor to document in his working papers – the components whose financial information audited by other auditors. The principal auditor should also document the procedures performed and the conclusions reached.



9. The auditor would document the results of discussions with the other auditor and review of the written summary of the other auditor's procedures.

However, the principal auditor need not document the reasons for limiting the procedures in the circumstances where sufficient appropriate audit evidence previously obtained that acceptable quality control policies and procedures are complied with in the conduct of other auditor's practice.

Where the other auditor's report is other than unmodified, the principal auditor should also document how he has dealt with the qualifications or adverse remarks contained in the other auditor's report in framing his own report.

III. CO-ORDINATION BETWEEN AUDITORS

There should be sufficient liaison between the principal auditor and the other auditor. For this purpose, the principal auditor may find it necessary to issue written communication(s) to the other auditor.

The other auditor, knowing the context in which his work is to be used by the principal auditor, should co-ordinate with the principal auditor-



10. By bringing to the principal auditor's immediate attention any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc. He should ensure compliance with the relevant statutory requirements.

Similarly, the principal auditor should advise the other auditor of any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.

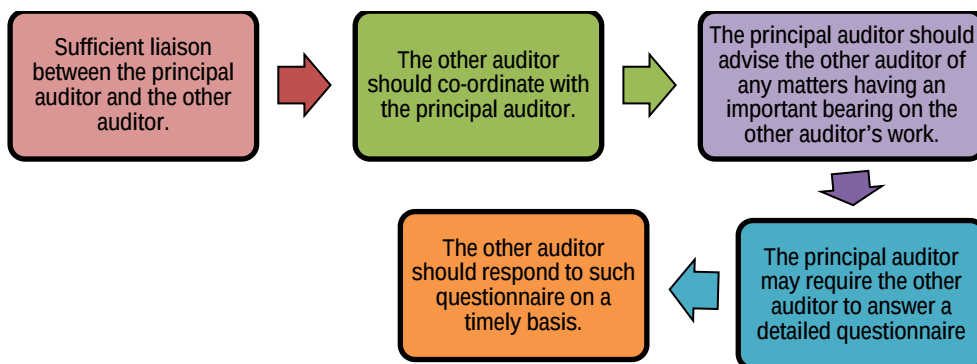


Diagram Showing Coordination Between the Auditors

IV. REPORTING CONSIDERATIONS

- Principal auditor to express a qualified opinion or disclaimer of opinion in case of a limitation on the scope of audit.



11. When the principal auditor concludes, based on his procedures, that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation on the scope of audit.

- If the other auditor issues a Modified Report



12. In all circumstances, if the other auditor issues, or intends to issue, a modified auditor's report, the principal auditor should consider whether the subject of the modification is of such nature and significance, in relation to the financial information of the entity on which the principal auditor is reporting that it requires a modification of the principal auditor's report.

V. DIVISION OF RESPONSIBILITY

The principal auditor would not be responsible in respect of the work entrusted to the other auditors, except in circumstances which should have aroused his suspicion about the reliability of the work performed by the other auditors.

When the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity. However, if the Principal Auditor notices any material

discrepancies, the same has to be brought to the knowledge of other Auditor. This should be incorporated in the Audit Report.

TEST YOUR UNDERSTANDING 4

CA. Sourabh is engagement partner conducting statutory audit of BBI Bank for SBT & Associates. The bank has 1034 branches spread all over the country which are audited by branch auditors. In respect of one large branch audited by a branch auditor, there were errors in NPA classification of many advances which were not pointed out by branch auditor in his report through memorandum of changes and NIL memorandum of changes was reported electronically.

During overall review of financial statements of bank by statutory auditor, the above said errors did not come into light. The statutory auditor had also called soft copies of internal inspection report and concurrent audit reports of above branch as part of overall review procedures. However, these reports did not point towards any irregularities in such accounts.

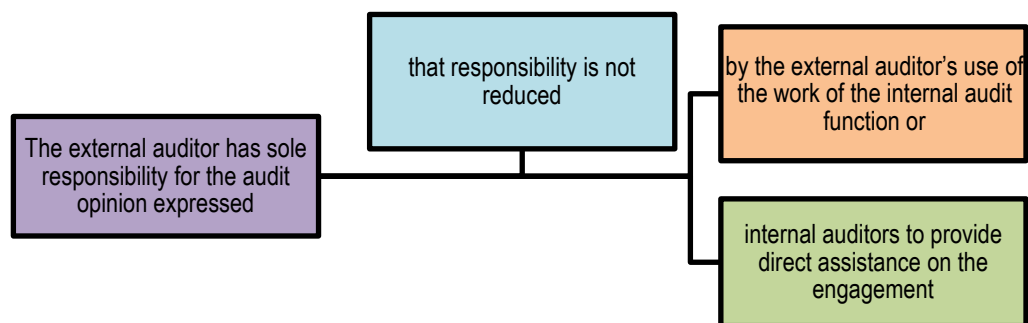
Would statutory auditor of bank be liable for above lapses? What precautions have to be taken by him while expressing opinion considering possibilities of such situations?

4.5.2 SA 610- Using the work of Internal Auditors

I. THE EXTERNAL AUDITOR'S RESPONSIBILITY FOR THE AUDIT

The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal audit function or internal auditors to provide direct assistance on the engagement. Although they may perform audit procedures similar to those performed by the external auditor, neither the internal audit function nor the internal auditors are independent of the entity as is required of the external auditor in an audit of financial statements in accordance with SA 200.

SA 610, "Using the work of Internal Auditors", therefore, defines the conditions that are necessary for the external auditor to be able to use the work of internal auditors. It also defines the necessary work effort to obtain sufficient appropriate evidence that the work of the internal audit function, or internal auditors providing direct assistance, is adequate for the purposes of the audit. The requirements are designed to provide a framework for the external auditor's judgments regarding the use of the work of internal auditors to prevent over or undue use of such work.



Review the Internal Auditor's Report which helps external auditor in procedural tests and audit planning.

II. SCOPE OF THIS SA

This (SA) deals with the external auditor's responsibilities if using the work of internal auditors. This includes

- (a) using the work of the internal audit function in obtaining audit evidence and
- (b) using internal auditors to provide direct assistance under the direction, supervision and review of the external auditor.

This SA does not apply if the entity does not have an internal audit function.

III. THE OBJECTIVES OF THE EXTERNAL AUDITOR, WHERE THE ENTITY HAS AN INTERNAL AUDIT FUNCTION

The objectives of the external auditor, where the entity has an internal audit function and the external auditor expects to use the work of the function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor, or to use internal auditors to provide direct assistance, are:

The objectives of the external auditor, where the entity has an internal audit function

To determine whether the work of the internal audit function or direct assistance from internal auditors can be used

If using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit

If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.

Meaning of Internal Audit Function & Direct Assistance–

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

Direct Assistance: The use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

The objectives and scope of internal audit functions: The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control such as the following:

<i>Activities Relating to Governance</i>	<i>Activities Relating to Risk Management</i>	<i>Activities Relating to Internal Control</i>
The internal audit function may assess the governance process in its accomplishment of objectives on : • ethics and values, performance management and accountability, • communicating risk and control information.	• The internal audit function may assist the entity by identifying and evaluating significant exposures to risk. • The internal audit function may perform procedures to assist the entity in the detection of fraud.	• Evaluation of internal control • Examination of financial and operating information • Review of operating activities. • Review of compliance with laws and regulations.

IV. EVALUATING WHETHER WORK OF THE INTERNAL AUDIT FUNCTION CAN BE USED FOR PURPOSES OF THE AUDIT

(i) The external auditor shall determine whether the work of the internal audit function can be used for purposes of the audit by evaluating the following: (a) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; (b) The level of competence of the internal audit function; and (c) Whether the internal audit function applies a systematic and disciplined approach, including quality control.	(ii) The external auditor shall not use the work of the internal audit function if the external auditor determines that: (a) The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors; (b) The function lacks sufficient competence; or (c) The function does not apply a systematic and disciplined approach, including quality control.

V. DETERMINING THE NATURE AND EXTENT OF WORK OF THE INTERNAL AUDIT FUNCTION THAT CAN BE USED

1. The external auditor shall consider the nature and scope of the work performed by Internal audit function.



13. Work of the internal audit function that can be used by the external auditor include the following:

- Testing of the operating effectiveness of controls.
- Substantive procedures involving limited judgment.
- Observations of inventory counts.
- Tracing transactions through the information system relevant to financial reporting.
- Testing of compliance with regulatory requirements.
- In some circumstances, audits or reviews of the financial information of subsidiaries that are not significant components to the group (where this does not conflict with the requirements of SA 600).

2. The external auditor shall make all significant judgments in the audit engagement and, to prevent undue use of the work of the internal audit function, shall plan to use less of the work of the function and perform more of the work directly:

(a)	More judgment is involved in:
(i)	Planning and performing relevant audit procedures; and
(ii)	Evaluating the audit evidence gathered;
(b)	The higher the assessed risk of material misstatement at the assertion level, with special consideration given to risks identified as significant;
(c)	The less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors; and
(d)	The lower the level of competence of the internal audit function.

3. Extent of involvement of external auditor: The external auditor shall also evaluate whether, in aggregate, using the work of the internal audit function to the extent planned would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed.

4. Communicate how the external auditor has planned to use the work of the internal audit function: The external auditor shall, in communicating with those charged with governance, share an overview of the planned scope and timing of the audit in accordance with SA 260, communicate how the external auditor has planned to use the work of the internal audit function.

VI. USING THE WORK OF THE INTERNAL AUDIT FUNCTION

1. Discussion and Coordination with the Internal Audit Function: If the external auditor plans to use the work of the internal audit function, the external auditor shall discuss the planned use of its work with the function as a basis for coordinating their respective activities.
2. The external auditor shall read the reports of the internal audit function relating to the work of the function that the external auditor plans to use to obtain an understanding of the nature and extent of audit procedures it performed and the related findings.
3. The external auditor shall perform sufficient audit procedures to determine adequacy of internal audit function for purposes of the audit, including evaluating whether:
 - (a) The work of the function had been properly planned, performed, supervised, reviewed and documented;
 - (b) Sufficient appropriate evidence had been obtained to enable the function to draw reasonable conclusions; and
 - (c) Conclusions reached are appropriate in the circumstances and the reports prepared by the function are consistent with the results of the work performed.
4. The nature and extent of the external auditor's audit procedures shall be responsive to the external auditor's evaluation of:
 - (a) The amount of judgment involved;
 - (b) The assessed risk of material misstatement;
 - (c) The extent to which the internal audit function supports the objectivity of the internal auditors; and
 - (d) The level of competence of the function.
5. The external auditor shall also evaluate whether the external auditor's conclusions regarding the internal audit function and the determination of the nature and extent of use of the work of the function for purposes of the audit remain appropriate.

VII. DETERMINING WHETHER INTERNAL AUDITORS CAN BE USED TO PROVIDE DIRECT ASSISTANCE FOR PURPOSES OF THE AUDIT

- (a) The external auditor prohibited from obtaining direct assistance from internal auditors.



14. In case where the external auditor is prohibited by law or regulation from using internal auditors to provide direct assistance, it is relevant for the principal auditors to consider whether the prohibition also extends to component auditors and, if so, to address this in the communication to the component auditors.

- (b) Using internal auditors to provide direct assistance is not prohibited

- (i) Evaluation of the existence and significance of threats to objectivity and the level of competence of the internal auditors.
- (ii) Evaluation of the existence and significance of threats shall include inquiry of the internal auditors.

The external auditor's evaluation of the existence and significance of threats to the internal auditors' objectivity shall include inquiry of the internal auditors regarding interests and relationships that may create a threat to their objectivity.

Objectivity refers to the ability to perform the proposed work without allowing bias, conflict of interest or undue influence of others to override professional judgments.

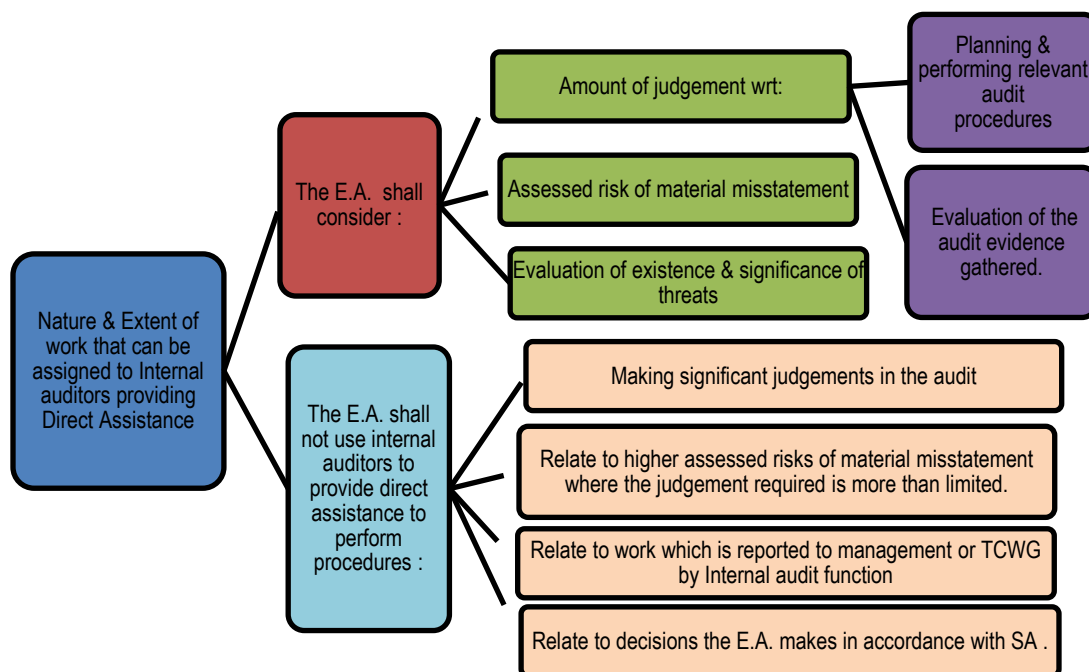
In evaluating the existence and significance of threats to the objectivity of an internal auditor, the following factors may be relevant:

	The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors.
	Family and personal relationships with an individual working in, or responsible for, the aspect of the entity to which the work relates.
	Association with the division or department in the entity to which the work relates.
	Significant financial interests in the entity other than remuneration on terms consistent with those applicable to other employees at a similar level of seniority.

The external auditor shall not use an internal auditor to provide direct assistance if:

(a) There are significant threats to the objectivity of the internal auditor; or	(b) The internal auditor lacks sufficient competence to perform the proposed work. As the function of Internal Auditor is again a concept of evaluation of Internal Control mechanism, it would amount to weaknesses in Internal Control System in case internal auditor does not apply required test procedures considering the Materiality aspects. This would in turn result in Higher Audit Risks.

Determining the Nature and Extent of Work that Can Be Assigned to Internal Auditors Providing Direct Assistance:



Review of the work performed by internal auditors

The external auditor shall direct, supervise and review the work performed by internal auditors on the engagement in accordance with SA 220. In doing so:

- The nature, timing and extent of direction, supervision, and review shall recognize that the internal auditors are not independent of the entity; and
- The review procedures shall include the external auditor checking back to the underlying audit evidence for some of the work performed by the internal auditors.

The direction, supervision and review by the external auditor shall be sufficient in order for the external auditor to be satisfied that the internal auditors have obtained sufficient appropriate audit evidence to support the conclusions based on that work.

[Note: Students are advised to refer SA 610 “Using the work of Internal Auditor” for more details, SA 610 is reproduced in Auditing Pronouncements.]

TEST YOUR UNDERSTANDING 5

CA. Keshavraj is conducting statutory audit of a listed company “Live with Nature Limited”. The company is engaged in producing environment-friendly niche products for new-born babies. There is also a well-functioning internal audit department in the company. On perusal of internal audit reports, he finds that not only verification of inventories was attended by internal auditor at regular intervals during the year, workings were also made in respect of inventory valuation as at year end.

He has also attended inventory count at end of financial year and no prima facie adverse inferences were drawn by him. However, on going through inventory reports, he gathers that inventories are being held for considerably long period before being sold. The internal audit reports have not taken this aspect into consideration. Should he choose to rely upon inventory valuation work performed by internal auditor?

Illustration 1

CA. Amboj, a practicing chartered accountant has been appointed as an internal auditor of Textile Ltd. He conducted the physical verification of the inventory at the year-end and handed over the report of such verification to CA. Kishore, the statutory auditor of the Company, for his view and reporting. Can CA. Kishore rely on such report?

Using the Work of Internal Auditor: As per SA 610 “Using the Work of Internal Auditors”, while determining whether the work of the internal auditors can be used for the purpose of the audit, the external auditor shall evaluate-

- (a) The extent to which the internal audit function’s organizational status and relevant policies and procedures support the objectivity of the internal auditors;
- (b) The level of competence of the internal audit function; and
- (c) Whether the internal audit function applies a systematic and disciplined approach, including quality control.

Further, the external auditor shall not use the work of the internal audit function if the external auditor

determines that:

- (a) The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;
- (b) The function lacks sufficient competence; or
- (c) The function does not apply a systematic and disciplined approach, including quality control.

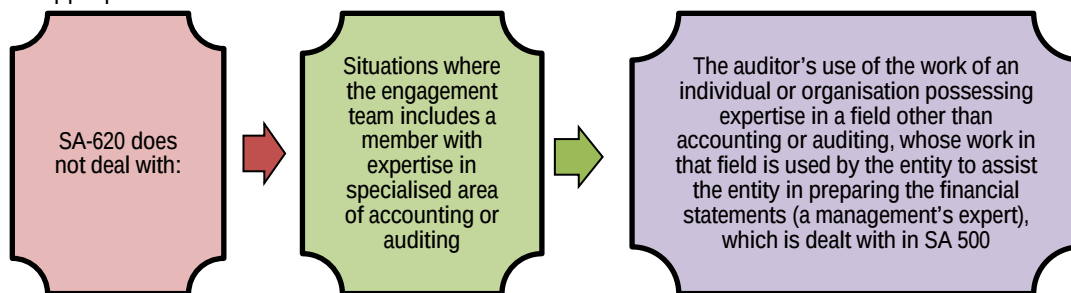
In the instant case, CA. Kishore should ascertain the internal auditor's scope of verification, area of coverage and method of verification. He should review the report on physical verification taking into consideration these factors. If possible, he should also test check few items and he can also observe the procedures performed by the internal auditors.

If the statutory auditor is satisfied about the appropriateness of the verification, he can rely on the report but if he finds that the verification is not in order, he has to decide otherwise. The final responsibility to express opinion on the financial statement remains with the statutory auditor.

4.5.3 SA 620-Using the Work of an Auditor's Expert

I. SCOPE OF SA 620

SA 620 deals with the auditor's responsibilities regarding the use of work in a field of expertise other than accounting or auditing when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence.



Auditor's Expert – An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert.

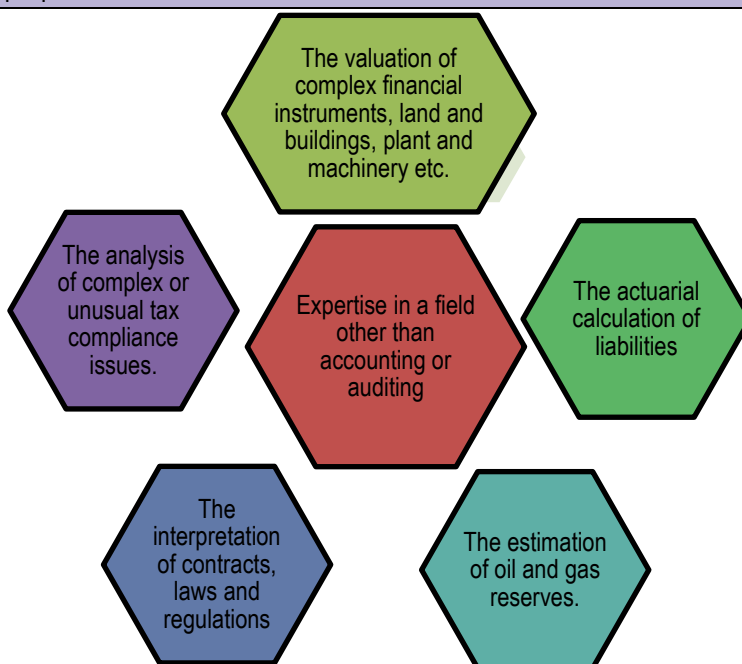
Management's Expert – An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

II. THE AUDITOR'S RESPONSIBILITY FOR THE AUDIT OPINION

The auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert. Nonetheless, if the auditor using the work of an auditor's expert, having followed this SA, concludes that the work of that expert is adequate for the auditor's purposes, the auditor may accept that expert's findings or conclusions in the expert's field as appropriate audit evidence.

The objectives of the auditor are:

- (a) To determine whether to use the work of an auditor's expert; and
- (b) If using the work of an auditor's expert, to determine whether that work is adequate for the auditor's purposes.



III. DETERMINING THE NEED FOR AN AUDITOR'S EXPERT

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.

Auditor may obtain understanding of other field: An auditor who is not an expert in a relevant field other than accounting or auditing may nevertheless be able to obtain a sufficient understanding of that field to perform the audit without an auditor's expert. This understanding may be obtained through.



15. Experience in auditing entities that require such expertise in the preparation of their financial statements.

- Education or professional development in the particular field. This may include formal courses, or discussion with individuals possessing expertise in the relevant field for the purpose of enhancing the auditor's own capacity to deal with matters in that field. Such discussion differs from consultation with an auditor's expert regarding a specific set of circumstances encountered on the engagement where that expert is given all the relevant facts that will enable the expert to provide informed advice about the particular matter.
- Discussion with auditors who have performed similar engagements.

IV. CONSIDERATIONS WHEN DECIDING WHETHER TO USE AN AUDITOR'S EXPERT

In other cases, however, the auditor may determine that it is necessary, or may choose, to use an auditor's expert to assist in obtaining sufficient appropriate audit evidence.

Considerations when deciding whether to use an auditor's expert may include:

- Whether management has used a management's expert in preparing the financial statements.
- The nature and significance of the matter, including its complexity.
- The risks of material misstatement in the matter.
- The expected nature of procedures to respond to identified risks, including the auditor's knowledge of and experience with the work of experts in relation to such matters; and the

availability of alternative sources of audit evidence.

When management has used a management's expert

When management has used a management's expert in preparing the financial statements, the auditor's decision on whether to use an auditor's expert may also be influenced by such factors as:

- The nature, scope and objectives of the management's expert's work.
- Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services.
- The extent to which management can exercise control or influence over the work of the management's expert.
- The management's expert's competence and capabilities.
- Whether the management's expert is subject to technical performance standards or other professional or industry requirements.
- Any controls within the entity over the management's expert's work.

V. NATURE, TIMING AND EXTENT OF AUDIT PROCEDURES

The nature, timing and extent of the auditor's procedures will vary depending on the circumstances. In determining the nature, timing and extent of those procedures, the auditor shall consider matters including:

- (a) The nature of the matter to which that expert's work relates;
- (b) The risks of material misstatement in the matter to which that expert's work relates;
- (c) The significance of that expert's work in the context of the audit;
- (d) The auditor's knowledge of and experience with previous work performed by that expert; and
- (e) Whether that expert is subject to the auditor's firm's quality control policies and procedures.



16. The following factors may suggest the need for different or more extensive procedures than would otherwise be the case:

- The work of the auditor's expert relates to a significant matter that involves subjective and complex judgments.
- The auditor has not previously used the work of the auditor's expert, and has no prior knowledge of that expert's competence, capabilities and objectivity.
- The auditor's expert is performing procedures that are integral to the audit, rather than

being consulted to provide advice on an individual matter.

- The expert is an auditor's external expert and is not, therefore, subject to the firm's quality control policies and procedures.

VI. THE COMPETENCE, CAPABILITIES AND OBJECTIVITY OF THE AUDITOR'S EXPERT

The auditor shall evaluate whether the auditor's expert has the necessary competence, capabilities and objectivity for the auditor's purposes. In the case of an auditor's external expert, the evaluation of objectivity shall include inquiry regarding interests and relationships that may create a threat to that expert's objectivity.



17. In case where that expert's work is subject to technical performance standards or other professional or industry requirements, ethical standards and other membership requirements of a professional body or industry association, accreditation standards of a licensing body, or requirements imposed by law or regulation.

VII. OTHER MATTERS THAT MAY BE RELEVANT INCLUDE

- The relevance of the auditor'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.



18. A particular actuary may specialise in property and casualty insurance, but has limited expertise regarding pension calculations.

- The auditor's expert's competence with respect to relevant accounting and auditing requirements



19. Knowledge of assumptions and methods, including models where applicable, 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 auditor's expert as the audit progresses.

VIII. EVALUATION OF THE SIGNIFICANCE OF THREATS TO OBJECTIVITY AND NEED FOR SAFEGUARDS

The evaluation of the significance of threats to objectivity and of whether there is a need for safeguards may depend upon the role of the auditor's expert and the significance of the expert's work in the context of the audit.



20. If a proposed auditor's expert is an individual who has played a significant role in preparing the information that is being audited, that is, if the auditor's expert is a management's expert.

Evaluating the objectivity of an auditor's external expert: When evaluating the objectivity of an auditor's external expert, it may be relevant to:

- (a) Inquire of the entity about any known interests or relationships that the entity has with the auditor's external expert that may affect that expert's objectivity.
- (b) Discuss with that expert any applicable safeguards, including any professional requirements that apply to that expert; 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 auditor's expert include:
 - Financial interests.
 - Business and personal relationships.
 - Provision of other services by the expert
 - In some cases, it may also be appropriate for the auditor to obtain a written representation from the auditor's external expert about any interests or relationships with the entity of which that expert is aware.

IX. OBTAINING AN UNDERSTANDING OF THE FIELD OF EXPERTISE OF THE AUDITOR'S EXPERT

The auditor shall obtain a sufficient understanding of the field of expertise of the auditor's expert to enable the auditor to:

- (a) Determine the nature, scope and objectives of that expert's work for the auditor's purposes; and
- (b) Evaluate the adequacy of that work for the auditor's purposes.

X. AGREEMENT WITH THE AUDITOR'S EXPERT

The auditor shall agree, in writing when appropriate, on the following matters with the auditor's expert:

- (a) The nature, scope and objectives of that expert's work;
- (b) The respective roles and responsibilities of the auditor and that expert;

- (c) The nature, timing and extent of communication between the auditor and that expert, including the form of any report to be provided by that expert; and

When the work of the auditor's expert relates to the auditor's conclusions regarding a significant risk, both a formal written report at the conclusion of that expert's work, and oral reports as the work progresses, may be appropriate. Identification of specific partners or staff who will liaise with the auditor's expert, and procedures for communication between that expert and the entity, assists timely and effective communication, particularly on larger engagements.

- (d) The need for the auditor's expert to observe confidentiality requirements.

It is necessary for the confidentiality provisions of relevant ethical requirements that apply to the auditor also to apply to the auditor's expert. Additional requirements may be imposed by law or regulation. The entity may also have requested that specific confidentiality provisions be agreed with auditor's external experts.

XI. EVALUATING THE ADEQUACY OF THE AUDITOR'S EXPERT'S WORK

The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including:

- (a) The relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence;

The Findings and Conclusions of the Auditor's Expert

Specific procedures to evaluate the adequacy of the auditor's expert's work for the auditor's purposes may include:

- Inquiries of the auditor's expert.
- Reviewing the auditor's expert's working papers and reports.
- Corroborative procedures, such as:
 - Observing the auditor's expert's work;
 - Examining published data, such as statistical reports from reputable, authoritative sources;
 - Confirming relevant matters with third parties;
 - Performing detailed analytical procedures to see whether Principles of materiality aspects considered; and
 - Re-performing calculations.

- Discussion with another expert with relevant expertise when, for example, the findings or conclusions of the auditor's expert are not consistent with other audit evidence.
- Discussing the auditor's expert's report with management.

(b) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and

Assumptions and Methods: When the auditor's expert's work is to evaluate underlying assumptions and methods, including models where applicable, used by management in developing an accounting estimate, the auditor's procedures are likely to be primarily directed to evaluating whether the auditor's expert has adequately reviewed those assumptions and methods.

When the auditor's expert's work is to develop an auditor's point estimate or an auditor's range for comparison with management point's estimate, the auditor's procedures may be primarily directed to evaluating the assumptions and methods, including models where appropriate, used by the auditor's expert.

SA 540 discusses the assumptions and methods used by management in making accounting estimates, including the use in some cases of highly specialised, entity-developed models. Although that discussion is written in the context of the auditor obtaining sufficient appropriate audit evidence regarding management's assumptions and methods, it may also assist the auditor when evaluating an auditor's expert's assumptions and methods.

When an auditor's expert's work involves the use of significant assumptions and methods, factors relevant to the auditor's evaluation of those assumptions and methods include whether they are:

- Generally accepted within the auditor's expert's field;
- Consistent with the requirements of the applicable financial reporting framework;
- Dependent on the use of specialised models; and

Consistent with those of management, and if not, the reason for, and effects of, the differences.

- (c) If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data.

When an auditor's expert's work involves the use of source data that is significant to that expert's work, procedures such as the following may be used to test that data:

- Verifying the origin of the data, including obtaining an understanding of, and 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

XII. WHEN WORK OF THE AUDITOR'S EXPERT IS NOT ADEQUATE FOR THE AUDITOR'S PURPOSES

If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, the auditor shall:

- (a) Agree with that expert on the nature and extent of further work to be performed by that expert; or
- (b) Perform further audit procedures appropriate to the circumstances.



21. Inadequate Work : If the auditor concludes that the work of the auditor's expert is not adequate for the auditor's purposes and the auditor cannot resolve the matter through the additional audit procedures, which may involve further work being performed by both the expert and the auditor, or include employing or engaging another expert, it may be necessary to express a modified opinion in the auditor's report in accordance with SA 705 because the auditor has not obtained sufficient appropriate audit evidence.

XIII. REFERENCE TO THE AUDITOR'S EXPERT IN THE AUDITOR'S REPORT

- 1 The auditor shall not refer to the work of an auditor's expert in an auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the auditor shall indicate in the auditor's report that the reference does not reduce the auditor's responsibility for the audit opinion.



22. In some cases, law or regulation may require a reference to the work of an auditor's expert, for the purposes of transparency in the public sector.

- 2 If the auditor makes reference to the work of an auditor's expert in the auditor's report because such reference is relevant to an understanding of a modification to the auditor's opinion, the auditor shall indicate in the auditor's report that such reference does not reduce the auditor's responsibility for that opinion.

ILLUSTRATION 2

While doing audit, Ram, the Auditor requires reports from experts for the purpose of Audit evidence. What types of reports/opinions he can obtain and to what extent he can rely upon the same?

Using the Work of an Auditor's Expert: As per SA 620, "Using the Work of an Auditor's Expert", during the audit, the auditor may seek to obtain, in conjunction with the client or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert.

While doing audit, Ram, the auditor can obtain the following types of reports, or options or statements of an expert for the purpose of audit evidence:

- (i) 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.
- (ii) The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans.
- (iii) The estimation of oil and gas reserves.
- (iv) The valuation of environmental liabilities, and site clean-up costs.
- (v) The interpretation of contracts, laws and regulations.
- (vi) The analysis of complex or unusual tax compliance issues.

When the auditor intends to use the work of an expert, he shall evaluate the adequacy of the auditor's expert's work, including the relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence; if that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and if that expert's work involves the use of source data that is significant to his work, the relevance, completeness, and accuracy of that source data.

If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, he shall agree with that expert on the nature and extent of further work to be performed by that expert; or perform further audit procedures appropriate to the circumstances

4.5.4 SA 540-AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE ACCOUNTING ESTIMATES & RELATED DISCLOSURES

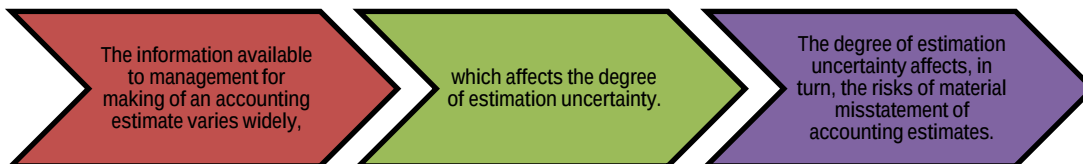
I. SCOPE OF THIS SA

This Standard on Auditing (SA) deals with the auditor's responsibilities regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how SA 315 and SA 330 and other relevant SAs are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.



II. NATURE OF ACCOUNTING ESTIMATES

Some financial statement items cannot be measured precisely, but can only be estimated. For purposes of this SA, such financial statement items are referred to as accounting estimates.



Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item.



23. Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements,

- Accounting estimates arising in entities that engage in business activities that are not complex.
- Accounting estimates that are frequently made and updated because they relate to routine transactions.
- Accounting estimates derived from data that is readily available, such as published interest rate data or exchange-traded prices of securities. Such data may be referred to as “observable” in the context of a fair value accounting estimate.
- Fair value accounting estimates where the method of measurement prescribed by the applicable financial reporting framework is simple and applied easily to the asset or liability requiring measurement at fair value.
- Fair value accounting estimates where the model used to measure the accounting estimate is well-known or generally accepted, provided that the assumptions or inputs to the model are observable.



24. For some accounting estimates, however, there may be relatively high estimation uncertainty, particularly where they are based on significant assumptions, for example:

- Accounting estimates relating to the outcome of litigation.
- Fair value accounting estimates for derivative financial instruments not publicly traded.
- Fair value accounting estimates for which a highly specialised entity-developed model is used or for which, there are assumptions or inputs that cannot be observed in the marketplace. Accounting estimates in cases of Wage Revision Agreements wherein negotiations with the Trade Unions is on the way or Government’s sanction is awaited leading to uncertainty.

III. THE DEGREE OF ESTIMATION UNCERTAINTY

The degree of estimation uncertainty varies based on :

the nature of the accounting estimate,

the extent to which there is a generally accepted method used to make the accounting estimate,

the subjectivity of the assumptions used to make the accounting estimate

1. Not all financial statement items requiring measurement at fair value, involve estimation uncertainty.



25. This may be the case for some financial statement items where there is an active and open market that provides readily available and reliable information on the prices at which actual exchanges occur, in which case the existence of published price quotations ordinarily is the best audit evidence of fair value.

However, estimation uncertainty may exist even when the valuation method and data are well defined. For example, valuation of securities quoted on an active and open market at the listed market price may require adjustment if the holding is significant in relation to the market or is subject to restrictions in marketability. In addition, general economic circumstances prevailing at the time, for example, illiquidity in a particular market, may impact estimation uncertainty.



26. Examples of situations where accounting estimates, other than fair value accounting estimates, may be required include:

- Allowance for doubtful accounts.
- Inventory obsolescence.
- Warranty obligations.
- Depreciation method or asset useful life.
- Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability.
- Outcome of long term contracts.
- Financial Obligations / Costs arising from litigation settlements and judgments.



27. Examples of situations where fair value accounting estimates may be required include:

- 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, for example, a non-monetary exchange of plant facilities in different lines of business.

2. **Estimation involves judgments:** Estimation involves judgments based on information available when the financial statements are prepared. For many accounting estimates, these include making assumptions about matters that are uncertain at the time of estimation. The auditor is not responsible for predicting future conditions, transactions or events that, if known at the time of the audit, might have significantly affected management's actions or the assumptions used by management.

IV. MANAGEMENT BIAS

Financial reporting frameworks often call for neutrality, that is, freedom from bias. Accounting estimates are imprecise, however, and can be influenced by management judgment. Such judgment may involve unintentional or intentional management bias (for example, as a result of motivation to achieve a desired result).

The susceptibility of an accounting estimate to management bias increases with the subjectivity involved in making it.

Unintentional management bias and the potential for intentional management bias are inherent in subjective decisions that are often required in making an accounting estimate. For continuing audits, indicators of possible management bias identified during the audit of the preceding periods influence the planning and risk identification and assessment activities of the auditor in the current period.

Management bias can be difficult to detect at an account level.

-  It may only be identified when considered in the aggregate of groups of accounting estimates or
-  all accounting estimates, or
-  when observed over a number of accounting periods.

Although some form of management bias is inherent in subjective decisions, in making such judgments, there may be no intention by management to mislead the users of financial statements.

Where, however, there is intention to mislead, management bias is fraudulent in nature.

V. THE MEASUREMENT OBJECTIVE OF ACCOUNTING ESTIMATES

The measurement objective of accounting estimates can vary depending on the applicable financial reporting framework and the financial item being reported. The measurement objective for some accounting estimates is to forecast the outcome of one or more transactions, events or conditions giving rise to the need for the accounting estimate. For other accounting estimates, including many fair value accounting estimates, the measurement objective is different, and is expressed in terms

of the value of a current transaction or financial statement item based on conditions prevalent at the measurement date, such as estimated market price for a particular type of asset or liability.



28. For example, the applicable financial reporting framework may require fair value measurement based on an assumed hypothetical current transaction between knowledgeable, willing parties (sometimes referred to as “marketplace participants” or equivalent) in an arm’s length transaction, rather than the settlement of a transaction at some past or future date.

A difference between the outcome of an accounting estimate and the amount originally recognised or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements. This is particularly the case for fair value accounting estimates, as any observed outcome is invariably affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements.

VI. OBJECTIVE OF SA 540

The objective of the auditor is to obtain sufficient appropriate audit evidence whether in the context of the applicable financial reporting framework:

- (a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognised or disclosed, are reasonable; and
- (b) related disclosures in the financial statements are adequate.

Important Definition:

Accounting estimate – An approximation of a monetary amount in the absence of a precise means of measurement. This term 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.

Auditor’s point estimate or auditor’s range – The amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management’s point estimate

Management bias – A lack of neutrality by management in the preparation and presentation of information.

Management’s point estimate – The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.

Estimation uncertainty – The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.

Outcome of an accounting estimate –The actual monetary amount which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by the accounting estimate.

VII. AUDITOR'S RESPONSIBILITY /AUDIT PROCEDURES

1. **Risk assessment procedures and related activities for accounting estimates:** When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, as required by SA 315, the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates:
 - (a) The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures.
 - (b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed in the financial statements. In obtaining this understanding, 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. As the assessment of accounting estimates affects the ultimate decision in forming an opinion, much care has to be taken in this regard. It is highly important as the auditors conclusion is based on above basis.
2. **Obtaining an Understanding of How Management Identifies the Need for Accounting Estimates:** In preparing the financial statements, management has the responsibility to determine whether a transaction, event or condition gives rise to the need to make an accounting estimate, and that all necessary accounting estimates have been recognised, measured and disclosed in the financial statements in accordance with the applicable financial reporting framework.

The auditor's understanding of the entity and its environment obtained during the performance of risk assessment procedures, together with other audit evidence obtained during the course of the audit, assist the auditor in identifying circumstances, or changes in circumstances, that may give rise to the need for an accounting estimate.

Inquiries of management about changes in circumstances may include, for example, inquiries about whether:

- The entity has engaged in new types of transactions that may give rise to accounting estimates.

- Terms of transactions that gave rise to accounting estimates that have changed.
- Accounting policies relating to accounting estimates have changed, as a result of changes to the requirements of the applicable financial reporting framework or otherwise.
- Regulatory or other changes outside the control of management have occurred that may require management to revise, or make new, accounting estimates.
- New conditions or events have occurred that may give rise to the need for new or revised accounting estimates.

During the audit, the auditor may identify transactions, events and conditions that give rise to the need for accounting estimates that management failed to identify. SA 315 deals with circumstances where the auditor identifies risks of material misstatement that management failed to identify, including determining whether there is a significant deficiency in internal control with regard to the entity's risk assessment processes.

3. How management makes the accounting estimates: How management makes the accounting estimates, and an understanding of the data on which they are based, including:
- (i) The method, including where applicable the model, used in making the accounting estimate;
 - (ii) Relevant controls;
 - (iii) Whether management has used an expert;
 - (iv) The assumptions underlying the accounting estimates;
 - (v) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and
 - (vi) Whether and, if so, how management has assessed the effect of estimation uncertainty.

The auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. 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.

4. **Estimation Uncertainty:** For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of SA 330, the auditor shall evaluate the following:

- (a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.
- (b) Whether the significant assumptions used by management are reasonable.
- (c) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.

If, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor shall, if considered necessary, develop a range with which to evaluate the reasonableness of the accounting estimate.

Recognition and Measurement Criteria: For accounting estimates that give rise to significant risks, the auditor shall obtain sufficient appropriate audit evidence whether the following are in accordance with the requirements of the applicable financial reporting framework:

- (a) management's decision to recognise, or to not recognise, the accounting estimates in the financial statements; and
- (b) the selected measurement basis for the accounting estimates.

I. Identifying and Assessing the Risks of Material Misstatements:

- (a) In identifying and assessing the risks of material misstatement as required by SA 315, the auditor shall evaluate the degree of estimation uncertainty associated with accounting estimates.
- (b) The auditor shall determine whether, in the auditor's judgment, any of those accounting estimate that have been identified as having high estimation uncertainty give rise to significant risk.

II. Responses to the Assessed Risks of Material Misstatement:

- (a) Based on assessed risk of material misstatement the auditor, shall determine:
 - Whether management has appropriately applied the applicable financial reporting framework relevant to the accounting estimate; and.

- Whether the methods for making the accounting estimates are appropriate and have been applied consistently
 - If there are changes in accounting estimates or in the method used for making those from prior period, are those appropriate in the present circumstances.
- (b) In response to the assessed risk of material misstatement, the auditor shall undertake one or more of the following, taking in account the nature of the accounting estimates.
- Determine whether events occurring up to the date of the auditor's report provide sufficient audit evidence regarding the accounting estimate.
 - Test checks the data used by the management for making accounting estimate.
 - The auditor shall also evaluate whether the method used for measurement is appropriate in the circumstances and assumptions made by the management are reasonable in the light of the measurement objective of the applicable financial reporting. This can be achieved by
 - Testing the extent to which data on which accounting estimate is based is accurate, complete and relevant and whether the accounting estimate has been properly determined using such data and management assumptions.
 - Considering the source, relevance and reliability of external data.
 - Recalculating the accounting estimate and reviewing information about an accounting estimate for internal consistency.
 - Test checks the effectiveness of the controls over the estimates used by the management together with appropriate substantive procedure.
- (c) While determining the matters identified or in responding to the assessed risks of material misstatement, the auditor shall consider whether specialized skills or knowledge in relation to one or more aspects of the accounting estimates are required in order to obtain sufficient appropriate audit evidence.

5. **Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements:** The auditor shall evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework, or are misstated.

VIII. AUDIT REPORTING & DISCLOSURE:

Disclosures Related to Accounting Estimates

The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the

financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework.

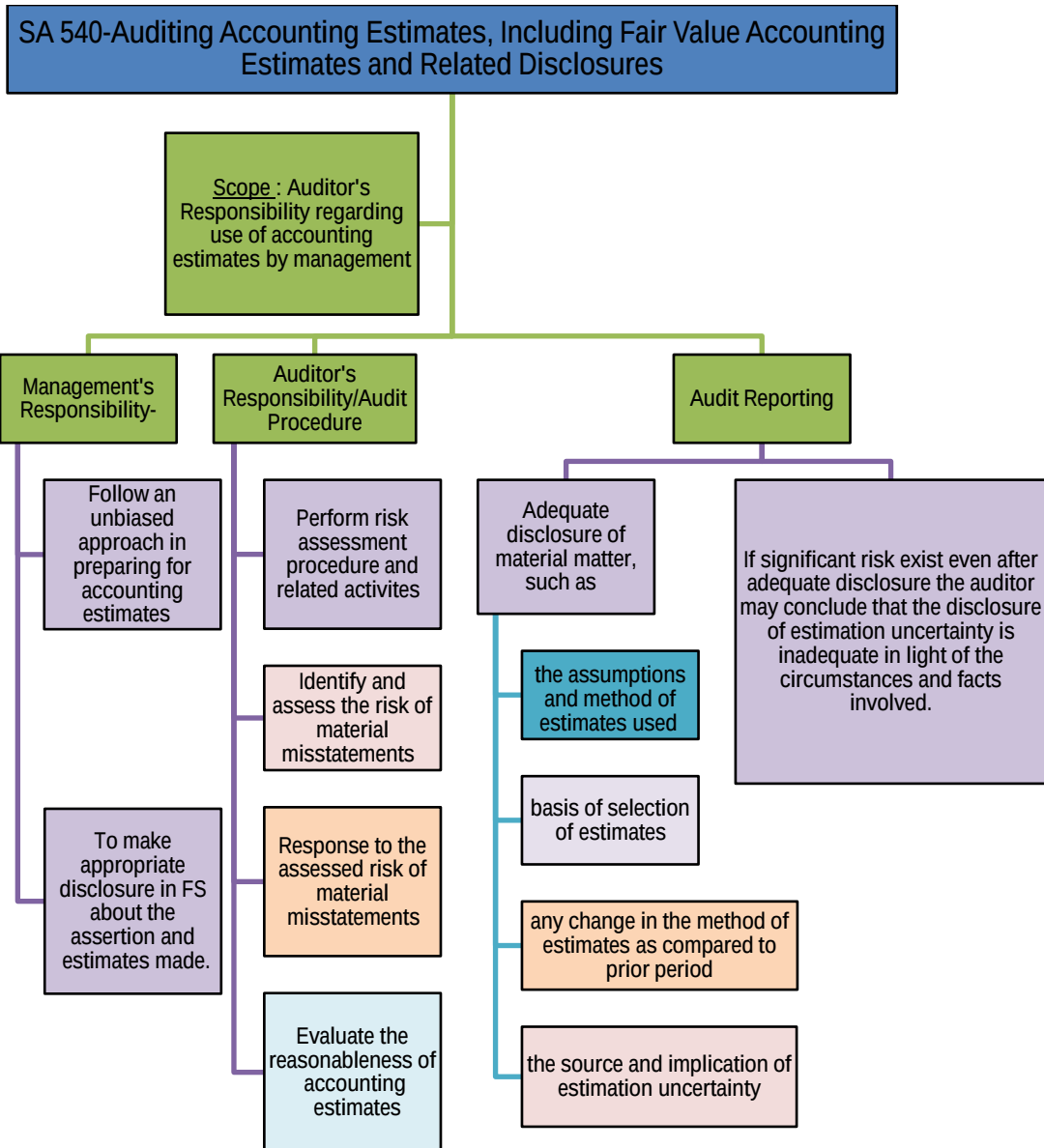
For accounting estimates that give rise to significant risks, the auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework

(a) The presentation of financial statement in accordance with the applicable financial reporting framework includes adequate disclosure of material matters. These disclosures may include, • The assumptions used. • The method of estimation used, including any applicable model. • The basis for the selection of the estimation. • Any changes in the method of estimation from prior period and its subsequent effect. • The sources and implication of estimation uncertainty.	(b) In relation to accounting estimate having significant risk, even where the disclosures are in accordance with the applicable financial reporting framework, the auditor may conclude that the disclosure of estimation uncertainty is inadequate in light of the circumstances and facts involved.

Written Representations: The auditor shall obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable.

Documentation of Accounting Estimates

The audit documentation shall include:
(a) The basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks; and
(b) Indicators of possible management bias, if any.



4.5.5 CONTROL OF QUALITY OF AUDIT WORK

Under SQC 1, the firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance that:

- (a) The firm and its personnel comply with professional standards and regulatory and legal requirements; and
- (b) The reports issued by the firm or engagement partners are appropriate in the circumstances.

Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement and provide the firm with relevant information to enable the functioning of that part of the firm's system of quality control relating to independence.

Engagement teams are entitled to rely on the firm's system of quality control, unless information provided by the firm or other parties suggests otherwise. SA 220 deals with audit quality at individual engagement level.

The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:

(a) The audit complies with professional standards and regulatory and legal requirements; and	(b) The auditor's report issued is appropriate in the circumstances.

(Students may refer Chapter 1 Quality Control for more details)

4.5.6 ANALYTICAL PROCEDURES PRIOR TO AUDIT AS WELL AS TOWARDS FINALIZATION

I. WHEN DESIGNING AND PERFORMING SUBSTANTIVE ANALYTICAL PROCEDURES

As per SA 520, "Analytical Procedures" the auditor shall:

- (a) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;
- (b) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;
- (c) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and
- (d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required.

II. ANALYTICAL PROCEDURES THAT ASSIST WHEN FORMING AN OVERALL CONCLUSION

The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent

with the auditor's understanding of the entity.

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

The results of such analytical procedures may identify a previously unrecognised risk of material misstatement. In such circumstances, SA 315 requires the auditor to revise the auditor's assessment of the risks of material misstatement and modify the further planned audit procedures accordingly.

The analytical procedures performed in accordance with above may be similar to those that would be used as risk assessment procedures.

III. INVESTIGATING RESULTS OF ANALYTICAL PROCEDURES

If analytical procedures performed in accordance with this SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

- (a) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses; and
- (b) Performing other audit procedures as necessary in the circumstances: The need to perform other audit procedures may arise when, 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.

Integrated Case Scenario

CA. Anoothi has been offered appointment as auditor of an NSE listed company. She has already ticked checkboxes relating to her independence vis-à-vis company and integrity of promoters and key management personnel. Being satisfied on this count and after sending formal engagement letter to the company, she is in midst of planning activities for company's audit. Owner of country's one of topmost writing instrument brands, above said company is in business of producing ball pens, gel pens, markers, folders and such general stationery products.

Business profile of the company including its brief history, detail of its key managerial persons and brief description of company's activities was obtained by her. She has also studied reports relating to growth of India's stationery market due to greater demand and impact of government driven

schemes like *Sarv Shiksha Abhiyaan (SSA)*. Besides, she has also obtained risk management policy of the company which contained company's strategy to contain various risks.

On perusal of financial statements of company, it is noticed that the company's inventories as at close of financial year stood at Rs. 200 crore which constitutes about 25% of its total assets. She is planning to identify significant audit risks pertaining to valuation of inventories.

She is also considering about materiality level for financial statements as a whole.

Keeping in view above, answer the following questions: -

1 The compliance with independence requirements and verification of integrity of promoters and key management personnel has been ensured by CA. Anoothi. In this regard, which of the following statements is likely to be a complete statement?

(a) Such activities are required to performed strictly in terms of requirements and procedures outlined in code of ethics issued by ICAI.

(b) Such activities are required to be performed in respect of an audit engagement in accordance with SA 220 and these preliminary engagement activities are specifically identified in SA 210.

(c) Such activities are required to performed in respect of an audit engagement in accordance with SA 220 and these preliminary engagement activities form part of planning an audit in accordance with SA 300.

(d) Such activities are required to be performed in terms of requirements and procedures outlined in code of ethics issued by ICAI and are specifically identified in SA 210.

2. The auditor has obtained risk management policy of the company. Which of the following statements is most appropriate in this regard?

(a) The understanding of company's risk management policy is required by auditor. It may help the auditor in identifying risks of material misstatement that management failed to identify.

(b) The understanding of company's risk management policy is not required by auditor. It deals with business risks of company. Audit risk is not influenced by company's business risks.

(c) The understanding of company's risk management policy is required by auditor. However, it cannot help the auditor in identifying risks of material misstatement that management failed to identify.

(d) The understanding of company's risk management policy is sufficient for an auditor to develop an audit plan.

3. Which of the following is not likely to be a procedure for auditor to understand the company?
- (a) Performing an online search to identify press reports relating to the company
 - (b) Reviewing any new SEBI and stock exchange requirements
 - (c) Reviewing whether fresh moneys were raised from public
 - (d) Seeking confirmation letters from bankers regarding outstanding balances
4. Considering auditor's intention to identify significant audit risks pertaining to inventory valuation, which of the following statements is likely to be true?
- (a) Procedures planned to identify significant audit risks pertaining to inventory valuation forms part of overall audit plan.
 - (b) Procedures planned to identify significant audit risks pertaining to inventory valuation forms part of overall audit strategy.
 - (c) Procedures planned to identify significant audit risks pertaining to inventory valuation forms part of tests of controls.
 - (d) Procedures planned to identify significant audit risks pertaining to inventory valuation forms part of tests of details.
5. In relation to materiality levels for financial statements as a whole, which of the following statements is most appropriate?
- (a) Materiality has to be decided by auditor after identification and assessment of risks of material misstatements.
 - (b) Materiality has to be decided by auditor prior to identification and assessment of risks of material misstatements.
 - (c) Materiality has to be decided by auditor after performing risk assessment procedures.
 - (d) Materiality has to be decided by auditor at time of designing tests of controls and substantive procedures.

Key Takeaways

- Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan.
- The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

- The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members.
- The audit programme may contain audit objectives for each area and should have sufficient detail to serve as a set of instructions to the assistants involved in the audit and as means to control the proper execution of work.
- During audit execution, there are certain other considerations which auditor is required to take care while executing the audit including responsibilities to use work of other auditor, work of internal auditors, work of auditor's expert. Besides, auditor has responsibilities regarding estimates. He has to apply analytical procedures towards finalization of audit in accordance with SA 520. Engagement has to be performed in qualitative manner in accordance with SA 220.
- SA 600 discusses the principal auditor's responsibility in relation to his use of the work of the other auditor.
- SA 610 defines the conditions that are necessary for the external auditor to be able to use the work of internal auditors. It also defines the necessary work effort to obtain sufficient appropriate evidence that the work of the internal audit function, or internal auditors providing direct assistance, is adequate for the purposes of the audit.
- SA 620 deals with the auditor's responsibilities regarding the use of work in a field of expertise other than accounting or auditing when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence
- SA 540 deals with the auditor's responsibilities regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.

FOR SHORTCUT TO ENGAGEMENT & QUALITY CONTROLS STANDARDS WISDOM:
SCAN ME !



TEST YOUR KNOWLEDGE

Theoretical Questions

1. While auditing Z Ltd., you observe certain material financial statement assertions have been based on estimates made by the management. As the auditor how do you minimize the risk of material misstatements?
2. KRP Ltd., at its annual general meeting, appointed Mr. X, Mr. Y and Mr. Z as joint auditors to conduct audit for the financial year 2022-23. For the valuation of gratuity scheme of the company, Mr. X, Mr. Y and Mr. Z wanted to refer their own known Actuaries. Due to difference of opinion, all the joint auditors consulted their respective Actuaries. Subsequently, major difference was found in the actuarial reports. However, Mr. X agreed to Mr. Y's actuary report, though, Mr. Z did not. Mr. X contends that Mr. Y's actuary report shall be considered in audit report due to majority of votes. Now, Mr. Z is in dilemma. Explain the responsibility of auditors, in case, report made by Mr. Y's actuary, later on, was found faulty.
3. A & Co. was appointed as auditor of Great Airways Ltd. As the audit partner what factors shall be considered in the development of overall audit plan?
4. As an auditor of garment manufacturing company for the last five years, you have observed that new venture of online shopping has been added by the company during current year. What factors would be considered by you in formulating the audit strategy of the company?
5. During the audit of FMP Ltd, a listed company, Engagement Partner (EP) completed his reviews and also ensured compliance with independence requirements that apply to the audit engagement. The engagement files were also reviewed by the Engagement Quality Control Reviewer (EQCR) except the independence assessment documentation. Engagement Partner was of the view that matters related to independence assessment are the responsibility of the Engagement Partner and not Engagement Quality Control Reviewer. Engagement Quality Control Reviewer objected to this and refused to sign off the documentation. Please advise as per SA 220.
6. AKJ Ltd is a small-sized 30 years old company having business of manufacturing of pipes. Company has a plant based out of Dehradun and have their corporate office in Delhi. Recently the company appointed new firm of Chartered Accountants as their statutory auditors.

The statutory auditors want to enter into an engagement letter with the company in respect of their services but the management has contended that since the statutory audit is

mandated by law, engagement letter may not be required. Auditors did not agree to this and have shared a format of engagement letter with the management for their reference before getting that signed. In this respect management would like to understand that as per SA 210 (auditing standard referred to by the auditors), if the agreed terms of the engagement shall be recorded in an engagement letter or other suitable form of written agreement, what should be included in terms of agreed audit engagement letter?

7. *A private company is engaged in the business of real estate. The auditor of the company requested the information from the management to review the outcome of accounting estimates (like estimated costs considered for percentage completion etc) included in the prior period financial statements and their subsequent re-estimation for the purpose of the current period.*

The management has refused the information to the auditor saying that the review of prior period information should not be done by the auditor. Please advise.

8. *X Ltd had a net worth of INR 1300 crores because of which Ind AS became applicable to them. The company had various derivative contracts – options, forward contracts, interest rate swaps etc. which were required to be fair valued for which company got the fair valuation done through an external third party. The statutory auditors of the company involved an auditor's expert to audit valuation of derivatives. Auditor and auditor's expert were new to each other i.e. they were working for the first time together but developed a good bonding during the course of the audit. The auditor did not enter into any formal agreement with the auditor's expert. Please advise.*

9. *Cineplex, a movie theatre complex, is the foremost theatre located in Delhi. Along with the sale of tickets over the counter and online booking, the major proportion of income is from the cafe, shops, pubs etc. located in the complex. Its other income includes advertisements exhibited within/outside the premises such as hoardings, banners, slides, short films etc. The facility for parking of vehicles is also provided in the basement of the premises.*

Cineplex appointed your firm as the auditor of the entity. Being the head of the audit team, you are, therefore, required to draw an audit programme initially in respect of its revenue and expenditure considering the above mentioned facts along with other relevant points relating to such complex.

Answers to Test your Understanding

1. SA 300 requires the auditor to plan the audit in such a manner that it is performed effectively. It also requires auditor to establish overall audit strategy including identifying the characteristics of the engagement, facilitating him to define its scope and planning of nature, timing and extent of audit procedures required to be performed to achieve the objective of audit.

SA 300 further requires the auditor to document the overall audit strategy, the audit plan and any significant changes made during the audit engagement to such plans.

In the given situation, auditor didn't even once visit the company and failed to understand about business of the company. Therefore, he has flouted requirement of SA 300 to plan the audit in such a manner that it is performed effectively. The auditor has to plan the audit commensurate to the nature and complexity of the business of the entity and identify and assess the risk of material misstatement.

Further, working papers of auditor also do not show his understanding of nature of business which is again a blatant violation of requirement of SA 300 which requires the auditor to document the overall audit strategy, the audit plan and any significant changes made during the audit engagement to such plans.

Inclusion of a checklist in working papers having requirement of test checking of cost of raw material consumed & cost of stores and spares shows that it was a general checklist and specifics of business were never understood and audit was not planned to be conducted in an effective manner in accordance with requirements of SA 300.

2. SA 300 states that audit plan shall include description about nature, timing and extent of audit procedures. The extent of audit procedures also includes deciding about sample sizes to be tested for performing audit procedures. Therefore, the said approach is not proper. Various procedures planned to be undertaken should also include considerations relating to sample sizes to be tested.
3. SA 300 requires auditor to document audit plan and significant changes made during the audit engagement to the audit plan. It also requires auditor to document reasons for such changes.

The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response

to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance.

Further, changes to audit plan along with reasons thereof due to embarking upon extensive procedures related to verification of foreign contributions in comparison to what was originally envisaged need to be documented.

Failure to document audit plan could entail risk of not conducting audit according to professional standards in a qualitative manner.

4. SA 600 states that the principal auditor would not be responsible in respect of the work entrusted to the other auditors, except in circumstances which should have aroused his suspicion about the reliability of the work performed by the other auditors. When the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/branches/subsidiaries or other components audited by other auditors.

In the given situation, nothing has come to light of statutory auditor which would arouse his suspicion about reliability of work performed by branch auditor. Therefore, he would not be responsible for work performed by branch auditor.

Further, it should be clearly stated in the report that 1034 branches of bank have been audited by branch auditors.

5. For a particular account balance, class of transaction or disclosure, the higher an assessed risk of material misstatement at the assertion level, the more judgment is often involved in planning and performing the audit procedures and evaluating the results thereof. In such circumstances, the external auditor will need to perform more procedures directly and accordingly, make less use of the work of the internal audit function in obtaining sufficient appropriate audit evidence. Furthermore, as explained in SA 200, the higher the assessed risks of material misstatement, the more persuasive the audit evidence required by the external auditor will need to be, and, therefore, the external auditor will need to perform more of the work directly.

In the given situation, inventories are being held for considerably long period before being sold. As company is dealing in niche products for new-born babies, there is a risk of inventory obsolescence due to changes in customer preferences. It carries a significant risk of material

misstatement and requires more judgment on part of statutory auditor in planning and performing procedures.

In such circumstances, statutory auditor needs to perform procedures directly like comparing net realizable value of products with costs to verify completeness of provisions, recomputing of provisions for obsolete stocks etc.

Therefore, in the given situation, he should perform procedures directly in accordance with SA 610.

Answers to Integrated Case Scenario

1. (c)
2. (a)
3. (d)
4. (a)
5. (b)

Answers to Theoretical Questions

1. As per SA 540 "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatements for accounting estimates:
 - (i) The requirements of the applicable financial reporting framework relevant to the accounting estimates, including related disclosures.
 - (ii) How Management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed, in the financial statements. In obtaining this understanding, 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.
 - (iii) The estimation making process adopted by the management including-
 - (1) The method, including where applicable the model, used in making the accounting estimates.

- (2) Relevant controls.
 - (3) Whether management has used an expert?
 - (4) The assumption underlying the accounting estimates.
 - (5) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and
 - (6) Whether and, if so, how the management has assessed the effect of estimation uncertainty.
2. Using the work of an Auditor's Expert: As per SA 620 "Using the Work of an Auditor's Expert", the expertise of an expert may be required in the actuarial calculation of liabilities associated with insurance contracts or employee benefit plans etc., however, the auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert.

The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including the relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence as per SA 500.

Further, in view of SA 620, if the expert's work involves use of significant assumptions and methods, then the relevance and reasonableness of those assumptions and methods must be ensured by the auditor and if the expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data in the circumstances must be verified by the auditor.

In the instant case, Mr. X, Mr. Y and Mr. Z, jointly appointed as auditors of KRP Ltd., referred their own known Actuaries for valuation of gratuity scheme. Actuaries are an auditor's expert as per SA 620. Mr. Y's referred actuary has provided the gratuity valuation report, which later on was found faulty. Further, Mr. Z is not in agreement with this report, therefore, he submitted a separate audit report specifically for such gratuity valuation.

In such situation, it was duty of Mr. X, Mr. Y and Mr. Z, before using the gratuity valuation report of Actuary, to ensure the relevance and reasonableness of assumptions and methods used. They were also required to examine the relevance, completeness and accuracy of source data used for such report before expressing their opinion.

Mr. X and Mr. Y will be held responsible for gross negligence and using such faulty report without examining the adequacy of expert actuary's work whereas Mr. Z will not be held liable for the same due to separate opinion expressed by him.

3. Development of an overall plan - Overall plan is basically intended to provide direction for audit work programming and includes the determination of timing, manpower development and co-ordination of work with the client, other auditors and other experts. The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit:
- (i) Terms of his engagement and any statutory responsibilities.
 - (ii) Nature and timing of reports or other communications.
 - (iii) Applicable Legal or Statutory requirements.
 - (iv) Accounting policies adopted by the clients and changes, if any, in those policies.
 - (v) The effects of new accounting and auditing pronouncement on the audit.
 - (vi) Identification of significant audit areas.
 - (vii) Setting of materiality levels for the audit purpose.
 - (viii) Conditions requiring special attention such as the possibility of material error or fraud or involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
 - (ix) Degree of reliance to be placed on the accounting system and internal control.
 - (x) Possible rotation of emphasis on specific audit areas.
 - (xi) Nature and extent of audit evidence to be obtained.
 - (xii) Work of the internal auditors and the extent of reliance on their work, if any in the audit.
 - (xiii) Involvement of other auditors in the audit of subsidiaries or branches of the client and involvement of experts.
 - (xiv) Allocation of works to be undertaken between joint auditors and the procedures for its control and review.
 - (xv) Establishing and coordinating staffing requirements.
4. Formulation of Audit Strategy: While formulating the audit strategy for a company, following factors may be considered -
- General Factors: Refer Para 2.1.
- Specific Factors for Online Shopping:

The auditor shall also obtain an understanding of the information system including the related business processes due to new venture of online shopping in the following areas:

- (i) The classes of transactions in the entity's operations that are significant to the financial statements;
- (ii) 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;
- (iii) 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;
- (iv) How the information system captures events and conditions, other than transactions, that are significant to the financial statements;
- (v) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

5. As per SA 220, Engagement Partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, Engagement Partner shall:

- Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;
- Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and
- Take appropriate action to 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. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.

Engagement Partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures.

As per SA 220, “Quality Control for Audit of Financial Statements”, for audits of financial statements of listed entities, Engagement Quality Control Reviewer (EQCR), on performing an engagement quality control review, shall also consider the engagement team’s evaluation of the firm’s independence in relation to the audit engagement.

In the given case, Engagement Partner is not right. The independence assessment documentation should also be given to Engagement Quality Control Reviewer for his review.

6. As per SA 210 ‘Agreeing the Terms of Audit Engagements’, the auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate.

The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:

- (i) The objective and scope of the audit of the financial statements;
- (ii) The responsibilities of the auditor;
- (iii) The responsibilities of management;
- (iv) Identification of the applicable financial reporting framework for the preparation of the financial statements; and
- (v) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

7. As per SA 540, “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”, the auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. 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.

The outcome of an accounting estimate will often differ from the accounting estimate recognised in the prior period financial statements. By performing risk assessment procedures to identify and understand the reasons for such differences, the 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.

The review of prior period accounting estimates may also assist the auditor, in the current period, in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The auditor's professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.

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.

In the given case, the management is not correct in refusing the relevant information to the auditor.

8. As per SA 620, Using the work of an Auditor's Expert, the nature, scope and objectives of the auditor's expert's work may vary considerably with the circumstances, as may the respective roles and responsibilities of the auditor and the auditor's expert, and the nature, timing and extent of communication between the auditor and the auditor's expert. It is therefore required that these matters are agreed between the auditor and the auditor's expert.

In certain situations, the need for a detailed agreement in writing is required like -

- The auditor's expert will have access to sensitive or confidential entity information.
- The matter to which the auditor's expert's work relates is highly complex.
- The auditor has not previously used work performed by that expert.
- The greater the extent of the auditor's expert's work, and its significance in the context of the audit.

In the given case, considering the complexity involved in the valuation and volume of derivatives and also due to the fact that the auditor and auditor's expert were new to each other, auditor should have signed a formal agreement/ engagement letter with the auditor's expert in respect of the work assigned to him.

9. Audit Programme of Movie Theatre Complex:

- (i) Peruse the Memorandum of Association and Articles of Association of the entity.
- (ii) Ensure the object clause permits the entity to engage in this type of business.
- (iii) In the case of income from sale of tickets:
 - (1) Verify the control system as to how it is ensured that the collections on sale of tickets of various shows are properly and accurately accounted.
 - (2) Verify the system relating to online booking of various shows and the system of realization of money.
 - (3) Check that there is overall system of reconciliation of collections with the number of seats available for different shows in a day.
- (iv) Verify the internal control system and its effectiveness relating to the income from café, shops, pubs, game zone etc., located within the multiplex.
- (v) Verify the system of control exercised relating to the income receivable from advertisements exhibited within the premises and inside the hall such as hoarding, banners, slides, short films etc.
- (vi) Verify the system of collection from the parking areas in respect of the vehicles parked by the customers.
- (vii) In the case of payment to the distributors verify the system of payment which may be either through out right payment or percentage of collection or a combination of both. Ensure at the time of settlement, any payment of advance made to the distributor is also adjusted against the amount due.
- (viii) Verify the system of payment of salaries and other benefits to the employees and ensure that statutory requirements are complied with.
- (ix) Verify the payments effected in respect of the maintenance of the building and ensure the same is in order.
- (x) Verify the insurance premium paid and ensure it covers the entire assets.

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MATERIALITY, RISK ASSESSMENT AND INTERNAL CONTROL

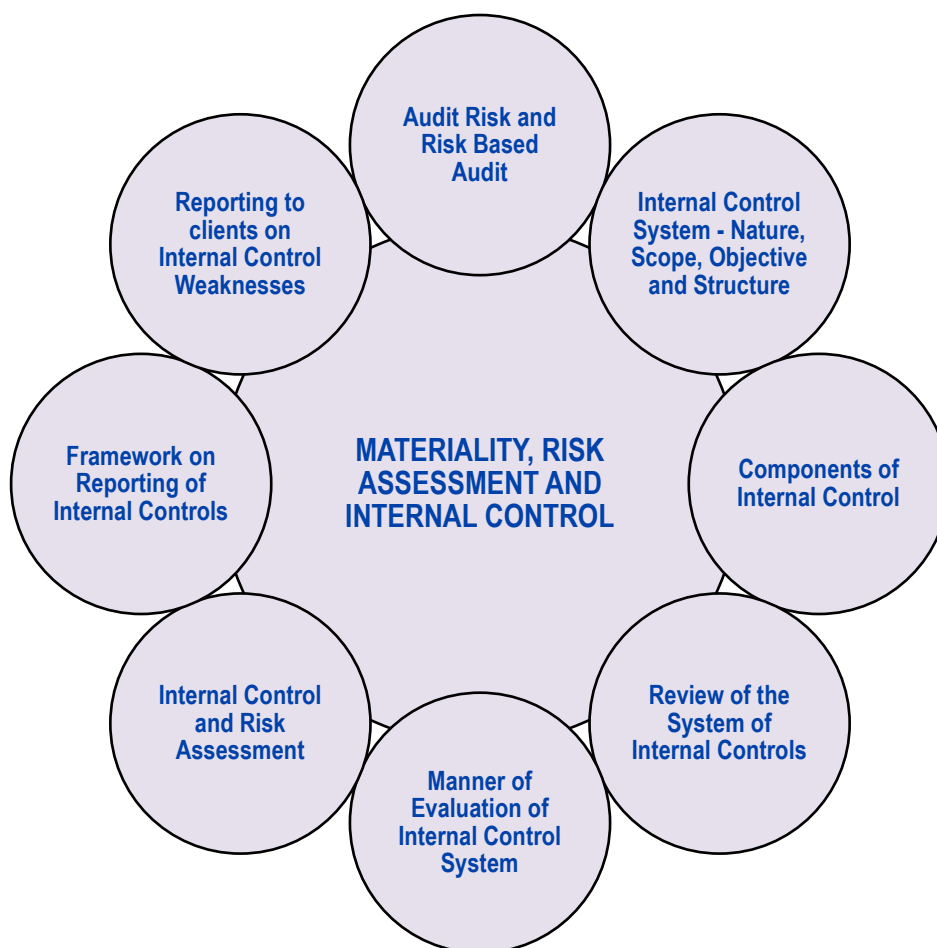


LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ☐ Understand the concept of Risk Based Audit, Internal Control and Risk Assessment.
- ☐ Identify the components of Audit Risk and Internal Control.
- ☐ Learn to review the systems of Internal Control.
- ☐ Know the Internal Control System-Nature, Scope, Objective and Structure.
- ☐ Gain knowledge of reporting to clients on Internal Control weaknesses.
- ☐ Know the framework of Reporting of Internal Control.
- ☐ Practicality of above concepts using examples and case study.

CHAPTER OVERVIEW



CA. Y, auditor of a company for last three years, is set to assess audit risk for the engagement. Before he proceeded, a question struck his mind. Is such an exercise useful for him practically? How assessing audit risk is useful for an auditor every year? He seemed to be caught in SALY approach (Same as last year). Turning to a webinar on the topic helped him illuminate his insight. Not only assessing audit risk is mandatory under Standards on Auditing, it leads to audit effectiveness and audit quality. Besides, it helps auditors to plan audits in a better way.

By understanding the company and its internal control, auditor can identify those areas which are prone to misstatements whether due to errors or frauds. The risk assessment need not be same as of last year due to new developments like change in laws, change in business model of the company or due to changes in industry in which the client company operates or due to other factors.

He also learnt how understanding business risks of the company and strategy formulated by the company to deal with business risks influences audit risk. Where the company has an established plan to deal with business risks peculiar to it, auditor gains comfort regarding management's ability to deal with such business risks by evaluating such plans.

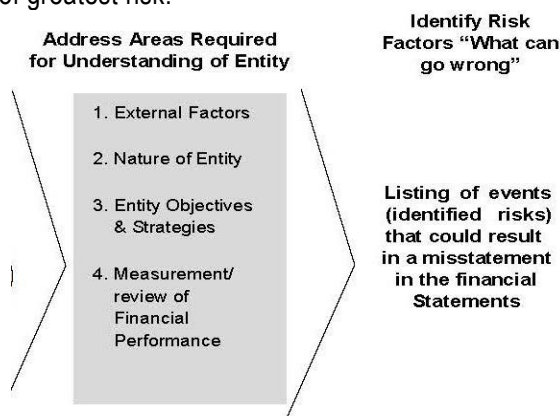
Evaluation of controls of a company helps auditor in zeroing in those areas where controls are deficient. It also aids in discovering those areas where controls may be missing and non-existent. If controls are not effective or are missing, risk of material misstatement also increases due to increase in control risk. By using needed risk assessment procedures like inquiries, inspection and observation, auditors can understand areas of risks of material misstatement. It would ultimately lead to performing an effective and qualitative audit.

What happens when an auditor identifies significant deficiencies in internal control system of the company? Besides having an impact on audit risk, auditor has also a responsibility to communicate such deficiencies to the management, to those responsible for governing the company. It may induce those sitting in board rooms to take note of the same and initiate corrective actions. Besides, such communications also end up saving auditor's skin. It is due to the reason that he has already taken pre-emptive steps in this regard. Significant deficiencies have already been communicated to management and this could come to defence of auditor later.

1. MATERIALITY & RISK ASSESSMENT

As per SA 320, the concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report. Materiality and audit risk are considered throughout the 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 financial statements and in forming the opinion in the auditor's report.

Risk assessment assesses the level of risk in the various business processes. Risk assessment focuses on the business environment, regulatory environment, organisation structure, organizational and business environmental changes and specific concerns of management and the audit committee to determine the areas of greatest risk.



1.1 Identification of Risks

Audit risk is the risk of expressing an inappropriate audit opinion on financial statements that are materially misstated.

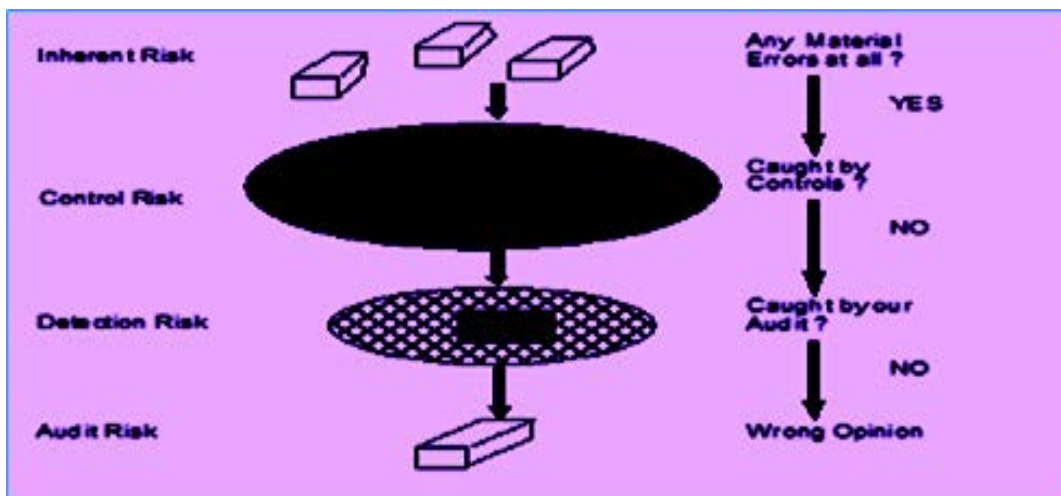


Fig.: Risks of Material Misstatement*

1.2 Audit Risk Components

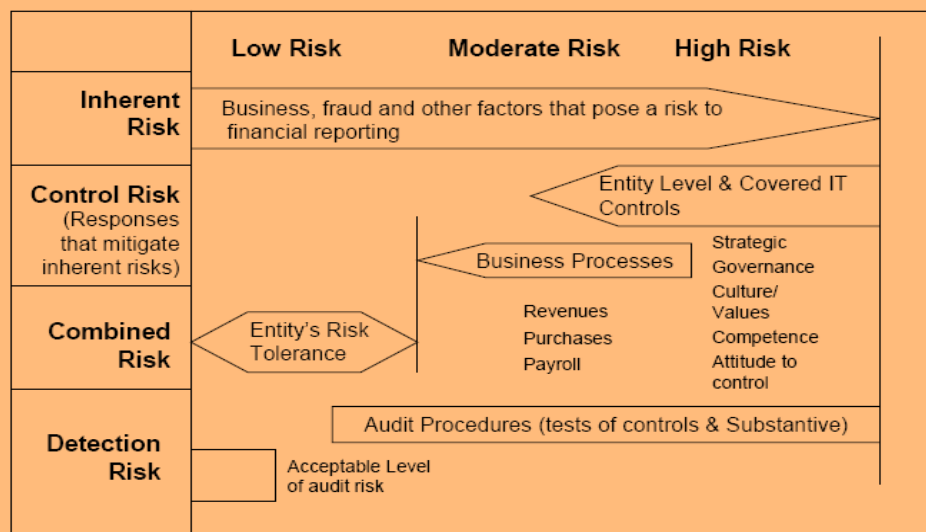
The major components of audit risk are described in the Table below

* Source : Source : cjess1 audit class pln - WordPress.com

Nature	Description	Commentary
Inherent Risk	Susceptibility of an assertion to a misstatement that could be material, individually or when aggregated with other misstatements, assuming that there are no related controls. Inherent risk is addressed at both the financial statement level and at the assertion level. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement.	These are the business and other risks that arise from the entity's objectives, nature of operations and industry, the regulatory environment in which it operates and its size and complexity. The risks of material misstatement will vary based on the nature of the account balance or class of transaction. Risks of particular concern to the auditor might include: • Complex calculations which could be misstated; • High value inventory; • Accounting estimates that are subject to significant measurement uncertainty; • Lack of sufficient working capital to continue operations; • A declining or volatile industry with many business failures; and • Technological developments that might make a particular product obsolete.
Control Risk (Do internal controls in place mitigate the inherent risks?)	Risk that the entity's internal control system will not prevent, or detect and correct on a timely basis, a misstatement that could be material, individually or when aggregated with other misstatements.	The entity should identify and assess its business and other risks (such as fraud) and respond by designing and implementing a system of internal control. Entity level controls such as board oversight, IT general controls, and HR policies are pervasive to all assertions whereas activity level controls generally, relate to specific assertions. Some control risk will always exist because

		of the inherent limitations of any internal control system. The auditor is required to understand the entity's internal control and perform procedures to assess the risks of material misstatement at the assertion level.
Detection Risk	This is the risk that the auditor will not detect a misstatement that exists in an assertion that could be material, either individually or when aggregated with other misstatements. The acceptable level of detection risk for a given level of audit risk bears an inverse relationship to the risks of material misstatement at the assertion level	The auditor identifies assertions where there are risks of material misstatement and concentrates audit procedures on those areas. In designing and evaluating the results of performing procedures, the auditor should consider the possibility of: • Selecting an inappropriate audit procedure; • Misapplying an appropriate audit procedure; or • Misinterpreting the results from an audit procedure.

Interrelationship of Audit Risk Components



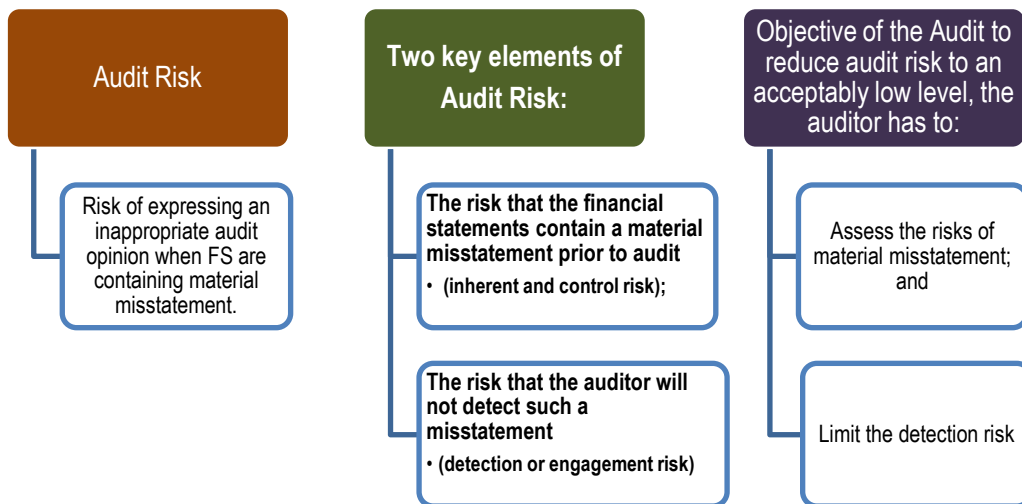
Risks of Material Misstatement

Mathematically Audit Risk (AR) can be expressed as a product of Inherent Risk (IR), Control Risk (CR) and Detection Risk (DR), i.e. $AR = IR \times CR \times DR$

Audit Risk has two components: Risk of material misstatement (the risk that the financial statements contain a material misstatement Prior to Audit) and detection risk (the risk that the auditor will not be able to detect such misstatement).

The relationship can be defined as follows.

Audit Risk = Risk of Material Misstatement X Detection Risk	
Risk of material Misstatement: - Risk of material misstatement is anticipated risk that a material misstatement may exist in financial statement before start of the audit. It has two components inherent risk and control risk. The relationship can be defined as <u>Risk of material Misstatement = Inherent risk X Control risk</u>	
Detection risk: It is a risk that a material misstatement remained undetected even if all audit procedures applied.	
It should be noted that the combined level of Inherent Risk and Control Risk is inversely related with Detection Risk, and Audit Materiality is also inversely related with Audit Risk.	



The objective of the audit is to reduce this audit risk to an acceptably low level. This may be achieved by performing procedures that respond to the assessed risks at the financial statement, class of transactions, account balance and assertion levels. Number of embedded assertions are included in management's representations about the financial statements. These relate to the recognition,

measurement, presentation and disclosure of the various elements (amounts and disclosures) in the financial statements.



1. Management of ABC Ltd. may assert to the auditor that the sales balance in the accounting records contains all the sales transactions (completeness assertion), the transactions took place and are valid (occurrence assertion), and transactions have been properly recorded in the accounting records and in the appropriate accounting period (accuracy and cut-off assertion).

SA 315, “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment” categorises the types of assertions used by the auditor to consider the different types of potential misstatements that may occur, as follows:

Assertions about classes of transactions and events for the period under audit:	(i) Occurrence—	transactions and events that have been recorded have occurred and pertain to the entity.
	(ii) Completeness—	all transactions and events that should have been recorded have been recorded.
	(iii) Accuracy—	amounts and other data relating to recorded transactions and events have been recorded appropriately.
	(iv) Cut-off—	transactions and events have been recorded in the correct accounting period.
	(v) Classification-	transactions and events have been recorded in the proper accounts.
Assertions about account balances at the period end:	(i) Existence—	assets, liabilities, and equity interests exist.
	(ii) Rights and obligations—	the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
	(iii) Completeness—	all assets, liabilities and equity interests that should have been.
	(iv) Valuation and allocation—	assets, liabilities, and equity interests are included in the FS at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

Assertions about presentation and disclosure:	(i) Occurrence and rights and obligations —	disclosed events, transactions, and other matters have occurred and pertain to the entity.
	(ii) Completeness—	all disclosures that should have been included in the financial statements have been included.
	(iii) Classification and understandability—	financial information is appropriately presented and described, and disclosures are clearly expressed.
	(iv) Accuracy and valuation—	financial and other information are disclosed fairly and at appropriate amounts.”

Auditors are required to assess the risks of material misstatement at two levels. The first is at the overall financial statement level, which refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.



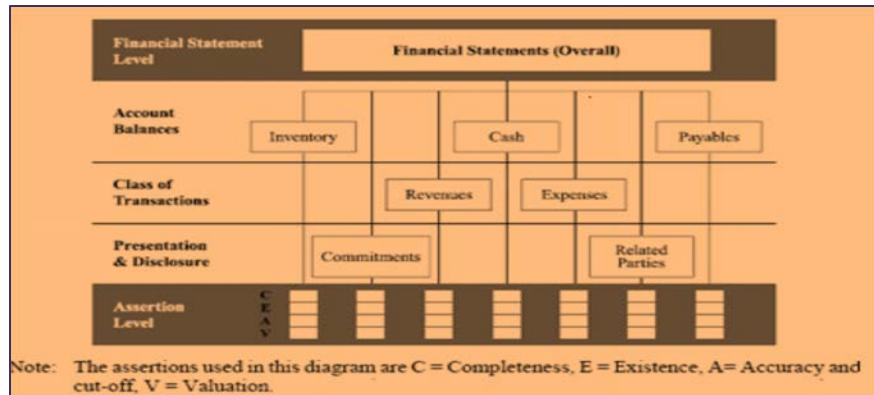
2. If the top accountant is not competent enough for the assigned tasks, it is quite possible that errors could occur in the financial statements. However, the nature of such errors will not often be confined to a single account balance, transaction stream or disclosure. In addition, the error is not likely be confined to a single assertion such as the completeness of sales. It could easily relate to other assertions such as accuracy, existence and valuation.

The second relates to risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. This means that for each account balance, class of transactions and disclosure, an assessment of risk (such as high, moderate, or low) should be made for each individual assertion (C, E, A, and V in the diagram below) being addressed.



3. While considering the valuation assertion, the auditor could assess the risk of error in payables as low; however, for inventory where obsolescence is a factor, the auditor would assess the valuation risk as high. Another example would be where the risks of material misstatement due to completeness (missing items) in the inventory balance are low, but high in relation to the sales balance.

The difference between assessing risk at the overall financial statement level and the assertion level is illustrated (in partial form only) below.



1.3 Steps for Risk Identification

- Assess the significance of the assessed risk, impact of its occurrence and also revise the materiality accordingly for the specific account balance.
- Determine the likelihood for assessed risk to occur and its impact on auditing procedures.
- Document the assertions that are effected.
- Consider the impact of the risk on each of the assertions.
- (completeness, existence, accuracy, validity, valuation and presentation) relevant to the account balance, class of transactions, or disclosure.
- Identify the degree of significant risks that would require separate attention and response by the auditor. Planned audit procedures should directly address these risks.
- Enquire and document the management's response.
- Consider the nature of the internal control system in place and its possible effectiveness in mitigating the risks involved. Ensure the controls:
 - ❖ Routine in nature (occur daily) or periodic such as monthly.
 - ❖ Designed to prevent or detect and correct errors.
 - ❖ Manual or automated.
- Consider any unique characteristics of the risk.
- Consider the existence of any particular characteristics (inherent risks) in the class of transactions, account balance or disclosure that need to be addressed in designing further audit procedures.

- Examples could include high value inventory, complex contractual agreements, absence of a paper trail on certain transaction streams or a large percentage of sales coming from a single customer.

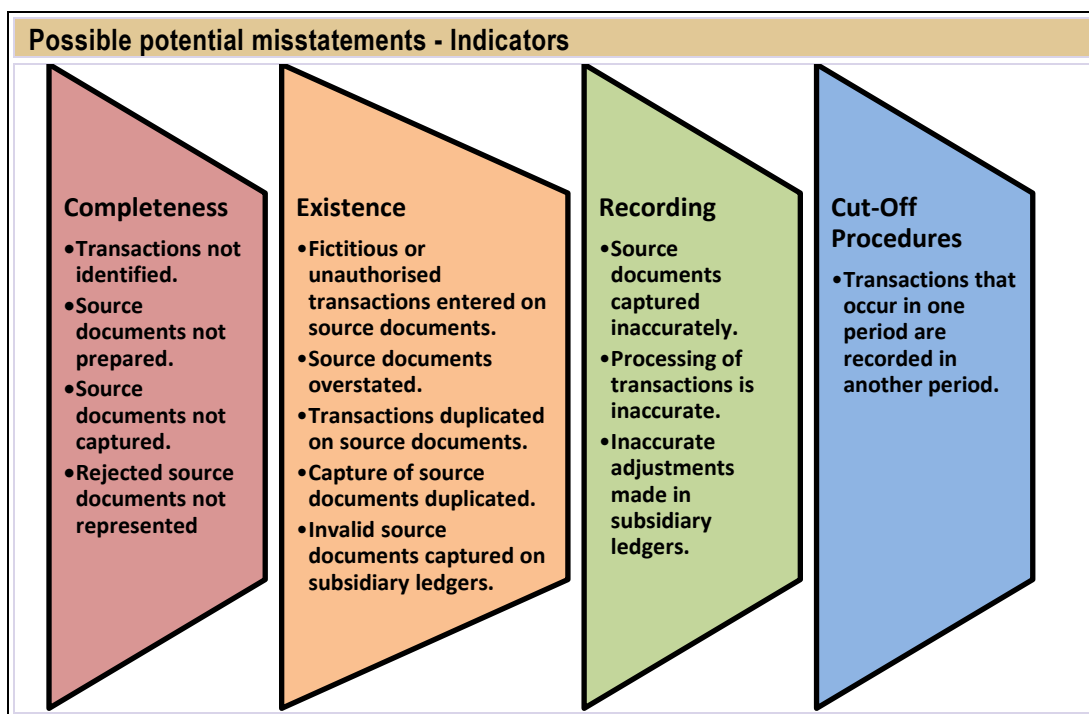


ILLUSTRATION 1

Background: During the process of extracting the exception reports, the auditors noted numerous purchase entries without valid purchase orders.

Analysis: In terms of percentage, about 40% of purchases were made without valid purchase orders and also few purchase orders were validated after the actual purchase. Also there was no reconciliation between the goods received and the goods ordered.

Assertions: Validity of purchases

Pervasive/Account Balance Level: Account Balance level

Account Balance(s) affected : (i) Purchases, (ii) Account Payable

Audit Procedures: The following procedures may address the validity of the account balance:

- *Make a selection of the purchases, review correspondence with the vendors, purchase requisitions (internal document) and reconciliations of their accounts.*
- *Review Vendor listing along with the ageing details. Follow up the material amounts paid before the normal credit period and analyse the reasons for exceptions.*
- *Meet with the company's Purchase officer and obtain responses to our inquiries regarding the purchases made without purchase orders.*
- *Discuss the summary of such issues with the client.*



2. RISK-BASED AUDIT APPROACH

Audit should be risk-based or focused on areas of greatest risk to the achievement of the audited entity's objectives. Risk-based audit (RBA) is an approach to audit that analyzes audit risks, sets materiality thresholds based on audit risk analysis and develops audit programmes that allocate a larger portion of audit resources to high-risk areas.

The auditor does not normally need to perform specific audit procedures on all areas of audit. He only needs to design audit programmes and procedures on areas earlier identified as major risks that could result in the financial statements being materially misstated.

Risk Based Audit is an essential element of financial audit- both in the attest audit of the financial statements and in the audit of financial systems and transactions including evaluation of internal controls. It focuses primarily on the identification and assessment of the financial statement misstatement risks and provides a framework to reduce the impact on the financial statements of these identified risks to an acceptable level before rendering an opinion on the financial statements. It also provides indicators of risks as a basis of opportunity for improvement of auditee risk management and control processes. This affords an opportunity to the auditee to improve its operations from recommendations on risks that do not have a current impact on the financial statements but impact the audited entity's operational strategies and performance over the longer term.

In the context of performance audit, it is the risk to delivery of an activity or scheme or programme of the entity with economy, efficiency and effectiveness. Awareness of areas that puts the programme or resources at risk from the point of view of economy, efficiency and effectiveness helps focus audit attention on them. The risk analysis provides a framework for assurance in performance auditing.

2.1 Audit Risk Analysis

The auditor should perform an analysis of the audit risks that impact on the auditee before undertaking specific audit procedures. Risk assessment is a subjective process. It is part of the professional judgment of the auditor and of the particular circumstances. It is the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated.

Audit risks are brought about by error and fraud:
◆ Error is an unintentional mistake resulting from omission, as when legitimate transactions and/or balances are excluded from the financial statements; or by commission, as when erroneous transactions and/or balances are included in the financial statements.
◆ Fraud is an intentional misstatement in the accounting records or supporting documents from which the financial statements are prepared. It is intended to deceive financial statement users or to conceal misappropriations.

The auditor has the responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud.

An error risk may arise from an error in principle, estimate, critical information processing, financial reporting process or disclosure.

Fraud risk involves manipulation, falsification of accounting records, or misrepresentation in the financial statements of events, transactions or other significant information, or misapplication of accounting principles or misappropriation of funds.

2.2 General Steps in the Conduct of Risk Based Audit

The auditor's objective in a risk-based audit is to obtain reasonable assurance that no material misstatements whether caused by fraud or errors exist in the financial statements.

This involves the following three key steps:

- Assessing the risks of material misstatement in the financial statements
- Designing and performing further audit procedures that respond to assessed risks and reduce the risks of material misstatements in the financial statements to an acceptably low level; and
- Issuing an appropriate audit report based on the audit findings.

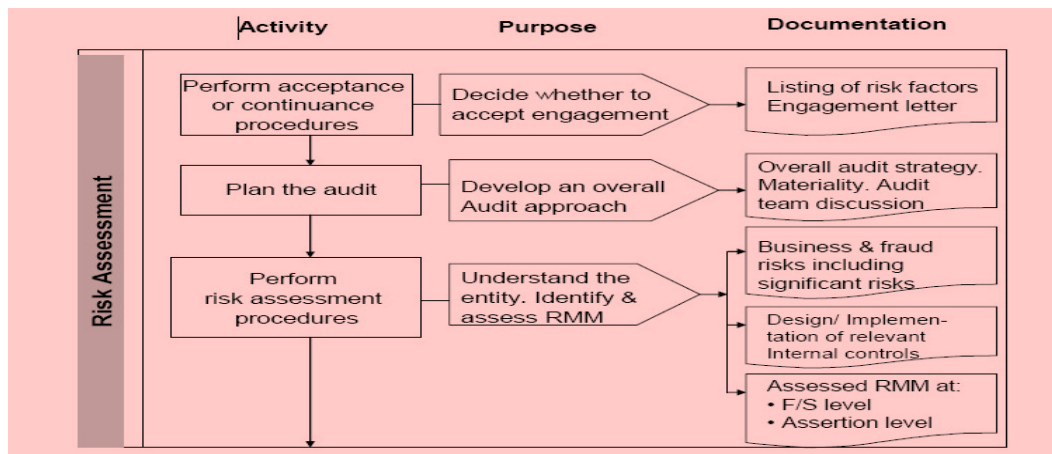
The risk-based audit process is presented in three distinct phases:

- ✍ Risk assessment.
- ✍ Risk response; and
- ✍ Reporting.

2.2.1. Risk Assessment

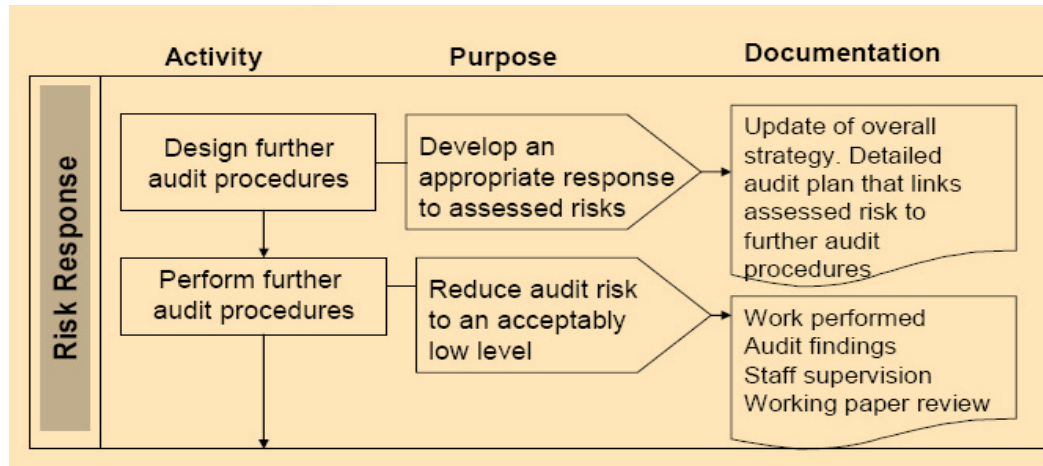
The risk assessment phase of the audit involves the following steps:

- Performing client acceptance or continuance procedures;
- Planning the overall engagement;
- Performing risk assessment procedures to understand the business and identify inherent and control risks;
- Identifying relevant internal control procedures and assessing their design and implementation (those controls that would prevent material misstatements from occurring or detect and correct misstatements after they have occurred);
- Assessing the risks of material misstatement in the financial statements;
- Identifying the significant risks that require special audit consideration and those risks for which substantive procedures alone are not sufficient;
- Communicating any material weaknesses in the design and implementation of internal control to management and those charged with governance; and
- Making an informed assessment of the risks of material misstatement at the financial statement level and at the assertion level.



2.2.2. Risk response

This phase of the audit is to design and perform further audit procedures that respond to the assessed risks of material misstatement and will provide the evidence necessary to support the audit opinion.



Some of the matters the auditor should consider when planning the audit procedures include:

- Assertions that cannot be addressed by substantive procedures alone. This can occur where there is highly automated processing of transactions with little or no manual intervention.
- Existence of internal control that, if tested, could reduce the need/scope for other substantive procedures.
- The potential for substantive analytical procedures that would reduce the need/scope for other types of procedures.
- The need to incorporate an element of unpredictability in procedures performed.
- The need to perform further audit procedures to address the potential for management override of controls or other fraud scenarios.
- The need to perform specific procedures to address “significant risks” that have been identified.

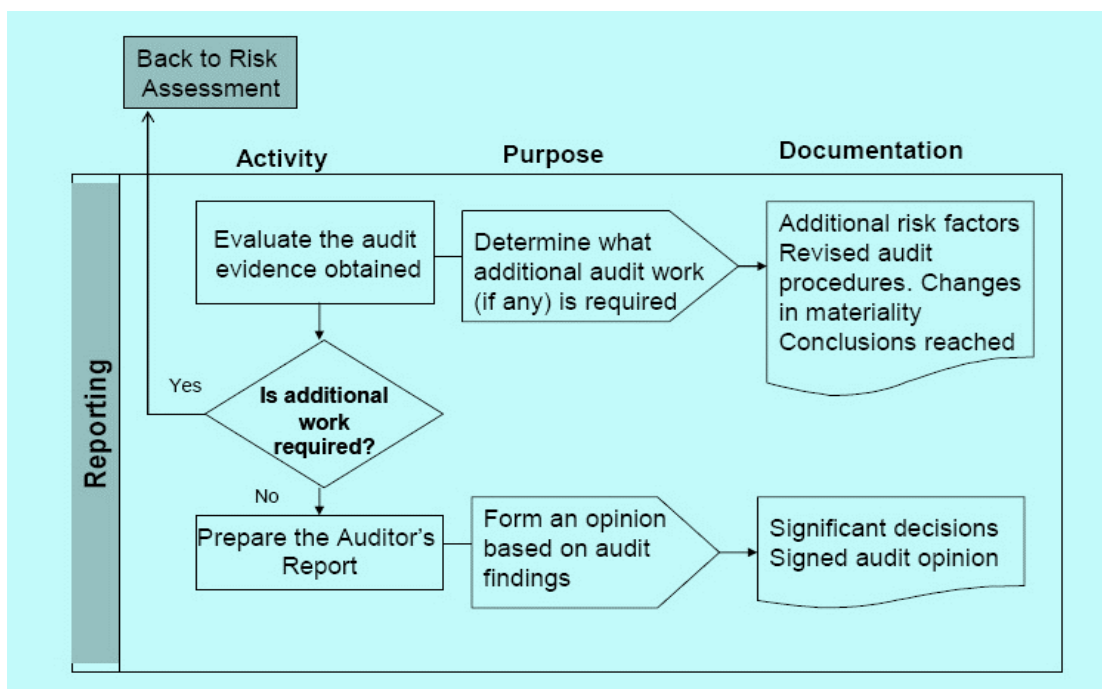
Audit procedures designed to address the assessed risks could include a mixture of:

- Tests of the operational effectiveness of internal control; and
- Substantive procedures such as tests of details and analytical procedures.



4. Before the conclusion of the audit, based on the results of substantive procedures and other audit evidence obtained by the auditor, the auditor should consider whether the assessment of control risk is confirmed. In case of deviations from the prescribed accounting and internal control systems, the auditor would make specific inquiries to consider their implications. Where, on the basis of such inquiries, the auditor concludes that the deviations are such that the preliminary assessment of control risk is not supported, he would amend the same unless the audit evidence obtained from other tests of control supports that assessment. Where the auditor concludes that the assessed level of control risk needs to be revised, he would modify the nature, timing and extent of his planned substantive procedures.

2.2.3. Reporting



The final phase of the audit is to assess the audit evidence obtained and determine whether it is sufficient and appropriate to reduce the overall Audit Risk to an acceptably low level.

It is important at this stage to determine:

- If there had been a change in the assessed level of risk;
- Whether conclusions drawn from work performed are appropriate; and
- If any suspicious circumstances have been encountered.

Any additional risks should be appropriately assessed, and further audit procedures performed as required.

When all procedures have been performed and conclusions reached:

- Audit findings should be reported to management and those charged with governance; and
- An audit opinion should be formed, and a decision made on the appropriate wording for the auditor's report.

TEST YOUR UNDERSTANDING 1

CA. R is conducting statutory audit of a Divisional office (DO) of a public sector insurance company. On going through delegation of powers laid down by company's head office, it is noticed that surveyors in claims under property insurance policies beyond estimated amounts of ₹30 lac are to be appointed by Divisional Claims Committee (DCC). However, on going through surveyor appointment details of 10 such claims during the year, 5 instances have come to his notice where above delegation of powers has not been followed and appointments were made by Divisional manager in place of DCC.

In the beginning, the auditor had assessed risks of material misstatement to be low. Describe why above finding would change auditor's assessment in relation to above.

TEST YOUR UNDERSTANDING 2

You have recently been appointed as an auditor of NGO working in the field of "upholding democracy" for the first time. The last year accounts of NGO were unaudited and its activities were limited at a small scale. However, it is only in the current year that NGO has received substantial donations including foreign funds. The said NGO is also crowdfunding its donations. The government has now legislative power to cancel FCRA certificate of NGO. Since it is working in field which encompasses political and social fields, accusations and counter-accusations are flying thick and fast.

What factors you may consider for assessing audit risk?



3. INTERNAL CONTROL SYSTEM - NATURE, SCOPE, OBJECTIVES AND STRUCTURE

Internal controls are a system consisting of specific policies and procedures designed to provide management with reasonable assurance that the goals and objectives it believes important to the entity will be met.



"Internal Control System" means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding

of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

SA 315 defines the system of internal control as the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations.

To state whether a set of financial statements presents a true and fair view, it is essential to benchmark and check the financial statements for compliance with the framework. The Accounting Standards specified under the Companies Act, 2013 is one of the criteria constituting the financial reporting framework on which companies prepare and present their financial statements under the Act and against which the auditors evaluate if the financial statements present a true and fair view of the state of affairs and the results of operations of the company in an audit of the financial statements carried out under the Act.

The auditor should obtain an understanding of the control environment sufficient to assess management's attitudes, awareness and actions regarding internal controls and their importance in the entity. Such an understanding would also help the auditor to make a preliminary assessment of the adequacy of the accounting and internal control systems as a basis for the preparation of the financial statements, and of the likely nature, timing and extent of audit procedures.

Ordinarily, development of the overall audit plan does not require an understanding of control procedures for every financial statement assertion in each account balance and transaction class. An auditor's judgement as to what is sufficient and appropriate audit evidence is affected by the degree of risk of misstatement. The auditor should obtain audit evidence through tests of control to

support any assessment of control risk which is less than high. The lower the assessment of control risk, the more evidence the auditor should obtain that accounting and internal control systems are suitably designed and operating effectively.

When obtaining audit evidence about the effective operation of internal controls, the auditor considers :

 how they were applied,	 the consistency with which they were applied during the period and	 by whom they were applied.

The concept of effective operation recognises that some deviations may have occurred. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human errors. When deviations are detected the auditor makes specific inquiries regarding these matters, particularly, the timing of staff changes in key internal control functions. The auditor then ensures that the tests of control appropriately cover such a period of change or fluctuation.

Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. The evaluation of deviations may result in the auditor concluding that the assessed level of control risk needs to be revised. In such cases, the auditor would modify the nature, timing and extent of planned substantive procedures.



5. The auditor might obtain audit evidence about the proper segregation of duties by observing the individual who applies a control procedure or by making inquiries of appropriate personnel. However, audit evidence obtained by some tests of control, such as observation, pertains only to the point in time at which the procedure was applied. The auditor may decide, therefore, to supplement these procedures with other tests of control capable of providing audit evidence about other periods of time.

The auditor should consider whether the internal controls were in use throughout the period. If substantially different controls were used at different times during the period, the auditor would consider each separately. A breakdown in internal controls for a specific portion of the period requires separate consideration of the nature, timing and extent of the audit procedures to be applied to the transactions and other events of that period.

The following are the Nature, Scope, Objectives and Structure of an Internal Control System:

3.1 Nature of Internal Control

A set of internally generated policies and procedures adopted by the management of an enterprise is a prerequisite for an organisations efficient and effective performance. It is thus, a primary responsibility of every management to create and maintain an adequate system of internal control appropriate to the size and nature of the business entity.

Internal control is a process/set of processes designed to facilitate and support the achievement of business objectives. Any system of internal control is based on a consideration of significant risks in operations, compliance and financial reporting. Objectives such as improving business effectiveness are included, as are compliance and reporting objectives.

3.2 Scope of Internal Controls

The scope of internal controls extends beyond mere accounting controls and includes all administrative controls concerned with the decision - making process leading to managements authorization of transaction, such controls include, production method, time and motion study, pricing policies, quality control, work standard, budgetary control, policy appraisal, quantitative controls etc.

In an independent financial audit, the auditor is primarily concerned with those policies and procedures having a bearing on the assertions underlying the financial statements. These comprise primarily controls relating to safeguarding of assets, prevention and detection of fraud and error, accuracy and completeness of accounting records and timely preparation of reliable financial information. Administrative controls, on the other hand, have only a remote relationship with financial records and the auditor may evaluate only those administrative controls which have a bearing on the reliability of the financial records.

The fundamental, therefore, is that effective internal control is a process effected by people that supports the organization in several ways, enabling it to provide reasonable assurance regarding risk and to assist in the achievement of objectives.

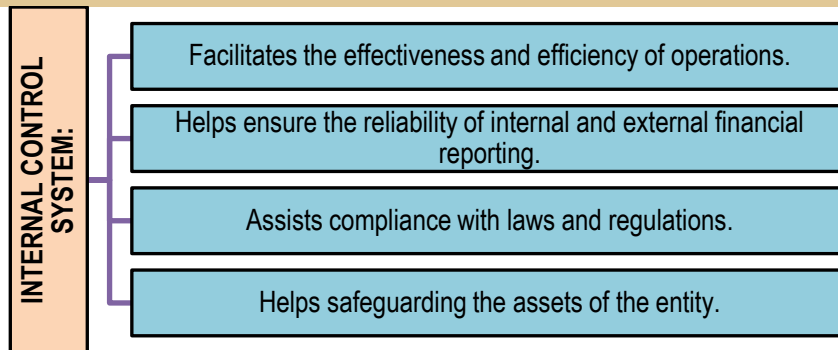
Fundamental to a system of internal control is that it is integral to the activities of the company, and not something practiced in isolation.



6. If production statistics were used as a basis for an analytical procedure, the controls to ensure the accuracy of such data would be relevant.

If non-compliance with certain laws and regulations has a direct and material effect on the financial statements, the controls for detecting and reporting on such non-compliance

would be relevant.

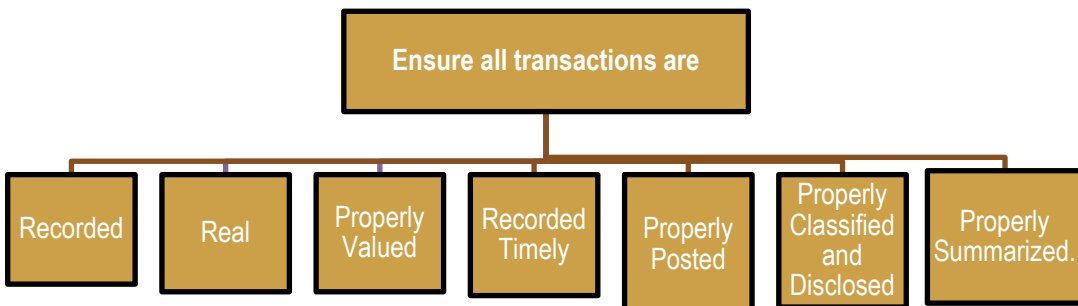


3.3 Objectives of Internal Control System

The objectives of internal control system are determined by the management, after considering the nature of business, scale operations, the extent of professionalism of the management etc.

The objectives of internal controls relating to the accounting system are:	
(i)	Transactions are executed through general or specific management authorization .
(ii)	All transactions are promptly recorded in an appropriate manner to permit the preparation of financial information and to maintain accountability of assets.
(iii)	Assets and records are safeguarded from unauthorized access, use or disposition .
(iv)	Assets are verified at reasonable intervals and appropriate action is taken with regard to the discrepancies .

Precisely, the control objectives ensure that the transactions processed are complete, valid and accurate. The basic accounting control objectives which are sought to be achieved by any accounting control system are:



If the response to all the above answer is positive, the auditor would be justified in limiting his account balance tests considerably.

In the case of excellent companies, where in a system a particular control is found to be deficient, audit attention can be focused on the areas where basic accounting control objectives are not being adhered to.



7. In case, if it found that sales transactions are not being properly valued in accordance with the price list determined by the management, the auditor would have to perform extensive searching tests on sales invoices to assure himself that the recoverable amounts are correctly posted. He may also want to expand his confirmation request at the year end to cover a large majority of trade receivables.

3.3.1 Limitations of Internal Control - Internal control, no matter how effective, can provide an entity with only reasonable assurance and not absolute assurance about achieving the entity's operational, financial reporting and compliance objectives.

Internal control systems are subject to certain inherent limitations, such as:	
R	Management's consideration that the cost of an internal control does not exceed the expected benefits to be derived.
R	The fact that most internal controls do not tend to be directed at transactions of unusual nature. The potential for human error, such as, due to carelessness, distraction, mistakes of judgement and misunderstanding of instructions.
R	The possibility of circumvention of internal controls through collusion with employees or with parties outside the entity.
R	The possibility that a person responsible for exercising an internal control could abuse that responsibility, for example, a member of management overriding an internal control.
R	Manipulations by management with respect to transactions or estimates and judgements required in the preparation of financial statements.

3.4 Structure of Internal Control

In order to achieve the objectives of internal controls, it is necessary to establish adequate control policies and procedures. Most of these policies and procedures cover:

3.4.1 Segregation of duties - Transaction processing are allocated to different persons in such a manner that no one person can carry through the completion of a transaction from start to finish or the work of one person is made complimentary to the work of another person. The purpose is to

minimize the occurrence of fraud and errors and to detect them on a timely basis, when they take place. The following functions are segregated -

- (a) authorization of transactions;
- (b) execution of transactions;
- (c) physical custody of related assets; and
- (d) maintenance of records and documents, while allocating duties, the considerations of cost and efficacy should be kept in mind as there is a tendency to stretch the allocation of tasks involved in a job to more persons than what is required resulting in cumbersome procedures, over elaboration of records and unduly high cost of administration.

Apart from segregation of duties, periodic rotation of duties of personnel is also desirable. The rotation of duties seeks to ensure that if a fraud and error is committed by a person, it does not remain undetected for long. It also ensures that a person cannot develop vested interest by holding a position for too long. Rotation of duties also ensures that each employee keeps his work up to date. This also makes an employee to be careful because he is aware that his performed tasks will be reviewed by others when duties are rotated.

3.4.2 Authorization of Transaction - Delegation of authority to different levels and to particular persons are required to establish by the management for controlling the execution of transaction in accordance with prescribed conditions. Authorization may be general or it may be specific with reference to a single transaction. It is necessary to establish procedures which provide assurance that authorizations are issued by persons acting within the scope of their authority, and that the transactions conform to the terms of the authorizations. This objective can be achieved by making independent comparison of transaction document with general or specific authorizations, as the case may be.

3.4.3 Adequacy of Records and Documents - Accounting controls should ensure that -

(i)	Transactions are executed in accordance with management's general or specific authorization.
(ii)	Transactions and other events are promptly recorded at correct amounts.
(iii)	Transactions should be classified in appropriate accounts and in the appropriate period to which it relates.
(iv)	Transaction should be recorded in a manner so as to facilitate preparation of financial statements in accordance with applicable accounting standards, other accounting policies and practices and relevant statutory requirements.

(v)	Recording of transaction should facilitate maintaining accountability for assets.
(vi)	Assets and records are required to be protected from unauthorized access, use or disposition.
(vii)	Records of assets such as sufficient description of the assets (to facilitate identification) its location should also be maintained so that the assets could be physically verified periodically.

For prompt, accurate, complete and appropriate recording of accounting transaction, several procedures are often established by the management. The assurance that transactions have been properly recorded can also be obtained through a comparison of records with an independent source of information which provides an indication of the execution of the relevant transactions.

3.4.4 Accountability and Safeguarding of Assets - The process of accountability of assets commences from acquisitions of assets its use and final disposal. Safeguarding of assets requires appropriate maintenance of records, their periodic reconciliation with the related assets. Assets like cash, inventories, investment scrips require frequent physical verification with book records. The frequency of reconciliation would differ for different assets depending upon their nature and amount. Assets which are considered sensitive or susceptible to error need to be reconcile more frequently than others. For proper safeguarding of assets, only authorized personnel should be given access to such asset. This not only means physical access but also exercising control over processing of documents relating to authorization for use and disposal of assets. It is essential to have effective controls over physical custody of cash, inventories, investments and other fixed assets. In some cases, as per requirement, special procedures regarding physical custody of assets may have to be designed by the management.

3.4.5 Independent Checks - Independent verification of the control systems, designed and implemented by the management, involves periodic or regular review by independent persons to ascertain whether the control procedures are operating effectively or not. Such process may be carried out by specially assigned staff under the banner of external audit.



4. COMPONENTS OF INTERNAL CONTROLS

In general, a system of internal control to be considered adequate should include the following five components:

- (i) Control environment;
- (ii) Entity's Risk assessment Process;

- (iii) Control activities;
- (iv) Information system and communication;
- (v) Monitoring of Controls

Components of Internal Control

Control
environment

Entity's risk
assessment
process

Control
activities

Information
system and
communication

Monitoring of
controls

4.1 Control Environment

The control environment encompasses the following elements:

- (a) **Communication and enforcement of integrity and ethical values:** The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.
- (b) **Commitment to competence:** Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job.
- (c) **Participation by those charged with governance:** An entity's control consciousness is influenced significantly by those charged with governance. The importance of the responsibilities of those charged with governance is recognised in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures and the process for reviewing the effectiveness of the entity's internal control.

- (d) **Management's philosophy and operating style:** Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions toward financial reporting may manifest themselves through conservative or aggressive selection from available alternative accounting principles, or conscientiousness and conservatism with which accounting estimates are developed.
- (e) **Organisational structure:** Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The appropriateness of an entity's organisational structure depends, in part, on its size and the nature of its activities.
- (f) **Assignment of authority and responsibility:** The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it may include policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.
- (g) **Human resource policies and practices:** Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity. For example, standards for recruiting the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behaviour – demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars illustrate expected levels of performance and behaviour. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

4.2 Entity's Risk Assessment Process

For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof.



8. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyses significant estimates recorded in the financial statements.

Risks relevant to reliable financial reporting include external and internal events, transactions or circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations.

Risks can arise or change due to circumstances such as the following:

- (a) Changes in operating environment. Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
- (b) New personnel. New personnel may have a different focus on or understanding of internal control.
- (c) New or revamped information systems. Significant and rapid changes in information systems can change the risk relating to internal control.
- (d) Rapid growth. Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- (e) New technology. Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
- (f) New business models, products, or activities. Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
- (g) Corporate restructurings. Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
- (h) Expanded foreign operations. The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
- (i) New accounting pronouncements. Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

4.3 Control Activities

Generally, control activities that may be relevant to an audit may be categorised as policies and procedures that pertain to the following:

- (a) **Performance reviews:** These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.
- (b) **Information processing:** The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT-controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. Examples of general IT-controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.
- (c) **Physical controls:** Controls that encompass:
 - The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
 - The authorisation for access to computer programs and data files.
 - The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting records). The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on circumstances such as when assets are highly susceptible to misappropriation.
- (d) **Segregation of duties:** Assigning different people the responsibilities of authorising transactions, recording transactions, and maintaining custody of assets. Segregation of

duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

Certain control activities may depend on the existence of appropriate higher level policies established by management or those charged with governance. For example, authorisation controls may be delegated under established guidelines, such as, investment criteria set by those charged with governance; alternatively, non-routine transactions such as, major acquisitions or divestments may require specific high level approval, including in some cases that of shareholders.

4.4 Information System, Including the Related Business Processes, Relevant to Financial Reporting, and Communication

An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT).

The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods and records that:

- (a) Identify and record all valid transactions.
- (b) Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- (c) Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- (d) Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- (e) Present properly the transactions and related disclosures in the financial statements.

The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.

Communication, which involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting, may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

4.5 Monitoring of Controls

An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of controls may include activities such as, management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring is done also to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.

Internal auditors or personnel performing similar functions may contribute to the monitoring of an entity's controls through separate evaluations. Ordinarily, they regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the effectiveness of internal control, and communicate information about strengths and deficiencies in internal control and recommendations for improving internal control.

Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

The overall systems of internal control comprises of Administrative Control and Accounting Controls, Internal Checks and Internal Audit are important constituents of Accounting Controls.

1. Internal Check System - Internal check system implies organization of the overall system of book-keeping and arrangement of staff duties in such a way that no one person can carry through a transaction and record every aspect thereof. It is a part of the overall control system and operates basically as a built-in-device as far as organization and job-allocation aspects of the controls are concerned.

The system provides existence of checks on the day-to-day transactions which operate continuously as part of the routine system whereby the work of each person is either proved independently or is made complimentary to the work of another.

The following are the objectives of the internal check system:

- (i) To detect error and frauds with ease.
- (ii) To avoid and minimize the possibility of commission of errors and fraud by any staff.
- (iii) To increase the efficiency of the staff working within the organization.
- (iv) To locate the responsibility area or the stages where actual fraud and error occurs.
- (v) To protect the integrity of the business by ensuring that accounts are always subject to proper scrutiny and check.
- (vi) To prevent and avoid the misappropriation or embezzlement of cash and falsification of accounts.

The effectiveness of an efficient system of internal check depends on the following considerations-

- (i) **Clarity of Responsibility** - The responsibility of different persons engaged in various operations of business transactions should be properly identified. A well-integrated organizational chart depicting the names of responsible persons associated with specific functions may help to fix up responsibility.
- (ii) **Division of Work** - The segregation of work should be made in such a manner that the free flow of work is not interrupted and also helps to determine that the work of one person is complementary to the other. Then, it is suggested that rotation of different employees through various components of the job should be effectively implemented.
- (iii) **Standardization** - The entire process of accounting should be standardized by creating suitable policies commensurate with the nature of the business, so as to strengthen the system of internal check.
- (iv) **Appraisal** - Periodic review should be made of the chain of operations and workflow. Such process may be carried out by preparing an audit flow chart.

The general condition pertaining to the internal check system may be summarized as under:

- (i) no single person should have complete control over any important aspect of the business operation. Every employee's action should come under the review of another person.
- (ii) Staff duties should be rotated from time to time so that members do not perform the same function for a considerable length of time.

(iii)	Every member of the staff should be encouraged to go on leave at least once a year.
(iv)	Persons having physical custody of assets must not be permitted to have access to the books of accounts.
(v)	There should exist an accounting control in respect of each class of assets, in addition, there should be periodical inspection so as to establish their physical condition.
(vi)	Mechanical devices should be used, where ever practicable to prevent loss or misappropriation of cash.
(vii)	Budgetary control should be exercised and wide deviations observed should be reconciled.
(viii)	For inventory taking, at the close of the year, trading activities should, if possible be suspended, and it should be done by staff belonging to several sections of the organization.
(ix)	The financial and administrative powers should be distributed very judiciously among different officers and the manner in which those are actually exercised should be reviewed periodically.
(x)	Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.

The scope of statutory audit is limited by both time and cost. Therefore, it is increasingly being recognized that for an audit to be effective especially in case of large organization, the existence of a system of internal check is essential.

2. Internal Audit - Internal audit may be defined as, an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization. The scope of the internal audit is determined by the management. Internal auditing includes a series of processes and techniques through which an organizations own employees ascertain for the management, by means of on-the-job observation, whether established management controls are adequate, and are effectively maintained; records and reports financial, accounting and otherwise reflect actual operation and results accurately and properly; each division, department or other units are carrying out the plans, policies and procedures for which they are responsible.

Note: For a detailed discussion on internal audit refer Chapter on Internal Audit in Module 3.

TEST YOUR UNDERSTANDING 3

RK Living Limited is engaged in manufacturing and processing of textile fabrics. It purchases its raw material from a company based in Silvassa taxable @ 12%. It takes about 3-4 days for raw materials to reach the company's plant. Recently, the company has revamped its internal control system for recording its transactions. You have also assumed charge as head of internal audit department of the company few days before.

It is noticed that information system requires booking of purchases in purchase ledger and stock records from date of purchase invoice only. How you would deal with above matter as internal auditor of the company?

TEST YOUR UNDERSTANDING 4

A company as part of its internal control set up has a system under which quarterly budgeted targets in respect of sales are analysed with respect to actual performance achieved. It also involves fixing responsibilities of different product departmental heads and taking timely correction. In case of product departmental heads not achieving quarterly budgeted targets, they have to give a detailed justification for the same and also lay down how shortfalls would be compensated in ensuing quarters.

Identify and explain component of internal control alluded to in above scenario.

**5. REVIEW OF THE SYSTEM OF INTERNAL CONTROLS**

The control environment sets the tone of an organization, influencing the control consciousness of its people. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity.

Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first. An improperly designed control may represent a material weakness or significant deficiency in the entity's internal control.

An entity's system of internal control contains manual elements and often contains automated elements. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported. An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of information technology.

Manual elements in internal control may be more suitable where judgment and discretion are required such as for the following circumstances:

-  Large, unusual or non-recurring transactions.
-  Circumstances where errors are difficult to define, anticipate or predict.
-  In changing circumstances that require a control response outside the scope of an existing automated control.
-  In monitoring the effectiveness of automated controls.

The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. The entity responds to the risks arising from the use of IT or from use of manual elements in internal control by establishing effective controls in light of the characteristics of the entity's information system.

The review of the internal control system enables the auditor -

- (i) to formulate his opinion as to the reliance he may place on the system itself i.e. whether the system is such as would enable the management to produce a true and fair set of financial statements; and
- (ii) to locate the areas of weakness in the system so that the audit programme and the nature, timing and extent of substantive and compliance audit procedures can be adjusted to meet the situation.



9. If the auditor is not satisfied with the control system as regards trade receivable, he may decide to have a wider coverage for confirmation of trade receivables' balances. Normally, investments and cash are physically verified at the end of the period and this routine is known to the client and his employees. In case the auditor comes across a weakness in the control either he may provide in the programme for a surprise cash count or investment verification on a day preceding or succeeding the routine verification. In such a case, a surprise check will be more useful if it is undertaken after the routine verification is over. Similarly, if he is of the view that because of weak controls the possibility of wrong billing to customers exists, he may

extend the programme for comparison of the invoices with the forwarding notes and for checking of the extensions and castings of the invoices.

Deciding the point of time appropriate for undertaking the review of the internal controls is a matter for individual judgement of the auditor. This decision can be taken on a consideration of the size and complexity of the client's operations. If the auditor, because of his continuing relationship with his client, is already aware of the features and efficacy of internal controls, he may just review the changes that have taken place in the intervening period because of changes in the operations of the client. However, a comprehensive review in such cases must be made at an interval of, say, 3 years. Ordinarily, the review of internal controls should be undertaken as a distinct phase of audit before finalisation of the audit programme. However, if the size of operations is rather small, the review can be undertaken in conjunction with other audit procedures and the programmes can be adjusted for any extension or elimination of checking.

When the auditor finds inadequacies or weaknesses in the internal control system, he should advise his client about such inadequacies and weaknesses and the consequences that may follow. It should be the duty of the auditor to see, in the course of his audit, how far the inadequacies and weaknesses have been removed. He will take this into account in preparing his audit report. It is a useful practice to note the following after each function, set out in the audit programme –

(a) Any change in the system of internal control from that record in the appropriate section of the internal control questionnaire.

(b) Any further weakness noted in the internal control.

(c) Any instance where the prescribed system or procedure has not been followed.

These should be considered in deciding whether any further modification in the audit programme is called for. Also, these should be communicated to the client and confirmation should be sought as regards changes in the system.

The review of internal control consists mainly of enquiries of personnel at various organisational levels within the enterprise together with reference to documentation such as procedures, manuals, job description and flow-charts, to gain knowledge about the controls which the auditor has identified as significant to his audit. The auditor may trace a few transactions through the accounting system to assist in understanding that system and its relation to internal controls. The auditor's preliminary

evaluation of internal controls should be made on the assumption that the controls operate generally as described and that they function effectively throughout the period of intended reliance. The purpose of the preliminary evaluation is to identify the particular controls on which the auditor still intends to rely and to test through compliance procedures. Different techniques are used to record information relating to an internal control system. Selection of a particular technique is a matter for the auditor's judgement.



6. INTERNAL CONTROL ASSESSMENT & EVALUATION



The quality & effectiveness of internal controls is directly dependent on the organisational environment. The tone at the top (the Board & Executive Management) & the credibility of the message on internal controls from top plays an important role in establishing strong control environment. Following are some of the key components to assess & evaluate the controls environment:

Standard Operating Procedures (SOPs): A well defined set of SOPs helps define role, responsibilities, process & controls & thus helps clearly communicate the operating controls to all touch points of a process. The controls are likely to be clearly understood & consistently applied even during employee turnover

1. **Enterprise Risk Management:** An organization which has robust process to identify & mitigate risks across the enterprise & its periodical review will assist in early identification of gaps & taking effective control measures. In such organizations, surprises of failures in controls is likely to be few.
2. **Segregation of Job Responsibilities:** A key element of control is that multiple activities in a transaction/decision should not be concentrated with one individual. Segregation of duties is an important element of control such that no two commercial activities should be conducted by the same person.



10. A buyer should not be involved in receiving of materials or passing of bills. Similarly bank reconciliation should be prepared by a person other than the one who maintains bank book.

3. **Job Rotation in Sensitive Areas:** Any job carried out by the same person over a long period of time is likely to lead to complacency & possible misuse in sensitive areas. It is therefore

important that in key commercial functions, the job rotation is regularly followed to avoid degeneration of controls.



If the same buyer continues to conduct purchase function for long period, it is likely that he gets into comfort zone with existing vendors & hence does not exercise adequate controls in terms of vendor development, competitive quotes etc.

4. **Delegation of Financial Powers Document:** As the organization grows, it needs to delegate the financial & other powers to their employees. A clearly defined document on delegation of powers allows controls to be clearly operated without being dependent on individuals.
5. **Information Technology based Controls:** With the advent of computers & enterprise resource planning (ERP) systems, it is much easier to embed controls through the system instead of being human dependent. The failure rate for IT embedded controls is likely to be low, is likely to have better audit trail & is thus easier to monitor. **For example** at the stage of customer invoicing, application of correct rates in invoices or credit control can all be exercised directly through IT system improving control environment.

6.1 Techniques of evaluation of Internal control

The following are the techniques of evaluation of internal control:

6.1.1 Questionnaire

Because of the widespread experience that auditors possess about the business operations in general and the knowledge about the appropriate control, most of the auditing firms have developed their own standardised internal control questionnaire on a generally applicable basis. In developing the standard questionnaire, endeavour is made to make it as wide as possible so that all situations, generally found, are included therein but all of these may not be applicable in a particular case. A questionnaire is a set of questions framed in an organised manner, about each functional area, which has as purpose the evaluation of the effectiveness of control and detection of its weakness if any. A questionnaire usually consists of several separate sections devoted to areas such as purchases, sales, trade receivables, trade payables, wages, etc. The questionnaire is intended to be filled by the company executives who are in charge of the various areas. However, this poses some practical difficulties. The questionnaire is to travel from executives and, therefore, it may take a pretty long time to be filled; also the questions may not be readily intelligible to busy executives and there is a possibility of the questionnaire being misplaced while travelling from one table to another. Having regard to these difficulties, it is now almost an accepted practice that the auditor (or his representative) arranges meetings with the executives concerned and gets the answers filled by

each executive. Sometimes, the auditor himself may be required to fill the answers. In such a case, he should ensure that the concerned executive has initiated the answers as a token of his agreement therewith.

Questions are so framed as generally to dispense with the requirement of a detailed answer to each question. For this purpose, often one general question is broken down into a number of questions and sub-questions to enable the executive to provide a just 'Yes', 'No' or 'Not applicable' form of reply. Questions are also framed in such a manner that generally a "No" answer will reflect weakness in the control system. This requires giving a positive power to the question, keeping in view what the proper control should be. Consider the question 'Are all receipts recorded promptly and deposited in bank daily? If the answer to this is 'Yes', it fits with the plan of good internal control. But if it is 'No' it indicates weakness in the system in as much as the moneys received may not be recorded and may be defalcated because the cashier has continued control over the amount for an uncertain period. However, this should not be taken as an unbreakable rule. Questions may be framed also when a 'Yes' answer would indicate weakness. The only thing that should be borne in mind is that the scheme of questions should be consistent, sequential, logical, and if possible corroborative. Wherever it is necessary, slightly detailed answers also may be asked for to bring clarity to the matter.

In the use of standardized internal control questionnaire, certain basic assumptions about elements of good control are taken into account. These are -

(i)	Certain procedures in general used by most business concerns are essential in achieving reliable internal control. This is a time-tested assumption. Deposit into bank of the entire receipts of a day or daily balancing of the cash book and ledgers or periodic reconciliation with the control accounts are examples of widely used practices which are considered good internal control practices. Besides, basic operations giving rise to these practices exist in all businesses irrespective of their nature.
(ii)	Organisations are such that permit an extensive division of duties and responsibilities. The larger the organisation, the greater is the scope of such division.
(iii)	Employees concerned with accounting function are not assigned any custodial function.
(iv)	No single person is thrust with the responsibility of completing a transaction all by himself.
(v)	There should always be evidence to identify the person who has done the work whether involving authorisation, implementation or checking.

(vi)	The work performed by each one is expected to come under review of another in the usual course of routine.
(vii)	There is proper documentation and recording of the transactions.

The questionnaire serves the purpose of a record so far as the auditor is concerned about the state of internal control as given to him officially. A question naturally arises as to whether it is necessary to issue questionnaire for every year of the auditor's engagement.

For the first year of engagements, issue of questionnaire is necessary.

For subsequent years, the auditor, instead of issuing a questionnaire again, may request the client to confirm whether any change in the nature and scope of business has taken place that necessitated a corresponding change in the control system, or whether, even without a change in the nature and scope of business, the control system has undergone a change.

If there has been a change, the auditor should take note of its and enter appropriate comments on the relevant part of the questionnaire. However, it would be a good practice in the case of continuing engagements to issue a questionnaire irrespective of any change, say, every third year. This will obviate unnecessary trouble of filling the answers every time and to that extent the client's and the auditor's own time will be saved. The rationale for issuance of a questionnaire every three years, in the case of even no change, lies in altering the client as regards unnoticed and unspectacular changes that might have taken place during the intervening period; also this will make the client more control-conscious. Questionnaires can be prepared for various aspects of the internal control system.

6.1.2 Check List

It is a series of instructions or questions on internal control which the auditor must follow or answer. When a particular instruction is carried out, the auditor initials the space opposite the instruction. If it is in the form of a question, the answer generally 'Yes', 'No' or 'Not Applicable' is entered opposite the question. A check list is more in the nature of a reminder to the auditor about the matters to be checked for testing the internal control system. While a questionnaire is basically a set of questions put to the client, a check list which may be in a form of instructions, questions or just points to be checked may be meant for the auditor's own staff it is a set of instructions or points; it may be meant for the client if it is in the form of questions. The question form of check list may even be meant for the auditor's own staff.



11. Questions in the check list may be formed in the following manner (this is an illustrative set of questions to be answered by the audit staff).

Have you checked that the cashier -

- (i) is not responsible for opening the incoming mails;
- (ii) does not authorise any of the ledgers;
- (iii) does not authorise any expenditure or receipt;
- (iv) does not sign cheques;
- (v) takes his annual leave regularly;
- (vi) inks and balances the cash book everyday;
- (vii) verifies physical cash balance with the book figure daily at the end of the day;
- (viii) prepares monthly bank reconciliation statement;
- (ix) holds no other funds or investment;
- (x) holds no unnecessary balance in hand;
- (xi) does not pay money without looking into compliance with proper procedure and due authorisation; and
- (xii) has tendered proper security or has executed a fidelity bond?

When the check list is in question form, it is hardly different from a questionnaire. However, generally questionnaire is a popular medium for the evaluation of the internal control system.

The basic distinction between internal control questionnaire and check list are as under:

1. The ICQ incorporates a large number of detailed questions but the check list generally contains questions relating to the main control objective with the area under review.
2. In ICQ, questions are usually answered by company executives. However, in a check list, the same are required to be answered by auditor/auditor staff.
3. The significance of 'No' in an ICQ does indicate a weakness but the significance of that weakness is not revealed automatically. However, in the check list, a specific statement is required where an apparent weakness may prove to be material in relation to the accounts as a whole.

6.1.3 Flow chart

The flow charting technique can also be resorted to for evaluation of the internal control system. It is a graphic presentation of internal controls in the organisation and is normally drawn up to show the controls in each section or sub-section. As distinct from a narrative form, it provides the most concise and comprehensive way for reviewing the internal controls and the evaluator's findings. In a flow chart, narratives, though cannot perhaps be totally banished are reduced to the minimum and by that process, it can successfully bring the whole control structure, specially the essential parts thereof, in a condensed but wholly meaningful manner. It gives a bird's eye view of the system and is drawn up as a result of the auditor's review thereof. It should, however, not be understood that details are not reflected in a flow chart. Every detail relevant from the control point of view and the details about how an operation is performed can be included in the flow chart. Essentially a flow chart is a diagram full with lines and symbols and, if judicious use of them can be made, it is probably the most effective way of presenting the state of internal controls in the client's organisation.

A properly drawn up flow chart can provide a neat visual picture of the whole activities of the section or department involving flow of documents and activities. More specifically, it can show-

- (i) at what point a document is raised internally or received from external sources;
- (ii) the number of copies in which a document is raised or received;
- (iii) the intermediate stages set sequentially through which the document and the activity pass;
- (iv) distribution of the documents to various sections, department or operations;
- (v) checking authorisation and matching at relevant stages;
- (vi) filing of the documents; and
- (vii) final disposal by sending out or destruction.

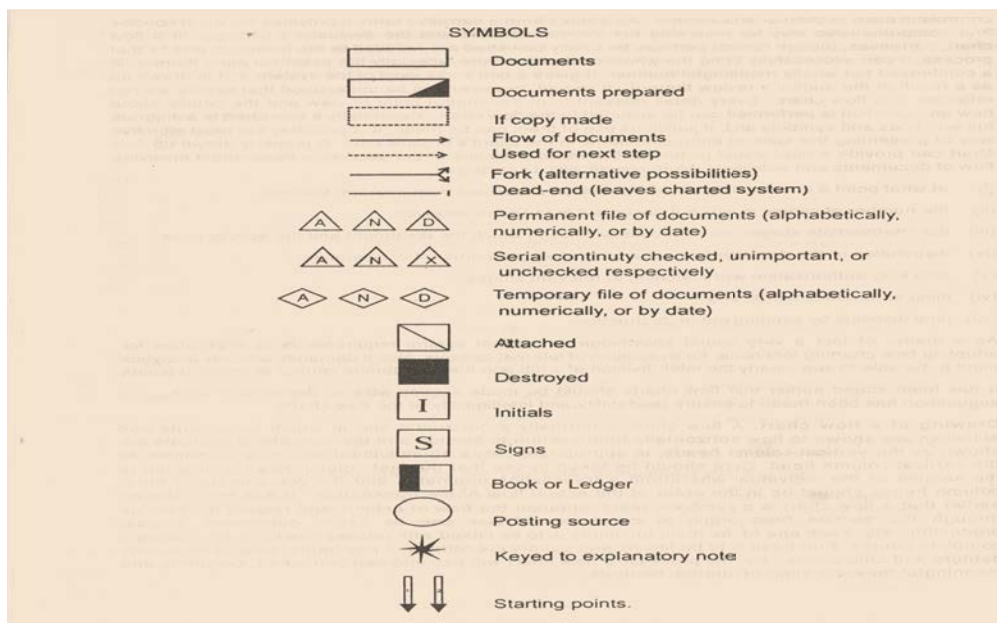
As a matter of fact, a very sound knowledge of internal control requirements is imperative for, adopting flow-charting technique for evaluation of internal controls; also it demands a highly analytical mind to be able to see clearly the inter division of a job and the appropriate control at relevant points.

It has been stated earlier that flow charts should be made section-wise or department-wise. The suggestion has been made to ensure readability and intelligibility of the flow charts.

Drawing of a flow chart - A flow chart is normally a horizontal one in which documents and activities are shown to flow horizontally from section to section and the concerned sections are shown as the vertical column heads; in appropriate cases an individual also may be shown as the vertical column head. Care should be taken to see that the first column head is devoted to the section or the

individual wherefrom a transaction originates, and the placements of other column heads should be in the order of the actual flow of the transaction.

It has been started earlier that a flow chart is a symbolic representation the flow of activity and related documents through the section from origin to conclusion. These can be sales, purchases, wages, production, etc. Each one of the main functions is to be linked with related functions for making a complete course. Purchase is to be linked with trade payables and payments; sales with trade receivables and collections. By this process, a flow chart will become self contained, complete and meaningful for evaluation of internal controls.



Generally, a questionnaire is also enclosed with a flow chart, incorporating questions, the answers to which are to be looked into from the flow chart. This is an evaluation of the control system through the process of flow charting. The internal control questionnaire contains questions; answers are available in the flow chart and they will reveal weakness, if any, in the system. In fact, the questionnaire is a guide for the study of a control system through flow charts.

We may examine the flow charting techniques for evaluation of internal controls on the sales and trade receivables function. Let us assume that these are -

1. Order receiving function.
2. Dispatch function.
3. Billing function.

4. Accounting in the trade receivables' ledger.
5. Main accounting functions.
6. Inventory recording function.

All these functions are carried out in distinct sections. As regards the Order Receiving Section, let us further assume that the section receives orders:

- (i) through mail;
- (ii) by telephone; and
- (iii) through the company's salesmen.

Basing the receipts of orders of customers, the section raises internal "Sales advices". These sales advices are consecutively numbered (by reference to the last number on the order book) and entered in the order book with the consecutive number, date, the party and other relevant details. The orders received from customers are temporarily filed in the alphabetical order. The sales advices are prepared in sets of four with a noting for the customer's sales-tax status. All the four copies are sent to the dispatch section. The dispatch section, after dispatch of the goods, sends back to the Order receiving Section the last copy of the sales advice after entering thereon the date of dispatch and the quantity despatched. Upon receipt of the last copy, the Order receiving Section enters the date of dispatch and the quantity despatched in the order book. If the quantity despatched is fulfillment of the quantity ordered, the last copy of the sales invoices is annexed to customer's order and filed in the customer's file. If, however, the order is only partly executed, the copy of the sales advice is kept in a temporary file in numerical order. Periodically this file is checked to determine the unfulfilled orders and, if inventory is then available, the Section again initiates fresh sales advices in respect of the unfulfilled part and all the processes, as in the case of original, are repeated. The last copy of the original set is annexed to the customer's order and kept in the customer's file.

The salesmen use the same advice form as is being used by the order receiving section.

For the purpose of drawing a flow chart to incorporate the above narration it is useful to know -

1. the point for originating the flow of transaction.
2. the documents, internal and external, and the flow of the transaction, number of copies, distribution flow and the details.
3. the books, if any, maintained and the details recorded there in and the source or sources for the details.
4. that there exists an alternative possibility.

[illegible]

CHART 1

After the receipt of the sales advices in sets of four, the dispatch section arranges dispatch of materials and put the date of dispatch and the quantities despatched; the head of the Section initials the advices. The last copy of the advice is sent back to the Order Receiving Section. The first copy is sent as a packing slip with the goods, the second copy goes to the Billing Department and the third copy accompanies the goods when delivered to the buyer and, obtaining the buyer's acknowledgement of the receipt of the goods therein, is received back and filed date-wise. In case of goods not directly delivered to the buyers, i.e., when the goods are sent either by rail, road or water transport, the copy constitutes the basis for raising the relevant forwarding note on the basis of which R.R. etc., can be prepared.

The flow chart for the dispatch section may be as follows -

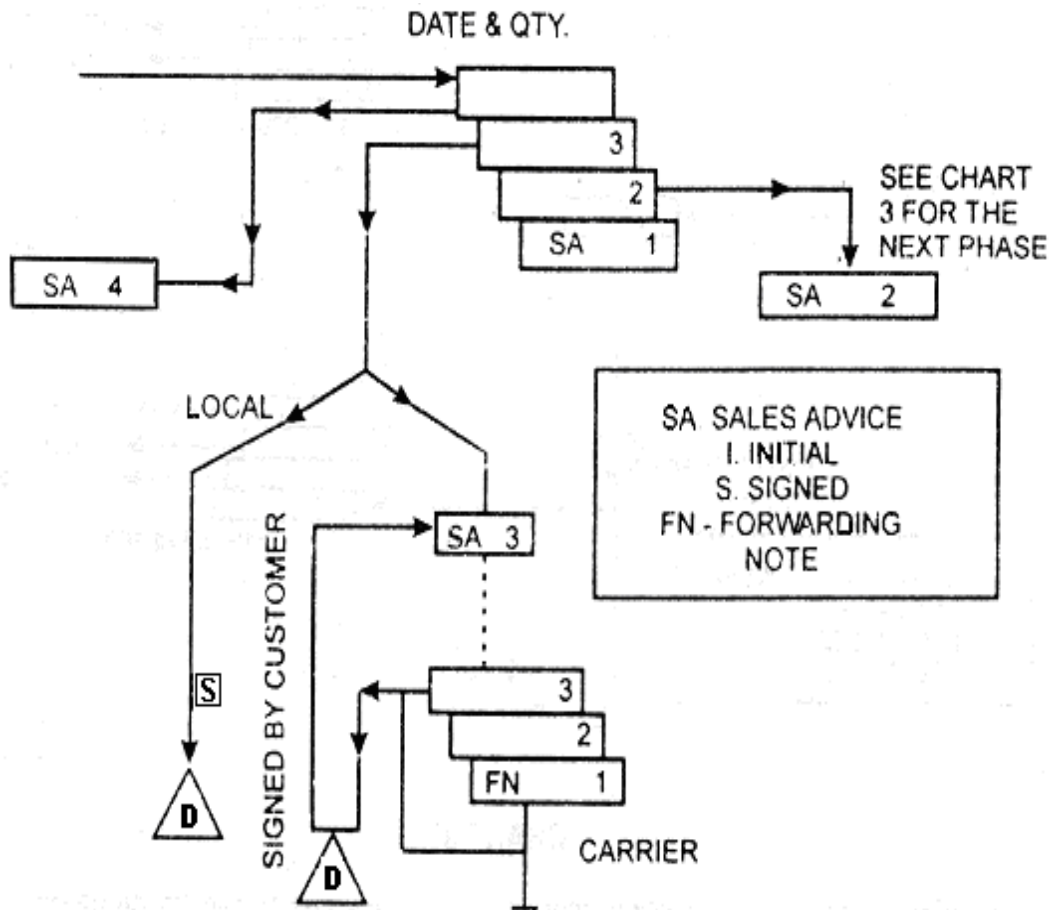
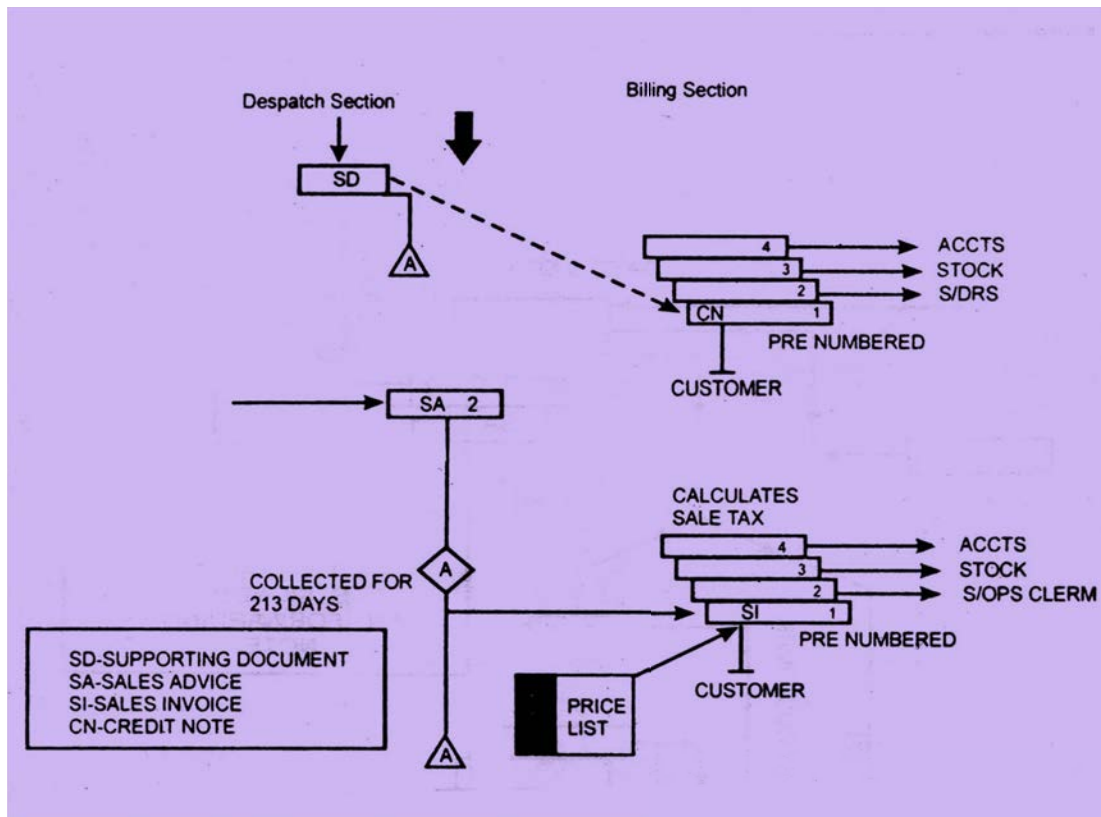


CHART 2

This flow is taken to the Billing Section. The Section generally accumulates the second copy of the Sales Advice for two or three days and prepares sales invoices in sets of four. The pricing of the sales invoice is done by reference to the company's current price list or the catalogue. The number of the sales advice is entered on the corresponding invoice which is pre-numbered, also, the number of the invoice is recorded on the copy of the sales advice which is then filed alphabetically. The first copy of the invoice is sent to the customer while the second, third and fourth copies are respectively sent to the trade receivables ledger clerk, the Inventory Section and the Accounts Section. The Billing Section also is responsible for raising credit notes on the basis of documents received. Credit notes are also prepared in sets of four and are distributed in exactly the same way as invoices. The inventories of invoice and the credit note forms remain in the Billing Section.

The Flow Chart for this Section is given below -

CHART 3



Now, in the order of the flow of activities, more sectional flow charts can be prepared to cover the activities in the Accounts Section and the Inventory Section and they together, when sequentially assembled, will constitute the complete flow chart for the sales transactions and trade receivables recordings.

(These flow charts have been prepared on the basis of the approach and the symbols used in the book "Analytical Auditing" by Skinner and Anderson. Students who desire to study the subject of preparation of flow charts further may refer to Chapter 4 of that book.)

It is now left for us to see how these flow charts reveal the state of internal control. A close look into flow charts will show the following:

- The advices are sent by salesmen; though prepared on the same sales advice form as is prepared in the section, there is no check that all the advices sent by salesmen have been

received. This may entail loss of business because of non-receipt of sales advice. (Refer to the flow chart for the Order Receiving Section).

- (ii) The raising of sales advises on the basis of telephonic orders, irrespective of the party's standing and record of performance is risky from the business point of view. (Refer to the flow chart for the Order Receiving Section).
- (iii) There is no system of prior credit sanction to the parties; in consequence, there may be dispatch of goods to bad credit risks. (Refer to the flow chart for the Dispatch Section).
- (iv) There is no check that all the second copies of the sales advices sent by the Dispatch Section have been received by the Billing Section. The possibility of dispatch not being, billed exists, (Refer to the flow chart for the Dispatch as well as the Billing Section).
- (v) There is no check in respect of pricing, extension and addition on the invoice or the credit notes. This may result in loss of revenue for wrong pricing or wrong calculation. (Refer to the flow chart for Billing Section).
- (vi) It is not clear whether the supporting documents are adequate for authorising the issue of credit notes where there is a need for a greater caution. (Refer to the flow chart for Billing Section).

So far we have seen the points of weaknesses that are evident from these flow charts. For a clearer understanding of the flow chart as a medium for evaluating internal controls, the following further points may be useful:

- (a) There exists proper numerical control over orders booked (except the case for the salesmen's orders).
- (b) There is a permanent and continuous record of the orders booked in the form of order book.
- (c) There is a definite basis for raising sales advices.
- (d) The order book record is always kept complete by entering the information about the execution of the order and this keeps the information about the pending orders ready at any moment.
- (e) Partly executed orders are reviewed from time to time so that as soon as goods are available, the same may be despatched to customers.
- (f) The customer's purchase order and the related sales advice are matched and kept together in the customer's file.

- (g) The sales advices are initialed by the Dispatch Section head as token of his having satisfied himself about the correctness of the entries as regards the quantity despatched and the date of dispatch.
- (h) Record of actual direct delivery is maintained through the copy of the sales advice bearing the customer's, acknowledgement of his having received the goods. Similarly, the record of out station deliveries is kept in the copy of the forwarding note annexed to the sales advice copy.
- (i) Documents have as many copies as are necessary for ensuring proper flow and proper control. There is neither wastage through unnecessary copies nor any hold up because of inadequacy of copies.
- (j) There are supporting documents for raising invoices and credit notes.
- (k) The distribution of invoices and credit notes is such as would enable the recording of billing at the relevant centres independent of each other.
- (l) There is control over the number of invoices and credit notes by pre-numbering.

Thus, by flow charting, an auditor can very clearly see the inter-relationships of the activities and flows and how they are integrated from stage to stage. However, the auditor has to be careful about the readability and intelligibility of the chart. Identification of all individual functions in a section is also highly relevant for preparation of the flow chart. The smaller the segment, the better is the possibility of quick comprehension. Naturally, the auditor should try to see each section as the natural assembly of distinct and identified components.

7. REPORTING TO CLIENTS ON INTERNAL CONTROL WEAKNESSES

During the course of audit work, the audit may notice material weaknesses in the internal control system. Material weaknesses are defined as absence of adequate controls on flow of transactions that increases the possibility of errors and frauds in the financial statements of the entity.



12. In case, if monthly age-wise analysis of trade receivables is not performed then it may result in inadequate provisioning of bad debts for the fiscal year under audit.

The auditor should communicate such material weaknesses to the management or the audit committee, if any, on a timely basis. This communication should be, preferably, in writing through a

letter of weakness or management letter. **Important points with regard to such a letter are as follows:**

- (a) The letter lists down the area of weaknesses in the system and offers suggestions for improvement.
- (b) It should clearly indicate that it discusses only weaknesses which have come to the attention of the auditor as a result of his audit and that his examination has not been designed to determine the adequacy of internal control for management.
- (c) This letter serves as a valuable reference document for management for the purpose of revising the system and insisting on its strict implementation.
- (d) The letter may also serve to minimize legal liability in the event of a major defalcation or other loss resulting from a weakness in internal control.

It should be appreciated that by writing a letter to the management about the weaknesses in the system, the auditor is not absolved from his duty to report the shortcomings in the accounts by way of qualification where the defects have not been corrected to the auditor's satisfaction weighing the materiality of weaknesses and their impact, if considered necessary.

The practice of the issue of letter of weaknesses has a great merit in relieving the auditor from liability in case serious frauds or losses have occurred, which probably would not have taken place had the client taken due note of the auditor's points in the letter of weakness. In the case *Re S.P. Catterson & Ltd.* (1937, 81, Act L.R. 62), the auditor was acquitted of the charge of negligence for employee's fraud in view of the fact that he had already informed the client about the unsatisfactory state in the specific areas of accounts and had suggested improvements which were not acted upon by the management.

The Council of ICAI has issued SA 265 on "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management" in this regard. This Standard on Auditing (SA) deals with the auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements. This SA does not impose additional responsibilities on the auditor regarding obtaining an understanding of internal control and designing and performing tests of controls over and above the requirements of SA 315 and SA 330.

The objective of the auditor is to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control.

If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies.

The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis.

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

- (a) In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and
- (b) Other deficiencies in internal control identified during the 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

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

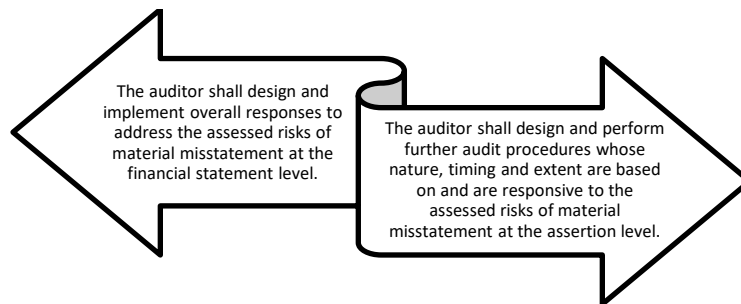
(a)	A description of the deficiencies and an explanation of their potential effects; and
(b)	Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that: (i) The purpose of the audit was for the auditor to express an opinion on the financial statements; (ii) The audit included consideration of internal control relevant to the preparation of the financial statements 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; and (iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

Based upon risks of material misstatements identified and assessed by the auditor, auditor develops responses to assessed risks.

SA 330, “The Auditor’s Responses to Assessed Risks” deals with the auditor’s responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with SA 315.

The objective of the auditor in accordance with SA 330 is to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

SA 330 states that:



In designing the further audit procedures to be performed, the auditor shall:

(a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:

- (i) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (i.e., the inherent risk); and
- (ii) Whether the risk assessment takes into account the relevant controls (i.e., the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and

(b) Obtain more persuasive audit evidence the higher the auditor’s assessment of risk.

The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when:

- (a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or
- (b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control. Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

TEST YOUR UNDERSTANDING 5

CA. S is statutory auditor of a listed company. On reviewing internal controls of the company, he is of the view that there can be possible situations where insurance premiums for keeping insurance policies current in respect of various assets of company may have become due and payable but internal control systems established by the company may not be able to capture it.

Elaborate how he should proceed to deal with the above matter.



8. FRAMEWORKS OF INTERNAL CONTROL

Corporate internal controls are part of governance mechanisms of every organisation and, whether a company adopts a global internal control framework or develops its own, management should always be guided by the need to safeguard business value. There are a number of global internal control frameworks that provide guidance to entities for developing and establishing their internal control systems.

Control should be built and established within the processes through which the company pursues its objectives. It follows that, rather than developing separate risk reporting systems, it would be more appropriate to build early warning mechanisms into existing management information systems. The board of directors or those charged with governance need to consider whether they have enough timely, relevant and reliable reports on progress against business objectives and significant risks.

Objective: Internal control is fundamental to the successful operation and day-to-day running of a business and it assists the company in achieving its business objectives. It is wider in scope and

encompasses all controls incorporated into the strategic, governance and management process, covering the company's entire range of activities and operations, and not limited to those directly related to financial operations and reporting. There are many internal control frameworks. The objective of this chapter is to give an overview of the common international frameworks.

Guidance Note on Audit of Internal Financial Controls Over Financial Reporting: ICAI has issued a Guidance Note on Audit of Internal Financial Controls Over Financial Reporting which covers aspects such as Scope of reporting on internal financial controls under Companies Act 2013, essential components of internal controls, Technical guidance on audit of Internal Financial Controls, Implementation guidance on audit of Internal Financial Controls. The Guidance Note states as below:

"To state whether a set of financial statements presents a true and fair view, it is essential to benchmark and check the financial statements for compliance with the financial reporting framework.

The Accounting Standards specified under the Companies Act, 1956 (which are deemed to be applicable as per Section 133 of the 2013 Act, read with Rule 7 of Companies (Accounts) Rules, 2014) is one of the criteria constituting the financial reporting framework based on which companies prepare and present their financial statements and against which the auditors evaluate if the financial statements present a true and fair view of the state of affairs and operations of the company in an audit of the financial statements carried out under the Companies Act, 2013.

Similarly, a benchmark internal control system, based on suitable criteria, is essential to enable the management and auditors to assess and state adequacy of and compliance with the system of internal control. In the Indian context, students are advised to refer Appendix 1 "Internal Control Components" of SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment" provides the necessary criteria for internal financial controls over financial reporting for companies.

8.1 International Internal Control Frameworks

An overview of different internal control frameworks followed internationally are given below:

A. Internal Control - Integrated Framework issued by Committee of the Sponsoring Organisations of the Treadway Commission (COSO Framework)

COSO's Internal Control – Integrated Framework was introduced in 1992 as guidance on how to establish better controls so companies can achieve their objectives. COSO categorizes entity-level objectives into operations, financial reporting, and compliance. The framework includes more than 17 basic principles representing the fundamental concepts associated with its five components:

control environment, risk assessment, control activities, information and communication, and monitoring. Some of the principles include key elements for compliance, such as integrity and ethical values, authorities and responsibilities, policies and procedures, and reporting deficiencies.

However, the Framework clarifies the requirements for effective internal control. This was largely done through the articulation of the 17 principles, which are relevant to every entity and must be present and functioning in order to have an effective system of internal control. Here are the tiles of the 17 internal control principles by internal control component as presented in COSO's framework:

<i>Control Environment</i>	<i>Risk Assessment</i>	<i>Control Activities</i>	<i>Information and Communication</i>	<i>Monitoring</i>
 Demonstrates commitment to integrity and ethical values  Exercises oversight responsibility  Establishes structure, authority, and responsibility  Demonstrates commitment to competence  Enforces accountability	 Specifies suitable objectives  Identifies and analyses risk  Assesses fraud risk  Identifies and analyses significant change	 Selects and develops control activities  Selects and develops general controls over technology  Deploys through policies and procedures	 Uses relevant information  Communicates internally  Communicates externally	 Conducts ongoing and/or separate evaluations  Evaluates and communicate deficiencies

The COSO Framework is designed to be used by organizations to assess the effectiveness of the system of internal control to achieve objectives as determined by management. The Framework lists three categories of objectives as below:

- **Operations Objectives** – related to the effectiveness and efficiency of the entity's operations, including operational and financial performance goals, and safeguarding assets against loss.
- **Reporting Objectives** – related to internal and external financial and non-financial reporting to stakeholders, which would encompass reliability, timeliness, transparency, or other terms as established by regulators, standard setters, or the entity's policies.
- **Compliance objectives** – In the Framework, the compliance objective was described as "relating to the entity's compliance with applicable laws and regulations." The Framework

considers the increased demands and complexities in laws, regulations, and accounting standards.

Limitations of Internal Control: The Framework acknowledges that there are limitations related to a system of internal control. For example, certain events or conditions are beyond an organization's control, and no system of internal control will always do what it was designed to do. Controls are performed by people and are subject to human error, uncertainties inherent in judgment, management override, and their circumvention due to collusion. An effective system of internal control recognizes their inherent limitations and addresses ways to minimize these risks by the design, implementation, and conduct of the system of internal control. However, an effective system will not eliminate these risks. An effective system of internal control provides reasonable assurance, not absolute assurance, that the entity will achieve its defined operating, reporting, and compliance objectives.

B. Guidance on Assessing Control published by the Canadian Institute of Chartered Accountants (CoCo)

CoCo was introduced with the objective of improving organizational performance and decision-making with better controls, risk management, and corporate governance.

The **Criteria of Control (CoCo)** framework was developed by the Canadian Institute of Chartered Accountants with the objective of improving organisational performance and decision making with better controls, risk management, and corporate governance. The framework includes 20 criteria for effective control in four areas of an organization: purpose (direction), commitment (identity and values), capability (competence), and monitoring and learning (evolution).

The framework emphasizes that control involves the entire organization but begins on an individual level, with the employee.

The CoCo framework outlines criteria for effective control in the following four areas:

- Purpose
- Commitment
- Capability
- Monitoring and Learning

In order to assess whether controls exist and are operating effectively, each criterion would be examined to identify the controls that are in place to address them.

C. Control Objectives for Information and Related Technology (COBIT)

COBIT stands for Control Objectives for Information and Related Technology. It is a framework created by the ISACA (Information Systems Audit and Control Association) for IT governance and management. COBIT has 34 high-level processes that cover 210 control objectives categorized in four domains: planning and organization, acquisition and implementation, delivery and support, and monitoring and evaluation. It is designed as a supportive tool for managers and allows bridging the crucial gap between technical issues, business risks and control requirements.

Business managers are equipped with a model to deliver value to the organization and practice better risk management practices associated with the IT processes. It is a control model that guarantees the integrity of the information system. Today, COBIT is used globally by all managers who are responsible for the IT business processes. It is a thoroughly recognized guideline that can be applied to any organization across industries. Overall, COBIT ensures quality, control and reliability of information systems in organization, which is also the most important aspect of every modern business.

This framework guides an organization on how to use IT resources (i.e., applications, information, infrastructure, and people) to manage IT domains, processes, and activities to respond to business requirements, which include compliance, effectiveness, efficiency, confidentiality, integrity, availability, and reliability. Well-governed IT practices can assist businesses in complying with laws, regulations, and contractual arrangements.

D. Internal Control: Guidance for Directors on the Combined Code, published by the Institute of Chartered Accountants in England & Wales (known as the Turnbull Report)

When the Combined Code of the Committee on Corporate Governance (the Code) was published, the Institute of Chartered Accountants in England & Wales agreed with the London Stock Exchange that it would provide guidance to assist listed companies to implement the requirements in the Code relating to internal control. The key principles of the Code are enunciated as below:

- The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.
- The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management.

- Companies which do not have an internal audit function should from time to time review the need for one.

The guidance requires directors to exercise judgement in reviewing how the company has implemented the requirements of the Code relating to internal control and reporting to shareholders thereon. The guidance is based on the adoption by a company's board of a risk-based approach to establishing a sound system of internal control and reviewing its effectiveness. This should be incorporated by the company within its normal management and governance processes. It should not be treated as a separate exercise undertaken to meet regulatory requirements.

E. Sarbanes-Oxley Section 404

Section 404 of Sarbanes-Oxley Act (Sarbanes-Oxley Act Section 404) of United States of America mandates that all publicly-traded companies must establish internal controls and procedures for financial reporting and must document, test and maintain those controls and procedures to ensure their effectiveness. The purpose of SOX is to reduce the possibilities of corporate fraud by increasing the stringency of procedures and requirements for financial reporting. The Sarbanes Oxley Act, has revamped federal regulations pertaining to publicly traded companies' corporate governance and reporting obligations. It was followed up with constitution of PCAOB (Public Company Accounting Oversight Board). It regulates the audits of public companies and SEC-registered brokers and dealers in order to protect investors and further the public interest in the preparation of informative, accurate, and independent audit reports.

The SEC rules and PCAOB standard require that:

- Management perform a formal assessment of its controls over financial reporting including tests that confirm the design and operating effectiveness of the controls.
- Management include in its annual report an assessment of ICFR.
- The external auditors provide two opinions as part of a single integrated audit of the company:
 - An independent opinion on the effectiveness of the system of ICFR.
 - The traditional opinion on the financial statements.

Case Study

Following is extract of information taken from draft financial statements of Find me Limited engaged in manufacturing of bicycles put up before you for audit for year 2022-23: - (₹ In lacs)

Particulars	2022-23	2021-22
Revenue from operations	35000	25000
Cost of sales	26950	20000
Gross Profit	8050	5000
Operating expenses	3825	3825
Finance costs	225	275
Depreciation and amortization expenses	1200	1300
Profit before tax	2800	(400)
Tax expense – current tax	750	0
Deferred tax	(50)	(385)
Total tax expense	700	(385)
Profit after tax	2100	15
Trade receivables	6000	3000
Inventories	10000	6000

The company has not made any substantial additions in its plant capacity during year 2022-23. It has reduced its dealer network and is approaching customers directly using its online platform. Encouraging response has been received from customers and sales have gathered momentum through online platform.

You are planning to use analytical procedures as risk assessment procedures. Keeping in view above, answer the following questions: -

1. The revenue from operations of company has increased by 40% in year 2022-23 as compared to last year. There are no additions in plant capacity. Which of the following statements is most appropriate in this regard?

- (a) There is audit risk that revenue from operations is overstated.
- (b) There is audit risk that revenue from operations is not overstated.
- (c) There is audit risk that fresh customers of company do not make payments.

(d) There is audit risk that company is overutilizing its plant capacity leading to rapid plant obsolescence.

2. The operating expenses of financial year 2021-22 and 2022-23 are same. Which of the following statements is most appropriate in overall context of case study?

- (a) Operating expenses figures of two years can be same. There is no audit risk involved.
- (b) It is an anomaly. However, there is no audit risk involved.
- (c) There is audit risk that previous year figures need to be revised under Companies Act.
- (d) There is audit risk that previous year figures have been presented in place of current year figures in draft financial statements.

3. Trade receivables turnover ratio has increased from 1.44 months in year 2021-22 to more than 2 months in year 2022-23. Identify the most appropriate statement.

- (a) In direct distribution through online platform, trade receivables turnover ratio is estimated to be high. Therefore, there is no audit risk involved.
- (b) In direct distribution through online platform, trade receivables turnover ratio should have fallen. Therefore, there is no audit risk involved.
- (c) In direct distribution through online platform, trade receivables turnover ratio should have fallen. It is possible that some of the dealers may not be meeting their commitments of past contracts. Therefore, there is audit risk that trade receivables could be undervalued.
- (d) In direct distribution through online platform, trade receivables turnover ratio should have fallen. It is possible that some of the dealers may not be meeting their commitments of past contracts. Therefore, there is audit risk that trade receivables could be overvalued.

4. The gross profit ratio of company has increased by 3% during year 2022-23 in comparison to last year. Which of the following statements is most appropriate?

- (a) There is audit risk that there is overstatement of cost of sales.
- (b) There is audit risk that margins with customers may have increased.
- (c) There is audit risk that closing inventories may be undervalued.
- (d) There is audit risk that cost of sales may not be completely recorded.

5. Inventory turnover ratio has increased from 2.88 months in year 2021-22 to about 3.42 months in year 2022-23. Which of the following statements is likely to be in accordance with overall context of case study?

- (a) Revenue jump in current year may have led to need for raising inventory holding levels. Therefore, there is audit risk pertaining to misstatement of inventories.
- (b) Raising of inventory levels may raise locked up funds in inventories. There is audit risk that it can lead to rise in costs.
- (c) Revenue jump in current year may have led to need for raising inventory holding levels. However, there is also a risk that some of inventories with dealers could have become obsolete. It leads to audit risk that inventories may be overvalued.
- (d) There is audit risk on account of both the factors stated at [b] & [c].

Key Takeaways

- Audit risk is the risk of expressing an inappropriate audit opinion on financial statements that are materially misstated. The components of audit risk include inherent risk, control risk and detection risk. Audit Risk (AR) can be expressed as a product of Inherent Risk (IR), Control Risk (CR) and Detection Risk (DR), i.e. $AR = IR \times CR \times DR$
- Auditors are required to assess the risks of material misstatement at two levels. The first is at the overall financial statement level, which refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions and second one relates to risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level.
- A set of internally generated policies and procedures adopted by the management of an enterprise is a prerequisite for an organisations efficient and effective performance. It is thus, a primary responsibility of every management to create and maintain an adequate system of internal control appropriate to the size and nature of the business entity.
- Internal control is the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations.
- Internal control, no matter how effective, can provide an entity with only reasonable assurance and not absolute assurance about achieving the entity's operational, financial reporting and compliance objectives.

- Components of internal control include control environment, entity's risk assessment process, the information system, including the related business processes, relevant to financial reporting, and communication, control activities and monitoring of controls.
- Review of internal control system enables auditor to formulate his opinion as to the reliance he may place on the system itself i.e. whether the system is such as would enable the management to produce a true and fair set of financial statements; and to locate the areas of weakness in the system so that the audit programme and the nature, timing and extent of substantive and compliance audit procedures can be adjusted to meet the situation.
- In accordance with SA 265, it is auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.
- Based upon risks of material misstatements identified and assessed by the auditor, auditor develops responses to assessed risks. SA 330 deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with SA 315.
- Corporate internal controls are part of governance mechanisms of every organisation and, whether a company adopts a global internal control framework or develops its own, management should always be guided by the need to safeguard business value. There are a number of global internal control frameworks that provide guidance to entities for developing and establishing their internal control systems.

FOR SHORTCUT TO ENGAGEMENT & QUALITY CONTROLS STANDARDS

WISDOM: SCAN ME !



Note : Content of SA 315-Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment and SA 320-Materiality in Planning and Performing an Audit is covered in depth at Intermediate level. Thus, application part of above SAs may be discussed in the form of Case Study at Final level.

TEST YOUR KNOWLEDGE

Theoretical Questions

1. CA. B was appointed as the auditor of ABC Limited for the financial year 2022-23. During the course of planning for the audit, CA. B intends to apply the concept of materiality for the financial statements as a whole. Please guide him with respect to the factors that may affect the identification of an appropriate benchmark for this purpose.

What benchmark should be adopted by CA. B, if ABC Limited is engaged in:

- (i) *the manufacture and sale of air conditioners and is having regular profits.*
 - (ii) *the construction of large infrastructure projects and incurred losses in the previous two financial years, due to pandemic.*
2. *What are the components of an internal control framework?*
 3. *During the course of his audit, the auditor noticed material weaknesses in the internal control system and he wishes to communicate the same to the management. You are required to elucidate the important points the auditor should keep in the mind while drafting the letter of weaknesses in internal control system.*
 4. *Explain briefly the Flow Chart technique for evaluation of the Internal Control system.*
 5. *As auditor of Z Ltd., you would like to limit your examination of account balance tests. What are the control objectives you would like the accounting control system to achieve to suit your purpose?*
 6. *New Life Hospital is a multi-speciality hospital which has been facing a lot of pilferage and troubles regarding their inventory maintenance and control. On investigation into the matter it was found that the person in charge of inventory inflow and outflow from the store house is also responsible for purchases and maintaining inventory records. According to you, which basis system of control has been violated? Also list down the other general conditions pertaining to such system which needs to be maintained and checked by the management.*
 7. *Compute the overall Audit Risk if looking to the nature of business there are chances that 40% bills of services provided would be defalcated, inquiring on the same matter management has assured that internal control can prevent such defalcation to 75%. At his part the Auditor assesses that the procedure he could apply in the remaining time to complete*

Audit gives him satisfaction level of detection of frauds & error to an extent of 60%. Analyse the Risk of Material Misstatement and find out the overall Audit Risk.

8. *ST Ltd is a growing company and currently engaged in the business of manufacturing of tiles. The company is planning to expand and diversify its operations. The management has increased the focus on the internal controls to ensure better governance. The management had a discussion with the statutory auditors to ensure the steps required to be taken so that the statutory audit is risk based and focused on areas of greatest risk to the achievement of the company's objectives. Please advise the management and the auditor on the steps that should be taken for the same.*
9. *Y Co. Ltd. has five entertainment centers to provide recreational facilities for public especially for children and youngsters at 5 different locations in the peripheral of 200 kilometers. Collections are made in cash. Specify the adequate system towards collection of money.*
10. *The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Explain.*
11. *Your engagement team is seeking advice from you as engagement partner regarding steps for risk identification. Elaborate.*
12. *BSF Limited is engaged in the business of trading leather goods. You are the internal auditor of the company for the year 2019-20. In order to review internal controls of the Sales Department of the company, you visited the Department and noticed the work division as follows:*
 - (1) *An officer was handling the sales ledger and cash receipts.*
 - (2) *Another official was handling dispatch of goods and issuance of Delivery challans.*
 - (3) *One more officer was there to handle customer/ debtor accounts and issue of receipts.*

As an internal auditor, you are required to briefly discuss the general condition pertaining to the internal check prevalent in internal control system. Do you think that there was proper division of work in BSF Limited? If not, why?

Answers to Case Study Question

1. (a)
2. (d)
3. (d)

- 4. (d)
- 5. (c)

Answers to Test your Understanding Question

1. Evaluation of internal controls influences auditor's assessment of risks of material misstatement. Risks of material misstatement also consists of control risk.

In the given situation of statutory audit of a Divisional office of a public sector insurance company, it is noticed that procedure relating to delegation of powers has not been followed and surveyor appointments have been made in violation of laid down procedures. It is a serious violation and shows that controls are not operating effectively as laid down by company management.

Such deviations from established controls may lead auditor to conclude that control risk needs to be revised. Revision of control risk assessment is likely to lead to revision in risks of material misstatement. It may also result in modification of nature, timing and extent of planned substantive procedures.

2. For assessing audit risk, auditor shall consider all components of audit risk. The said NGO is working in a political-cum-social field which can make its activities inherently risky. Crowdfunding donations may have to be seen in relation to constitution of NGO which may make these risky. Since the NGO is in receipt of foreign funds, it may make transactions inherently risky. The credibility and integrity of persons behind NGO is important. Shady NGOs can be involved in money laundering activities and may be involved in mis utilizing funds from donors. Since last year accounts were unaudited, it also increases inherent risk due to probable effect of misstatements, if any, of last year. Non-compliance with strict laws has the potential to make activities of NGO inherently risky.

Since NGO has received substantial donations in current year and its activities were on a relatively small scale during last year, formal controls may not be in place. Lack of formal controls may lead to non-compliance with laws. Non-compliance with FCRA can have serious consequences including cancelling such certificate of NGO. Therefore, control risk could be high.

Further, audit for NGO has been accepted for the first time. There may be a lack of understanding of activities of NGO. It may lead to higher detection risk due to inappropriate sampling procedures or faulty application of audit procedures.

3. Internal audit involves continuous and critical appraisal of 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 its strategic risk management and internal control system.

Internal audit also involves evaluation of internal control to provide assurance to management regarding design, implementation and operating effectiveness of control.

In the given situation, information system requires booking of purchases in purchase ledger and stock records from date of invoice. Such a control system is likely to present a distorted picture of stocks of the company. It would show stocks of raw material as received whereas these goods could be in transit. Therefore, design of the control itself is faulty which allows booking from date of purchase invoice only. Further, such a system can have implications with respect to GST laws.

The internal auditor should report above matter asking management for corrective action.

4. The above referred component of internal control is “Control activities”. Control activities that may be relevant to an audit include policies and procedures that pertain to “performance reviews”.

Such control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.

The control activities pertaining to analysis of budgeted target of sales with respect to actual performance, fixing of responsibilities and taking timely corrective action falls in nature of performance reviews. Such performance reviews are part of control activities which is a component of internal control.

5. A deficiency in internal control exists when: -
- (i) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis or
 - (ii) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

In above situation, there is a possibility that internal control systems established by the company may not be able to capture insurance premiums which may have become due and payable. It is a significant deficiency as failure to keep insurance policies current would render assets of the company uninsured. It may lead to losses for the company in case of any eventuality.

Further, in accordance with SA 265, the significance of a deficiency or a combination of deficiencies in internal control depends not only on whether a misstatement has actually

occurred, but also on the likelihood that a misstatement could occur and the potential magnitude of the misstatement. Significant deficiencies may, therefore, exist even though the auditor has not identified misstatements during the audit.

The susceptibility to loss of an asset is a factor in determining whether a deficiency constitutes significant deficiency in internal control.

The auditor shall communicate in writing significant deficiency in internal control to those charged with governance and include in the written communication of significant deficiencies in internal control: -

- (a) A description of the deficiencies and an explanation of their potential effects and
- (b) Sufficient information to enable those charged with governance and management to understand the context of the communication.

Answers to Theoretical Questions

1. **Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole:**
As per SA 320, determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
- The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
- The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- The relative volatility of the benchmark.

Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen

benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue.

In case if ABC Limited is engaged in manufacture and sale of air conditioner, and is having regular profits: CA. B, the auditor may consider profit before tax /Earnings.

In case if ABC Limited is engaged in the construction of large infrastructure projects and incurred losses in the previous two financial years, due to pandemic: CA. B, the auditor may consider Revenue or Gross Profit as benchmarking. Alternatively, CA B, the auditor may consider the criteria relevant for audit of the entities doing public utility programs/ projects, Total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for that particular program/project activity. Where an entity has custody of the assets, assets may be an appropriate benchmark.

2. There are **five components** of an internal control framework. They are as follows:
 - Control Environment;
 - Risk Assessment;
 - Information & Communication;
 - Monitoring;
 - Control Activities.
3. **Important Points to be kept in Mind While Drafting Letter of Weakness:** As per SA 265, "Communicating Deficiencies in Internal Control to Those who Charged with Governance and Management", the auditor shall include in the written communication of significant deficiencies in internal control -
 - (i) A description of the deficiencies and an explanation of their potential effects; and
 - (ii) Sufficient information to enable those charged with governance and management to understand the context of the communication.

In other words, the auditor should communicate material weaknesses to the management or the audit committee, if any, on a timely basis. This communication should be, preferably, in writing through a letter of weakness or management letter. Important points with regard to such a letter are as follows-

- (1) The letter lists down the area of weaknesses in the system and offers suggestions for improvement.

- (2) It should clearly indicate that it discusses only weaknesses which have come to the attention of the auditor as a result of his audit and that his examination has not been designed to determine the adequacy of internal control for management.
 - (3) This letter serves as a valuable reference document for management for the purpose of revising the system and insisting on its strict implementation.
 - (4) The letter may also serve to minimize legal liability in the event of a major defalcation or other loss resulting from a weakness in internal control.
4. Refer Para 6.1.3
5. Basic Accounting Control Objectives: The basic accounting control objectives which are sought to be achieved by any accounting control system are -
- (i) Whether all transactions are recorded;
 - (ii) Whether recorded transactions are real;
 - (iii) Whether all recorded transactions are properly valued;
 - (iv) Whether all transactions are recorded timely;
 - (v) Whether all transactions are properly posted;
 - (vi) Whether all transactions are properly classified and disclosed;
 - (vii) Whether all transactions are properly summarized.
6. **Basic system of Control:** Internal Checks and Internal Audit are important constituents of Accounting Controls. Internal check system implies organization of the overall system of book-keeping and arrangement of Staff duties in such a way that no one person can carry through a transaction and record every aspect thereof.

In the given case of New Life Hospital, the person-in-charge of inventory inflow and outflow from the store house is also responsible for purchases and maintaining inventory records. Thus, one of the basic system of control i.e. internal check which includes segregation of duties or maker and checker has been violated where transaction processing are allocated to different persons in such a manner that no one person can carry through the completion of a transaction from start to finish or the work of one person is made complimentary to the work of another person.

The general condition pertaining to the internal check system may be summarized as under-

- (i) No single person should have complete control over any important aspect of the business operation. Every employee's action should come under the review of another person.
 - (ii) Staff duties should be rotated from time to time so that members do not perform the same function for a considerable length of time.
 - (iii) Every member of the staff should be encouraged to go on leave at least once a year.
 - (iv) Persons having physical custody of assets must not be permitted to have access to the books of accounts.
 - (v) There should exist an accounting control in respect of each class of assets, in addition, there should be periodical inspection so as to establish their physical condition.
 - (vi) Mechanical devices should be used, where ever practicable to prevent loss or misappropriation of cash.
 - (vii) Budgetary control should be exercised and wide deviations observed should be reconciled.
 - (viii) For inventory taking, at the close of the year, trading activities should, if possible be suspended, and it should be done by staff belonging to several sections of the organization.
 - (ix) The financial and administrative powers should be distributed very judiciously among different officers and the manner in which those are actually exercised should be reviewed periodically.
 - (x) Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.
7. According to SA-200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the Audit Risk is a risk that Auditor will issue an inappropriate opinion while Financial Statements are materially misstated.
- Audit Risk, has two components: Risk of material Misstatement and Detection Risk. The relationship can be defined as follows.
- Audit Risk = Risk of material Misstatement X Detection Risk
- Risk of material Misstatement: - Risk of Material Misstatement is anticipated risk that a material Misstatement may exist in Financial Statement before start of the Audit. It has two components Inherent risk and Control risk. The relationship can be defined as

Risk of material Misstatement = Inherent risk X control risk

Inherent risk: it is a susceptibility of an assertion about account balance; class of transaction, disclosure towards misstatements which may be either individually or collectively with other Misstatement becomes material before considering any related internal control which is 40% in the given case.

Control risk: it is a risk that there may be chances of material Misstatement even if there is a control applied by the management and it has prevented defalcation to 75%.

Hence, control risk is 25% (100%-75%)

Risk of material Misstatement: Inherent risk X control risk i.e. $40\% \times 25\% = 10\%$

Chances of material Misstatement are reduced to 10% by the internal control applied by management.

Detection risk: It is a risk that a material Misstatement remained undetected even if all Audit procedures applied, Detection Risk is $100 - 10 = 90\%$

In the given case, overall Audit Risk can be reduced up to 4% as follows:

Audit Risk: Risk of Material Misstatement X Detection Risk = $10\% \times 40\% = 4\%$

8. Refer Para 2.2

9. **Control System over Selling and Collection of Tickets:** In order to achieve proper internal control over the sale of tickets and its collection by the Y Co. Ltd., following system should be adopted -

- (i) **Printing of tickets:** Serially numbered pre-printed tickets should be used and designed in such a way that any type of ticket used cannot be duplicated by others in order to avoid forgery. Serial numbers should not be repeated during a reasonable period, say a month or year depending on the turnover. The separate series of the serial should be used for such denomination.
- (ii) **Ticket sales:** The sale of tickets should take place from the Central ticket office at each of the 5 centres, preferably through machines. There should be proper control over the keys of the machines.
- (iii) **Daily cash reconciliation:** Cash collection at each office and machine should be reconciled with the number of tickets sold. Serial number of tickets for each entertainment activity/denomination will facilitate the reconciliation.

- (iv) **Daily banking:** Each day's collection should be deposited in the bank on next working day of the bank. Till that time, the cash should be in the custody of properly authorized person preferably in joint custody for which the daily cash in hand report should be signed by the authorized persons.
 - (v) **Entrance ticket:** Entrance tickets should be cancelled at the entrance gate when public enters the centre.
 - (vi) **Advance booking:** If advance booking of facility is made available, the system should ensure that all advance booked tickets are paid for.
 - (vii) **Discounts and free pass:** The discount policy of the Y Co. Ltd. should be such that the concessional rates, say, for group booking should be properly authorized and signed forms for such authorization should be preserved.
 - (viii) **Surprise checks:** Internal audit system should carry out periodic surprise checks for cash counts, daily banking, reconciliation and stock of unsold tickets etc.
10. Communication and enforcement of integrity and ethical values: Refer Para 4.1
11. Refer Para 1.3
12. The general condition pertaining to the internal check system may be summarized as under: refer para 4.5
- In the given scenario, Company has not done proper division of work as:
- (i) the receipts of cash should not be handled by the official handling sales ledger and
 - (ii) delivery challans should be verified by an authorised official other than the officer handling despatch of goods.

AUDIT EVIDENCE

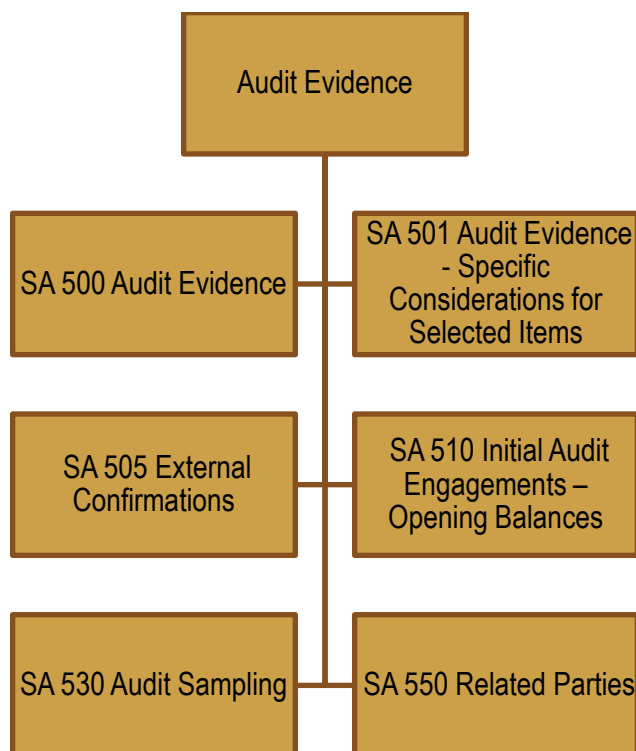


LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ☐ Refreshen up your knowledge about procedures relating to Audit Evidence.
- ☐ Glance through relevant SAs-SA 500, SA 501, SA 505, SA 510, SA 530 and SA 550 pictorially.
- ☐ Gain application-based knowledge of above SAs.
- ☐ Understand the concepts through use of analytical examples and case studies.
- ☐ Gain knowledge about varied practical situations for an auditor while performing such procedures.

CHAPTER OVERVIEW



CA. Kartik is intrinsically efficient and has an inherent dislike for wasting time on frivolous things. He wants to do everything perfect- spick and span- and in a cost- effective manner. Adopting the same approach, in the course of his professional work as an auditor, he is very particular in completing work quickly in a time bound manner.

During one such audit of a company's accounts, he chose to select some specific items for performing “tests of details” according to his judgment. Like, he decided to verify sales transactions above the threshold amount of ₹ 25 lacs. Fresh additions to “Property, Plant and Equipment” above the threshold of the same amount were selected by him for detailed verification.

He also grew suspicious about certain sales transactions aggregating to ₹ 50 lacs. Such transactions were at fag end of the year, and goods moved out from the company's premises were purportedly sent through non-motorised conveyance without accompanying e-way bills to a single customer over a span of few days. It was agreed to send external confirmation request to this customer only. Besides, it was decided to go through all related party transactions in a detailed manner without exception to dig out any material misstatement.

Litigation claims involving the company were considered a misstatement prone area and came for detailed examination on his radar. Such a testing approach, he thought, would be efficient and cost-effective for obtaining audit evidence.

Can above approach followed by auditor be construed as “audit sampling”? What does it signify and to what kind of risk such an approach is subject to? Such a testing approach to obtain audit evidence relates to “selective examination of specific items” from class of transactions and account balances. While “selective examination of specific items” as a testing means to obtain audit evidence could be an efficient way of obtaining audit evidence, it does not constitute audit sampling.

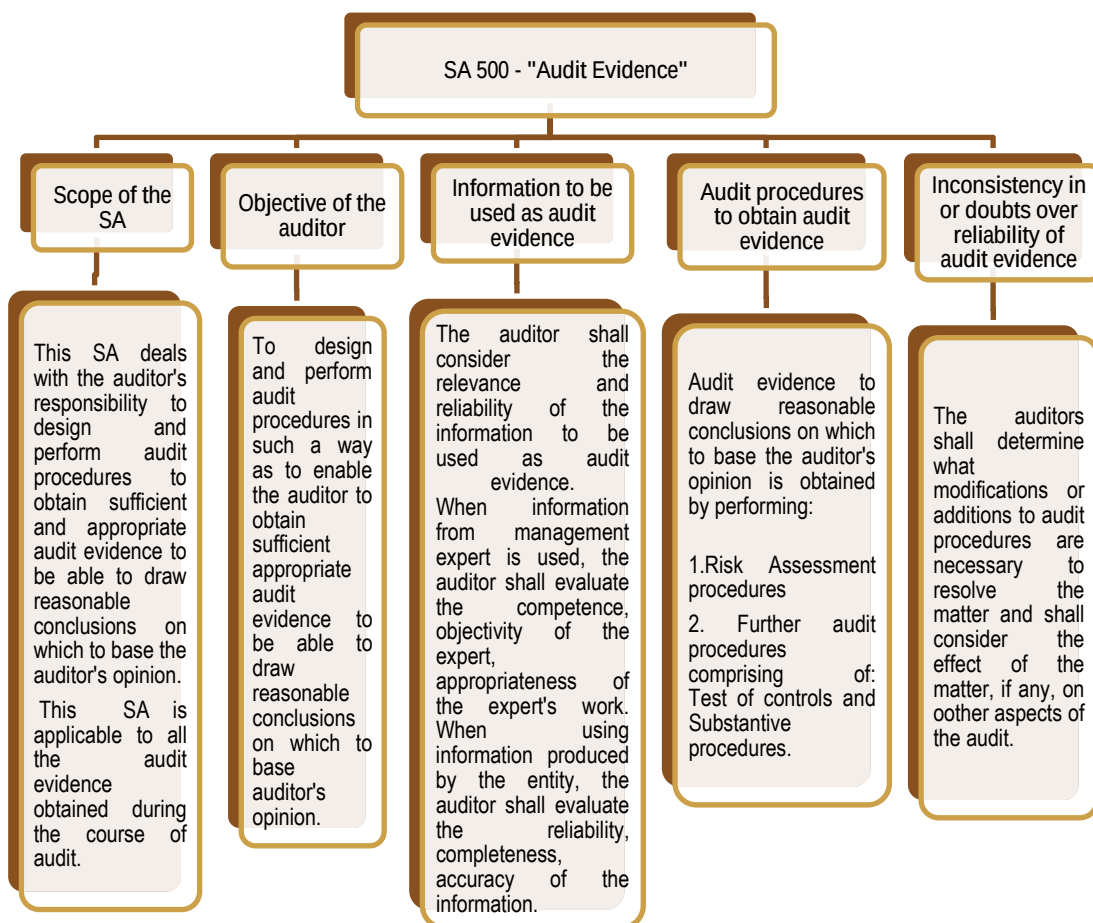
The results of audit procedures to items selected in this way cannot be projected to the entire population. “Selective examination of specific items” does not provide audit evidence concerning the remainder of the population. Such an approach is subject to non-sampling risk. It is the risk of an auditor reaching an erroneous conclusion due to inappropriate audit procedures, misinterpretation of audit evidence and failure to recognise a misstatement or deviation.

Whereas “audit sampling” refers to the application of audit procedures to less than 100% of items within a population relevant under the audit, such that all the items in the population have an equal chance of selection. Being subject to sampling risk, testing on the basis of samples may also lead to erroneous conclusions. It can be due to the risk that the auditor’s conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Such a risk is always there in audit sampling!

1. SA 500 AUDIT EVIDENCE

SA 500 deals with the auditor’s responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor’s opinion. It also explains what constitutes audit evidence in an audit of financial statements.

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



TEST YOUR UNDERSTANDING 1

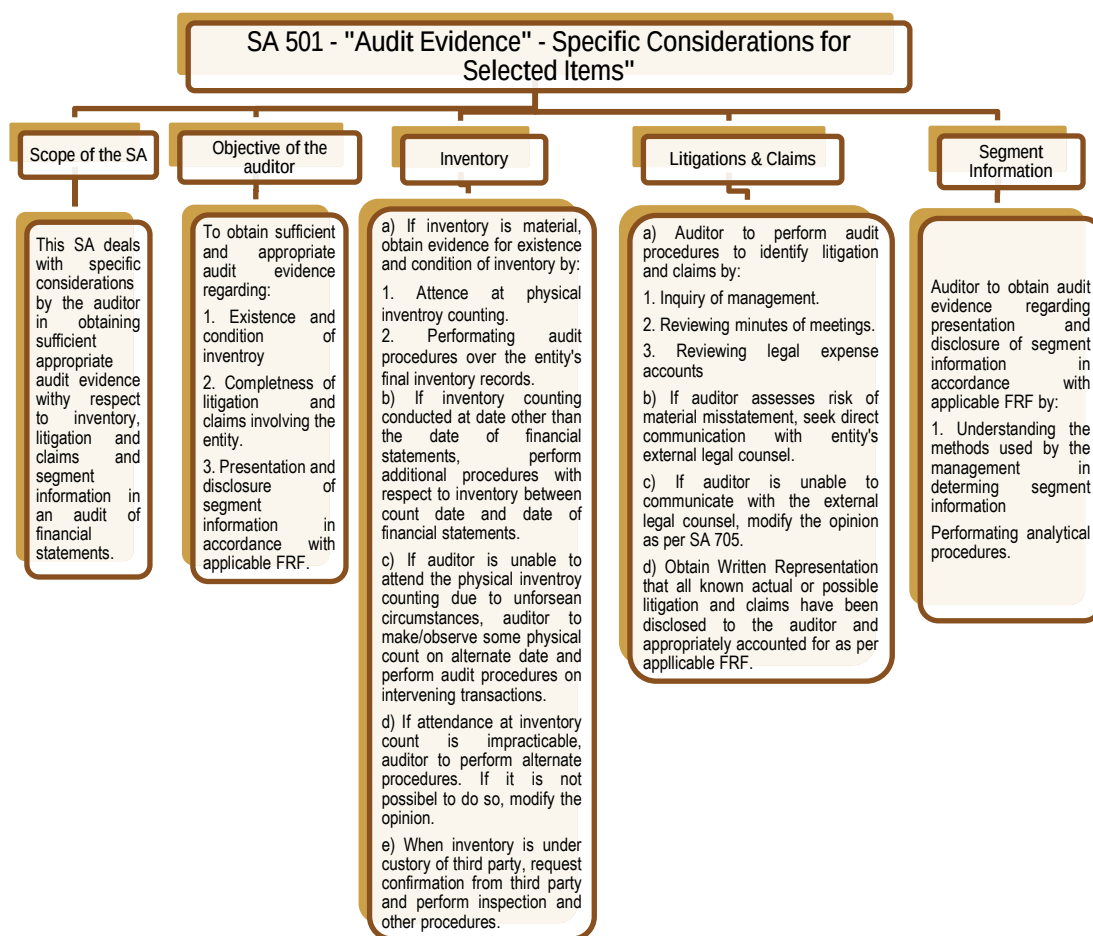
During the course of the audit of TK Home Private Limited, a recognized export house engaged in manufacturing of T-shirts under brand name of "TK". CA Tripti is verifying export revenues of the company for the year 2022-23. She has verified transactions entered in "Export Sales" account maintained in accounting software from relevant export invoices. The export sales are being made on payment of IGST, for which a refund is automatically credited in the account of the company after the goods are shipped.

On enquiring from internal audit staff regarding the recognition of export revenues, she is told that export sales are recognised for the year on the basis of "Bills of Lading". However, she is not convinced with such a response and feels that the same does not appear to be proper.

She finds that three export invoices bearing dates in the month of March 2023 having a value of ₹ 75.00 lacs have not been recognized in export revenue on the ground that bills of lading for these invoices were issued in the month of April 2023.

Discuss from what sources she can obtain reliable audit evidence in this regard. How can she challenge management's assertion regarding the completeness of export revenues for the year 2022-23?

2. SA 501 AUDIT EVIDENCE - SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS



SA 501 deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence with respect to certain aspects of inventory, litigation and claims involving the entity, and segment information in an audit of financial statements.

TEST YOUR UNDERSTANDING 2

CA Prabhjot has planned observing the physical count of inventories at the plant of a company located in remote area in the state of Uttarakhand as part of a statutory audit exercise as at close of year ending 31st March 2023. He has already informed the management of his intention to reach the plant site by evening of 29th March 2023. He plans to inspect inventories, observe the counting process and perform test counts among other matters.

The management has made all necessary arrangements to facilitate the above exercise. However, an agitation in Himalayan hills has started on 28th March 2023 for the promulgation of a strict law relating to the conversion of agricultural land for commercial use. Many civil society groups are participating in the agitation. NH-7 leading to the plant site is blocked by protestors. The plant is not accessible through any other mode. The blockade is lifted after one month when state government announced the formation of a committee to look into protestors' demands.

Does the above case highlight to a situation of "impracticability of attendance" at inventory counting in terms of requirements of SA 501?

How should the auditor proceed in above situation?

TEST YOUR UNDERSTANDING 3

On reviewing legal expenses account of Zed Ltd., CA. Sunitha, auditor of company, finds that legal fees amounting to ₹ 10 lac was paid to B. George, a reputed lawyer, during the year 2022-23. On inquiry with management regarding the purpose of such expenditure, evasive reply was received from management stating that a lot of work is performed by the said lawyer on behalf of the company. However, no specific details were provided.

She finds it proper to correspond directly with the lawyer. She obtains the address and mail id of the lawyer from his professional services bill. She shoots off an inquiry letter asking for the nature and status of litigation claims against the company on her letterhead.

Is her approach proper? Irrespective of the merits of the approach followed by her, what she is trying to achieve by corresponding with lawyer of the company?

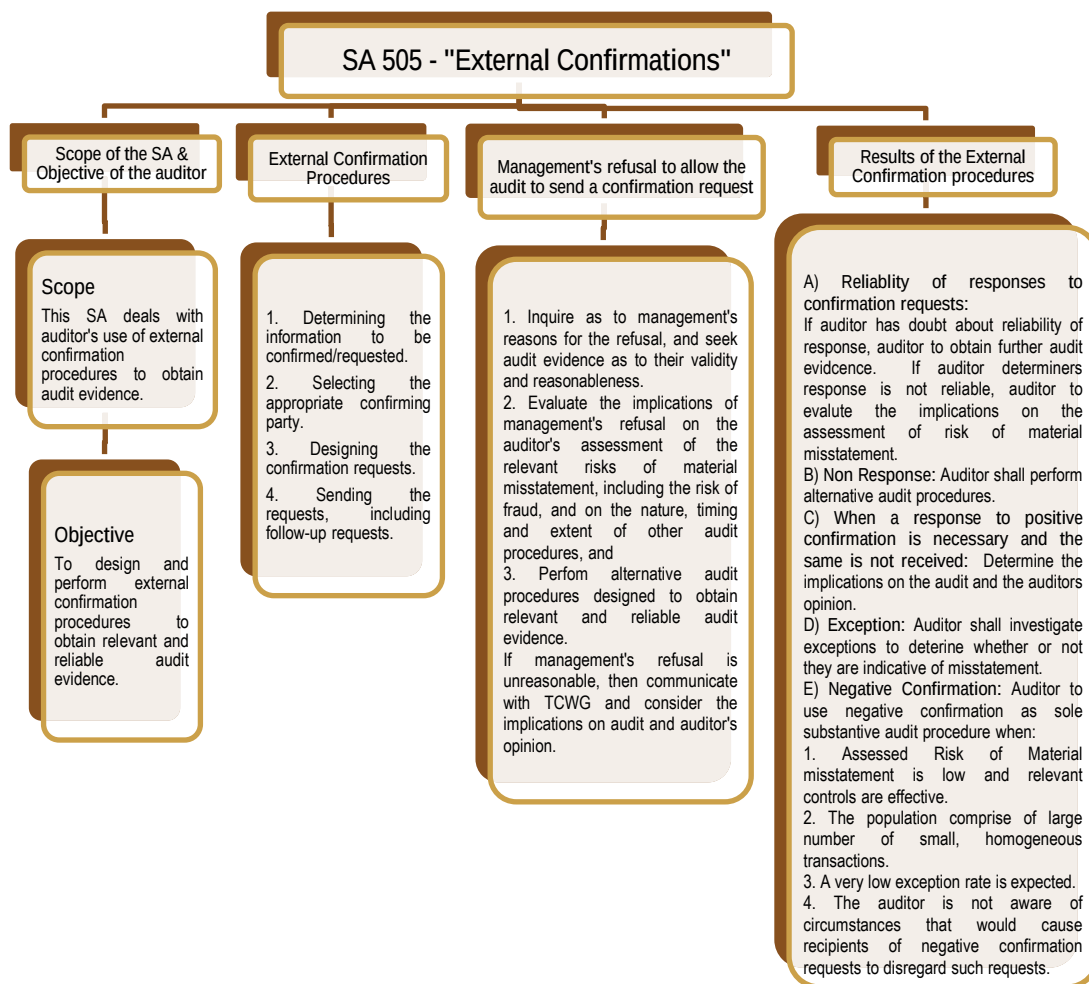
TEST YOUR UNDERSTANDING 4

On going through financial statements and records of "TS Ltd.," during the course of statutory audit, CA Tanmaya finds that substantial inventories of the company consisting of mast lighting poles remain with "Super Industries" for certain finishing works. While planning audit procedures, he had planned about seeking confirmation from "Super Industries" regarding existence and condition of such mast lighting poles belonging to TS Ltd. lying with them as on 31st March, 2023.

However, the premises of "Super Industries" were raided by DGGI officials (Director General of GST Intelligence) in connection with the busting of a fake billing scam. The proprietor of the firm was arrested in November 2022 and came out on bail in the month of March 2023. The details of proprietor and his firm were flashed prominently in local newspapers of the city where company is located. CA. Tanmaya also belongs to the same place. Discuss how he should proceed in the above matter as auditor of TS Ltd.



3. SA 505 EXTERNAL CONFIRMATIONS



SA 505 deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of SA 500. It is intended to assist the auditor in designing and performing external confirmations procedures to obtain relevant and reliable audit evidence.

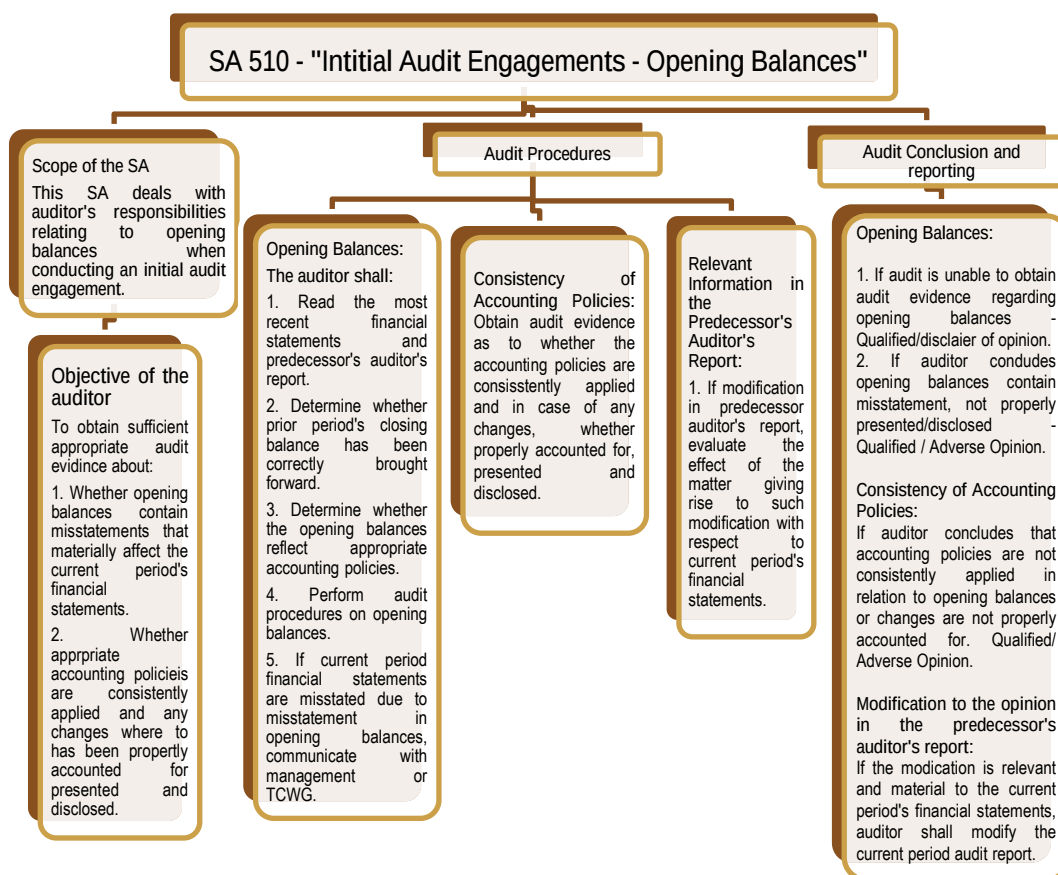
TEST YOUR UNDERSTANDING 5

As auditor of Groom Limited, you have sent positive confirmation requests to 30 creditors of the company in March 2023. All of the creditors in informal sector are small concerns. You choose to send positive confirmation requests to all the above parties at their business addresses stated on respective bills after discussing the matter with CFO of the company. The CFO is cooperative and does not raise any hassles in the matter.

Responses to confirmation requests are received within a week's time. Your articled clerk informs you that out of above 30 creditors, GST registrations of 25 concerns have been cancelled during financial year 2022-23 itself by collating information from GST portal. He further informs you that there are no fresh registrations pertaining to PANs of these parties.

How you would proceed to deal with the situation as auditor of the company?

4. SA 510 INITIAL AUDIT ENGAGEMENTS-OPENING BALANCES



SA 510 deals with the auditor's responsibilities relating to opening balances when conducting an initial audit engagement. An initial audit engagement is an engagement in which either the financial statements for prior period were not audited or were audited by a predecessor auditor.

TEST YOUR UNDERSTANDING 6

CA M. Hussain is appointed auditor of a firm for year 2022-23 on 31st July, 2022. The accounts of firm were unaudited in year 2021-22. The firm had material inventories reflected in its financial statements even as on close of 31st March, 2022.

He is performing audit procedures, including attending physical inventory count as on 31st March, 2023. However, there is a lingering doubt in his mind regarding opening inventories reflected in financial statements.

Does there exist any responsibility on his part in such a situation?

5. SA 530 AUDIT SAMPLING

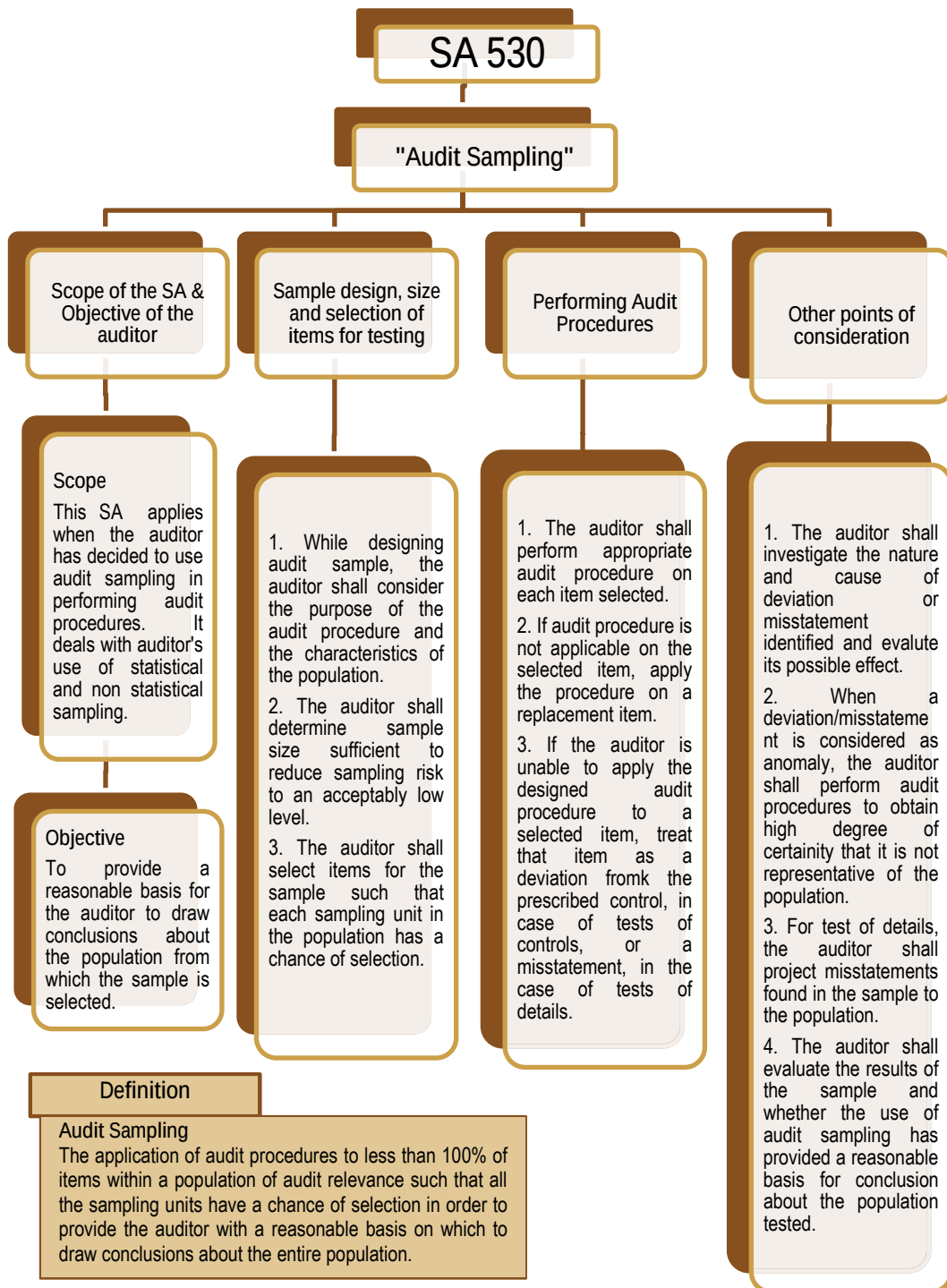
SA 530 deals with the auditor's use of statistical and non-statistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details and evaluating the results from the sample.

TEST YOUR UNDERSTANDING 7

CA. Ritesh Deshpande has drawn some samples during the course of audit of a manufacturing company for testing controls as well as for tests of details. On the basis of the samples selected, he reaches an erroneous conclusion that access controls on applications are less effective.

Further, on the basis of samples selected, he concludes erroneously that work-in progress inventories amounting to ₹ 5 crore in financial statements are materially misstated.

Outlining the above risk involved, discuss how it is going to affect his audit of the company.





6. SA 550 RELATED PARTIES

SA 550- " Related Parties"					
Scope of the SA	Objectives of the auditor	Requirements of the SA	Identification of previously unidentified or undisclosed related party transactions.	Identified significant related party transactions outside the entity's normal course of business	Other important points
This SA deals with the auditor's responsibilities regarding related party relationships and transactions. It expands on how SA 315, SA 330, SA 240 are to be applied in relation to related party relationships and transactions.	To obtain an understanding of the related party transactions to: 1. recognize fraud risk factors arising from such transactions. 2. conclude whether financial statements in so far as they are affected by such transactions a) achieve a true and fair presentation. b) are not misleading. To obtain audit evidence as to whether the related party transactions are properly identified, accounted for, and disclosed in the financial statements.	1. Risk Assessment procedures and related activities. 2. Understanding the Entity's related party relationships and transactions. 3. Maintaining alertness for related party information when reviewing records or documents. 4. Sharing related party information with the Engagement team. 5. Identification and assessment of the risk of material misstatement associated with related party transactions and relationships. 6. Responses to the Risks of Material Misstatement associated with related party relationships and transactions.	1. Auditor shall determine whether the underlying circumstances confirm the existence of such transactions. 2. Communicate within the team. 3. Request management to identify all transactions with newly identified related parties. 4. Perform more substantive procedures. 5. Reconsider risks with respect to other related parties. 5. If non disclosure by the management appears intentional, evaluate the implications for the audit.	1. Inspect the underlying contracts and evaluate: a) the business rationale of the transactions. b) whether the terms of transactions are consistent with management's explanations. c) whether such transactions have been properly accounted for. 2. Obtain audit evidence that the transactions have been appropriately authorised and approved.	The auditor shall obtain Written Representation that: a) all the related parties and related party transactions have been disclosed to the auditor and b) all such transactions have been properly accounted for and disclosed. Communication with TCWG The auditor shall communicate with TCWG significant matters arising during the audit in connection with the entity's related parties. Documentation: The auditor shall include in audit documentation names of the related parties and the nature of the related party transactions.

SA 550 deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements. Specifically, it applies in relation to risks of material misstatement associated with related party relationships and transactions.

TEST YOUR UNDERSTANDING 8

"Living Well Private Limited" is engaged in the manufacturing and export of floor coverings. Such products are labour-intensive and do not require much of capital investment in machinery. The company has no plans to diversify in other product lines. Its directors are also holding significant interest in another company "My Living Private Limited" engaged in manufacturing of blankets using capital intensive machinery.

During the course of the audit of "My Living Private Limited", it was noticed by you that the company has sold machinery of ₹ 1 crore to "Living Well Private Limited" during the year. The transaction has been done at normal market rates applicable to such used machinery.

How do you view the above transaction as auditor of "My Living Private Limited"?

Case Study 1

Honest Speciality Chemicals Private Limited is a ₹ 1,000 crore turnover company having plants in Khopoli, Mahad, and Ankleshwar for manufacturing various products for fertilizer units, cosmetics and paint industry, etc. The company has built up a good reputation, and apart from the domestic market, it exports to the European market and the Middle East. The company is a closely held company owned by three friends and their family members. The types of materials handled and produced are hazardous.

Following further latest information relating to the company is as under: -

- The company needs to import the key raw materials and is exposed to high risk of price fluctuations and currency risks.
- The company carries high inventory due to the long import cycle and seasonal sales pattern.
- The working capital is almost 60% blocked in inventory and rest in receivables.
- The company has huge investments in plant and machinery financed through term loans from financial institutions.
- Since the company has large imports, it buys import licenses from the open market.

- The company has received customs notices about using fake licenses for importing materials without paying duty. The company has filed an appeal against the said notice and the same is pending with the Appellate Tribunal. The amount involved is material and, along with interest and penalty, could be more than 10% of turnover.
- The company has liquid chemicals stored in huge tanks.
- The powdered form of chemicals is stored in standard-sized drums
- Few items of stocks like coal, sulphur are lying in the open area.
- The company has huge domestic sales on a consignment basis, and vast quantities of finished inventories are lying with the consignees across India.
- The company has received an order from NGT to pay a fine of INR 1.5 crores for the emission of toxic chemicals in the air and water. The company has filed an appeal against the said order.
- The type of plant is such that it has to be a continuous process, and at any time, huge quantities of materials are in process.
- Raw Materials are stored in huge tanks located 2 kilometres from the plant, and to transport the chemicals (liquid), there is a network of pipes connecting them, and at any point in time, there are huge quantities of materials lying in the pipeline.
- The company has prepared its inventory details by involving a management expert.
- During the year, the previous auditor resigned, and a new auditor got appointed.

Theoretical Questions

Based on the case study, please advise the auditor on the important aspects of carrying out the audit procedures to obtain sufficient appropriate audit evidence in respect of the following: -

1. *Which audit procedures are required for verifying existence and condition of company's inventories with specific reference to its nature of operations?*
2. *The company has prepared inventory details by involving a management's expert. Elaborating upon its rationale, discuss responsibilities of auditor in regard to information prepared by company involving such an expert.*
3. *What additional procedures does the auditor need to carry out in respect of stocks lying with consignees all over the country?*
4. *What procedures should the auditor need to undertake for litigation matters?*

Multiple Choice Questions

1. *The objectivity of the management's expert is likely to be lesser if:*
 - (a) *The expert is competent*
 - (b) *The expert is capable*
 - (c) *The expert has relevant experience*
 - (d) *The expert is employed by the entity*
2. *Which of the following matters is irrelevant for auditor in planning attendance at physical inventory counts?*
 - (a) *Nature of inventory*
 - (b) *The timing of physical inventory counting*
 - (c) *The nature of the internal control related to inventory*
 - (d) *Whether 100% of inventory is covered in the count*
3. *External confirmations for receivables are not reliable in which of the following situations:*
 - (a) *The response directly received by the auditor*
 - (b) *The confirmation has come from the address of the confirming party*
 - (c) *The confirmation is signed by the plant manager*
 - (d) *The confirmation is positive confirmation*
4. *The new auditor planned certain procedures with respect to opening balances. Which of the following procedures is not in accordance with SA 510?*
 - (a) *Reading the most recent financial statements and audit report*
 - (b) *Where the prior period report is modified, the impact on the current period*
 - (c) *Correctly bringing forward of prior period closing balances*
 - (d) *Ascertaining whether predecessor auditor had attended physical inventory count*

Answers to Theoretical Questions

1. The auditor needs to obtain sufficient appropriate audit evidence regarding existence and condition of inventory.

For the above, the auditor needs to do all the following: -

- (a) Attendance at physical inventory counting to:
 - (i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting like:
 - The existence of appropriate control activities: collection of used physical inventory count records, accounting for unused physical inventory count records, count and recount procedures.
 - The accurate identification of the stage of completion of work-in-progress, of slow moving, obsolete, or damaged items and of inventory lying in tanks, in pipes and in open areas.
 - The procedures used to estimate physical quantities, for liquid chemicals lying in process, tanks, pipelines, in open areas like coal pile, sulphur pile, etc.
 - Control over the moment of inventory between areas and the shipping and receipt of inventory before and after the cut off date.
 - (b) Observe the performance of Management's count procedure by observing the control over the movement of inventory before, during and after the count to determine adequacy and effectiveness of count procedure.
 - (c) Inspect the inventory to assist in identifying obsolete, damaged or ageing of inventory.
 - (d) Perform the test counts to obtain the sufficient appropriate audit evidence
 - (i) By tracing items selected from the physical inventory to management's count records,
 - (ii) By obtaining copies of Management's completed physical inventory count records
 - (e) Cross matching the final inventory records with the actual inventory count results.
- 2. The company deals with speciality chemicals which are in liquid condition, powdered condition, lying in the huge tanks or in plants under process, lying in pipelines or lying in open areas like coal and sulphur. The unit of measurement for each of the above categories may be different and could involve technical and mathematical principles involving technical and

scientific expertise. Keeping these matters in view, inventory details have been prepared by involving management's expert.

When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, having regard to the significance of that expert's work for the auditor's purposes:

- (a) Evaluate the competence, capabilities and objectivity of that expert
 - (b) Obtain an understanding of the work of that expert and
 - (c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.
3. Apart from obtaining the confirmation from the third party as to the quantities and condition of the inventory held on behalf of the entity, the auditor may perform the following other audit procedures:
 - Attending, or arranging for another auditor to attend, the third party's physical counting of inventory,
 - 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
4. The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity by:-
 - Inquiry of management and, where applicable, others within the entity including in-house legal counsel.
 - Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel.
 - Reviewing legal expense account.

The legal claims involving customs and fine of NGT are material. In such circumstances if auditor assesses risk of material misstatements regarding litigation, he can seek letter of specific inquiry from the external legal counsel including: -

- A list of litigation and claims

- Where applicable, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including cost involved and
- A request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered incomplete or incorrect.
- The auditor may seek meeting with the external legal counsel if the matter is having significant risk, it is complex or there is disagreement between management assertion and legal counsel's views.
- Obtaining written representation from the management and where appropriate those charged with governance that all the known actual or possible litigation and claims whose effects should be considered when preparing the financial statement have been disclosed to the auditor and appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.

Answers to Multiple Choice Questions

1. (d)
2. (d)
3. (c)
4. (d)

Case Study 2

"Trustworthy Real Estate Private Limited" with Mr. Bharose Lal as MD along with his wife, Maya, owned the company.

The company had floated one SPV *"Real Trust Developers Private Limited"* in which a foreign entity became a Joint Venture partner with a 50% stake.

The venture was formed with its Head Office in Mumbai to invest in SRA projects (Slum rehabilitation authority) and develop them into commercial units for sale.

Mr. Bharose Lal was going through a rough patch in his life. He was in financial difficulty and had mounting dues and huge outstanding exposure to banks and suppliers in his companies. Mrs. Maya was from a very wealthy family and had fallen in love with Mr. Bharose Lal, who was from a middle-class family. Mrs. Maya had an expensive lifestyle and was always short of funds to maintain her

lifestyle. Mr. Bharose Lal sensed a golden opportunity in the new venture because the foreign partner had no knowledge of Indian regulations and how the SRA projects worked and was solely dependent on the local partner to get all the permissions, scouting for the projects, getting consents from the slum dwellers for the project, giving contracts for the construction of projects and such matters.

M/S ABC and Company, Chartered Accountants were appointed as the auditor of the joint venture, and the engagement team was headed by CA Sceptic, who had, in his stint with the firm, was instrumental in unearthing two major frauds and had the ability to sniff out any such scenarios.

Mr. Bharose Lal has a dominant personality and a powerful influence on functioning, and everybody looks to him for guidance. The governance structure was very poor in the organization, and Mr. Bharose Lal used to dictate the decisions. Even though as part of the Joint Venture, there was a detailed governance structure and policies and procedures in place for the decision-making process at the joint venture. However, the representative on the board of the Joint Venture of the foreign partner who had shifted to India to supervise the SRA project had grown friendly with Mr. Bharose Lal, and Mr. Bharose Lal had even gone out of the way to help him get good accommodation and second-hand Mercedes. Often, they both go to a club in the evening for a drink.

The dealings in the SRA project are not very transparent and above board but are very opaque. Given the above situation, CA Sceptic wants to discuss with the audit team areas and situations where risk of material misstatement is possible and there are chances of having an undisclosed related party relationship to misappropriate the funds.

Theoretical Questions

1. *Please guide the engagement team on the further course of action as per SA 550.*
2. *What are fraud risk factors in given case?*
3. *Given the situation that each partner in the joint venture has to bring into the entity a contribution of 5 crores each and given the situation that Mr Bharose Lal had appointed one agency, the name Useless & Sons Private Limited, to get consent from the slum dwellers, for which the agency was paid 20 crores as Kitty to get the job done.*

CA Sceptic inclines that there is some connection between the 20 crores paid and, simultaneously, within a short span, the infusion of INR 5 crores as equity contribution by Mr. Bharose Lal.

Please guide CA Sceptic in establishing this link based on the guidance available in SA 550 and SA 240.

What additional audit procedures does his team need to undertake for the conclusion?

4. *If, based on additional audit procedures undertaken by CA Sceptic, it is established that there is a likelihood of misappropriation of funds and the financial statements as a whole may be materially misstated, how CA Sceptic needs to plan the future course of action?*

Multiple Choice Questions

1. *Which of the following best describes the method that Mr. Bharose Lal can indulge to commit fraud?*
 - (a) *Concealing and not disclosing facts that could affect the amounts recorded in financial statements.*
 - (b) *Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.*
 - (c) *Causing an entity to pay for goods or services not received.*
 - (d) *Using undisclosed business partners to misappropriate funds in the garb of making a business transaction and thus siphoning off the funds.*
2. *In the given case scenario, the main factor giving rise to risk of material misstatement is:*
 - (a) *The expensive lifestyle of owners.*
 - (b) *Appointment of an auditor having experience in unearthing of frauds*
 - (c) *The deteriorating financial condition of the owner's business.*
 - (d) *The vulnerability and dependence of the foreign partner on the local partner.*
3. *In the given case scenario, which is the most important red flag for auditor:*
 - (a) *Expensive lifestyle*
 - (b) *Undisclosed related party relationships to siphon off the funds.*
 - (c) *Financial crunch*
 - (d) *The dominant influence of the owners*
4. *Which of the following is not a fraud risk factor?*
 - (a) *Dominant influence of the owners*
 - (b) *Expensive lifestyle*
 - (c) *Fraud risk due to the nature of the industry*
 - (d) *Floating of a new SPV itself*

Answers to Theoretical Questions

1. The engagement team shall include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions.
 - The nature and extent of the entity's relationships and transactions with related parties as identified independently by the Auditor by verification of MBP-1 data and data available on MCA website relating to directors and companies, etc.
 - An emphasis on the importance of maintaining Professional Skepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions.
 - The circumstances or conditions of the entity that may indicate the existence of related party relationships or transactions that management has not identified or disclosed to the auditor (e.g., a complex organisational structure, use of special purpose entities off-balance sheet transactions, or an inadequate information system).
 - The records or documents that may indicate the existence of related party relationships or transactions.
 - The importance of management and those charged with governance attached to the identification, appropriate accounting for, and disclosure of related party relationships and transactions (if the applicable financial reporting framework establishes related party requirement), and the related risk of Management override of relevant controls.
 - In addition, the discussion in the context of fraud may include specific consideration of how related parties may be involved in fraud. For example:
 - (a) How special-purpose entities controlled by management might be used to facilitate earnings management
 - (b) How transaction between the entity and known business partner of a key member of management could be arranged to facilitate misappropriation of the entity's assets.
 - An exchange of ideas among engagement team members about how and where they believe the entity's financial statements may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and 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 behaviour 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 through out 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.
2. The fraud risk factors are the events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

The fraud risk factors are classified based on the three conditions that are generally present when fraud exists:

- (i) An incentive or pressure to commit fraud
- (ii) A perceived opportunity to commit fraud
- (iii) An ability to rationalize the fraudulent action.

In the given case scenario following fraud risk factors can be segregated in the 2 conditions of incentive or pressure to commit fraud in a perceived opportunity to commit fraud.

- 1) An incentive or pressure to commit fraud:
 - Financial difficulty with huge outstanding dues towards vendors and Financial Institutions.
 - Expensive lifestyle.
 - Requirement to fund ₹ 5 crore as equity contribution in the SPV.
- 2) A perceived opportunity to commit fraud:
 - Dependency of the foreign partner and no knowledge of the foreign partner of local laws and the SRA business model in India
 - The risk is due to the way the real estate industry functions and particularly risk due to the SRA business model.
 - Dominant personality of MD, which can lead to management override of controls for undisclosed business relationships with M/s. Useless and Sons (P) Ltd.
3. If the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditors, the auditor shall determine whether the underlying circumstances confirm the existence of those relationships or transactions.

In such situations, the auditor shall:

- Promptly communicate the relevant information to the other members of the engagement team in order to assist them in determining whether this information affects the results of and conclusions drawn from risk assessment procedures already performed, including whether the risk of material misstatement needs to be reassessed.
- Where the applicable financial reporting framework establishes related party requirements:

- (i) Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation; and
- (ii) Inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;
 - Perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions.
 - Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclose to the auditor, and perform additional audit procedures as necessary; and
 - If the non-disclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit. In such cases, the requirements and guidance in SA-240 regarding the auditor's responsibilities relating to fraud in an audit of financial statements are relevant where management appears to have intentionally failed to disclose related parties or significant related party transactions to the auditor. The auditor may also consider whether it is necessary to re-evaluate the reliability of management's responses to the auditor's inquiries and management's representations to the auditor.
 - The Auditor needs to carry out verification and inspection of the ownership structure and the review of the financial statements of the M/s. Useless and Sons (P) Ltd through the MCA website and establish the nexus between the two.
 - The Auditor needs to carry out an inspection of the data filed by Mr. Bharose Lal for his group companies to establish any past transactions/relationships between the two entities.
 - The Auditor needs to ask for all the documents for the utilization of INR 20 crore and can investigate by visiting the parties involved and asking for confirmation directly.

4. The Auditor needs to reassess the reliability of evidence previously obtained as there are doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation.
- (a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is the requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
 - (b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and
 - (c) If the auditor withdraws:
 - (i) Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and
 - (ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

MCQ answers

1. (d) 2. (d) 3. (b) 4. (d)

Integrated Case Scenario

Black & White Ltd. is into the business of manufacturing readymade garments in Amritsar. It procures all the raw material required for its production from Punjab, Himachal Pradesh & J&K. Its sales market, however, covers almost all the northern parts of the country. CA Anu is the engagement partner of Maheshwari & Co appointed as the statutory auditor of the company. She calls for a meeting of the engagement team to delegate work and responsibilities. During the audit, the engagement team comes across the following facts:-

- Woolen Private Limited is one of the vendors of the company from which the company has been purchasing wool for many years on a current account basis, but no single purchase has been made in the last nine months, and the outstanding balance stands as it is in the books of accounts. CA Anu wants to confirm the balance and requests the CFO of the company for sending a balance confirmation request to Woolen Private Ltd., to which he refuses and is not willing.

- The Fashion Jingo Ltd. is one of the customers of the company and hasn't replied to CA Anu's positive balance confirmation request sent.
- Mr X, one of the fashion designers, had sold his designs to the company but owing to a dispute, the contract got cancelled, and now both the parties are under litigation in the local court of law. The engagement team is guided as to the procedures to be designed and performed to identify this matter.
- CA Anu simultaneously seeks direct communication with the company's external legal counsel sensing the risk of material misstatement. However, it ends up in vain as the external legal counsel, Mr Chadha, refuses to comment. She is unable to obtain sufficient appropriate audit evidence in this regard through alternative audit procedures either.

The team documents all the relevant information w.r.t. the above facts, and CA Anu issues the audit report accordingly.

Multiple Choice Questions

1. *Fashion Jingo Ltd. has not responded to CA Anu's request. What should be proper course of action for her in such a situation?*
 - (a) *Perform alternative audit procedures*
 - (b) *Consider it as a negative confirmation*
 - (c) *Give a Qualified opinion*
 - (d) *Should visit the customer company premises herself and confirm the balance on the spot.*
2. *With respect to advocate Chadha's cold shoulder to CA Anu's request, what she should do?*
 - (a) *Modify her audit opinion*
 - (b) *Give an unqualified opinion*
 - (c) *Give a disclaimer of opinion*
 - (d) *Withdraw from this engagement*
3. *What should be CA Anu's first and foremost response in the case of request made relating to balance confirmation from Woolen Pvt. Ltd.?*
 - (a) *Perform alternate audit procedures.*

- (b) *Withdraw from the engagement.*
 - (c) *Communicate with Those charged with Governance telling the effects on his audit opinion.*
 - (d) *Inquire as to the reasons behind the management's response and seek audit evidence as to its validity and reasonableness.*
4. *Which of the following procedures will not be performed by the engagement team as audit procedures while dealing with the case of Mr. X?*
- (a) *Inquiry of Management.*
 - (b) *Inquiry of Mr. X*
 - (c) *Reviewing Minutes of Meetings*
 - (d) *Reviewing Legal expenses account*

Answer to MCQs of Integrated Case Scenario

1. (a) 2. (a) 3. (d) 4. (b)

Key Takeaways

- SA 500 deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.
- The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based.
- Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing.
- Reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability.

- When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes, evaluate competence, capability and objectivity of such an expert besides obtaining understanding of his work. Further, appropriateness of management's expert work as audit evidence for relevant assertion has also to be evaluated.
- SA 501 deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence with respect to certain aspects of inventory, litigation and claims involving the entity, and segment information in an audit of financial statements.
- When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by attendance at physical inventory counting, unless impracticable.
- The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement. Litigation and claims involving the entity may have a material effect on the financial statements and thus may be required to be disclosed or accounted for in the financial statements.
- Segment information refers to information about different types of products and services of an enterprise and its operations in different geographical areas. In accordance with SA 501, the auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework.
- SA 505 deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of SA 500. It is intended to assist the auditor in designing and performing external confirmations procedures to obtain relevant and reliable audit evidence.
- SA 510 deals with the auditor's responsibilities relating to opening balances when conducting an initial audit engagement. An initial audit engagement is an engagement in which either the financial statements for prior period were not audited or were audited by a predecessor auditor.
- SA 530 deals with the auditor's use of statistical and non-statistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details and evaluating the results from the sample.

- The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.
- Sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure.
- Whatever may be the approach, statistical sampling or non-statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.
- SA 550 deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements.

FOR SHORTCUT TO ENGAGEMENT & QUALITY CONTROLS STANDARDS WISDOM:
SCAN ME !



Note : Content of SA 500- Audit Evidence; SA 501-Audit Evidence - Specific Considerations for Selected Items; SA 505-External Confirmations; SA 510- Initial Audit Engagements – Opening Balances; SA 530 Audit Sampling & SA 550 - Related Parties is covered in depth at Intermediate level. Thus, application part of above SAs may be discussed in the form of Case Study at Final level.

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *Coccyx Ltd. supplies navy uniforms across the country. The company has 3 warehouses at different locations throughout the India and 5 warehouses at the borders. The major stocks are generally supplied from the borders. Coccyx Ltd. appointed M/s OPAQE & Co. to conduct its audit for the financial year 2022-23. Mr. P, partner of M/s OPAQE & Co., attended all the physical inventory counting conducted throughout the India but could not attend the same at borders due to some unavoidable reason.*

You are required to advise M/s OPAQE & Co.,

- (I) *How sufficient appropriate audit evidence regarding the existence and condition of inventory may be obtained?*
 - (II) *How is an auditor supposed to deal when attendance at physical inventory counting is impracticable?*
2. *GHK Associates, Chartered Accountants, conducting the audit of PBS Ltd., a listed company for the year ended 31.03.2023 is concerned with the presentation and disclosure of segment information included in Company's Annual Report. GHK Associates want to ensure that methods adopted by management for determining segment information have resulted in disclosure in accordance with the applicable financial reporting framework. Guide GHK Associates with 'Examples of Matters' that may be relevant when obtaining an understanding of the methods used by the management with reference to the relevant Standards on Auditing.*
3. *Chintamani Ltd appoints Chintan & Mani as statutory auditors for the financial year 2022-2023. Chintan & Mani seem to have different opinions on Audit approach to be adopted for audit of Chintamani Ltd. Mani is of the opinion that 100% checking is not required and they can rely on Audit Sampling techniques in order to provide them a reasonable basis on which they can draw conclusions about the entire population.*

Chintan is concerned that whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

You are required to guide Chintan about his role if audit sampling has not provided a reasonable basis for conclusions about the population that has been tested in accordance with SA 530.

4. *During the audit of Star Ltd. a company engaged in the production of paper, the auditor received certain confirmation for the balances of trade payables outstanding in the balance sheet through external confirmation by "Negative Confirmation Request". In the list of trade payables, there are number of small balances except one which is an old outstanding of ₹ 20 lakhs for which no confirmation was received. Comment with respect to Standards of Auditing relating to the confirmation process and how to deal the non-receipt of confirmation.*

Answers to Test your Understanding

1. She can obtain reliable audit evidence by going through GST returns filed by the company on GST portal and correlating the same with e-way bills. She can obtain audit evidence about how company has reflected its export sales in its GST returns and whether export sales pertaining to three invoices having value of ₹ 75.00 lacs are reflected in such returns.

Further, e-way bills generated on the portal would provide evidence that goods have moved out of the company's premises. The export revenue should have been booked at the time the goods moved out of the company's premises. The company is claiming an IGST refund. The refund is linked to the monthly sales return. This aspect can also be verified.

"Bill of Lading" is only a document issued by the carrier to the shipper of goods that goods have been taken on board. She should challenge and counter management's assertion on the above grounds and point out violations of relevant accounting standards and principles. In this way, she can obtain reliable audit evidence.

Highlighting such digital and other evidence, she can challenge management's assertion regarding the completeness of export revenues and point out that export revenues are understated.

2. The above situation does not highlight the impracticability of attendance at inventory counting. It only shows that the auditor is unable to attend physical inventory counting due to unforeseen circumstances arising out of agitation by protestors. It has led to the inaccessibility of the plant site for a month. The blockade is lifted after a month.

SA 501 states that if the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date and perform audit procedures on intervening transactions. Therefore, the

audit should attend to the physical inventory count after the blockade is lifted and perform audit procedures on intervening transactions.

3. SA 501 states that when audit procedures performed indicate that material litigation or claims may exist, the auditor shall seek direct communication with the 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.

Therefore, her approach in communicating with an external lawyer is wrong. She has to make management aware of her intention to communicate directly with the lawyer. The letter of enquiry has to be prepared by management and sent by her.

Her purpose in corresponding with the lawyer of the company is to identify litigation and claims involving the entity which may give rise to a risk of material misstatement. It is due to the reason that litigation and claims involving the entity may have a material effect on the financial statements and thus may be required to be disclosed or accounted for in the financial statements.

4. SA 501 states that when inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

- (a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.
- (b) Perform inspection or other audit procedures appropriate in the circumstances.

It further states that 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.

Examples of other audit procedures include:

- 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

In the given case, the integrity of the third party appears to be doubtful in view of DGGI raids and his possible involvement in a fake billing scam. He has already been behind bars.

Keeping in view above, besides obtaining confirmation from such party, he may attend a third party's physical counting or ask some other auditor to attend physical counting as on reporting date, depending upon practical considerations. He can also inspect the record of goods sent and received back from such party by tracing it to challans, e-ways bills etc. and correlate the above information.

5. SA 505 states that if the auditor determines that a response to a confirmation request is not reliable, the auditor shall evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures.

In the instant case, GST registrations of 25 concerns have been cancelled in the year 2022-23. It indicates that businesses on those addresses were closed. Further, there are no fresh registrations pertaining to the PANs of these parties. However, the auditor sent external confirmation requests in March 2023, which were duly responded. It raises questions on the reliability of responses received.

SA 500 indicates that even when audit evidence is obtained from sources external to the entity, circumstances may exist that affect its reliability. All responses carry some risk of interception, alteration or fraud. Such risk exists regardless of whether a response is obtained in paper form or by electronic or other medium. Factors that may indicate doubts about the reliability of a response include:

- Was received by the auditor indirectly or
- Appeared not to come from the originally intended confirming party.

Keeping in view the circumstances described in the case situation, there is a risk that the response has not come from the originally intended confirming party.

Unreliable responses may indicate a fraud risk factor that requires evaluation.

6. SA 510 states that in conducting an initial audit engagement, one of the objectives of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether opening balances contain misstatements that materially affect the current period's financial statements. The auditor has to evaluate whether audit procedures performed in the current period provide evidence relevant to the opening balances or specific

audit procedures are required to be performed to obtain evidence regarding the opening balances.

In the case of inventories, however, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional audit procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence:

- Observing a current physical inventory count and reconciling it to the opening inventory quantities.
- Performing audit procedures on the valuation of the opening inventory items.
- Performing audit procedures on gross profit and cut-off.

7. The described risk is sampling risk. It is a risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure.

In the given case, the auditor has arrived at erroneous conclusions on the basis of the samples selected. In the case of a test of controls, he has concluded that access controls are less effective than they actually are. In the case of a test of details, he has concluded erroneously that a material misstatement exists when in fact, it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

8. In respect of significantly related party transactions outside the normal course of business of an entity, it is the responsibility of the auditor, in accordance with SA 550, to evaluate the business rationale or lack thereof of transactions that may have been entered to indulge in fraudulent financial reporting or conceal misappropriation of assets.

The auditor has to seek to understand the business rationale of such a transaction from a related party's perspective. It would help him understand the economic reality of such a transaction and why it was carried out.

In the given situation, there is no primary rationale for such a transaction. Living Well Private Limited does not manufacture blankets, and the purchase of part of old machinery pertaining to blanket manufacturing has no rationale for it primarily. A business rationale from the related party's perspective that appears inconsistent with the nature of its business may represent a fraud risk factor.

Hints /Answers to Theoretical Questions

1. (I) **Special Consideration with Regard to Inventory:** As per SA 501 “Audit Evidence-Specific Considerations for Selected Items”, when inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:
 - (1) Attendance at physical inventory counting, unless impracticable, to:
 - (i) Evaluate management’s instructions and procedures for recording and controlling the results of the entity’s physical inventory counting;
 - (ii) Observe the performance of management’s count procedures;
 - (iii) Inspect the inventory; and
 - (iv) Perform test counts; and
 - (2) Performing audit procedures over the entity’s final inventory records to determine whether they accurately reflect actual inventory count results.
- (II) **Attendance at Physical Inventory Counting Not Practicable:** In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the 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. The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in SA 200 “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”, the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

Further, 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 sufficient appropriate audit evidence about the existence and condition of inventory.

In some cases, though, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705 on Modifications to the Opinion in the Independent Auditor’s Report, requires the auditor to modify the opinion in the auditor’s report as a result of the scope limitation.

2. The auditors, GHK Associates wanted to ensure and obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by obtaining an understanding of the methods used by management in determining segment information. SA 501 guides in this regard. As per SA 501- “Audit Evidence—Specific Considerations for Selected Items”, example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:
 - (i) Sales, transfers and charges between segments, and elimination of inter-segment amounts.
 - (ii) Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
 - (iii) The allocation of assets and costs among segments.
 - (iv) Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.
3. As per SA 530, “Audit Sampling”, the auditor shall evaluate:
 - (a) The results of the sample; and
 - (b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

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:

 - (I) Request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or
 - (II) 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.
4. **External Confirmation:** As per SA 505, “External Confirmation”, negative confirmation is a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request. Negative confirmations 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.

Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation 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 favour, and less likely to respond otherwise.

In the instant case, the auditor sent the negative confirmation requesting the trade payables having outstanding balances in the balance sheet while doing audit of Star Limited. One of the old outstanding of ₹ 20 lakh has not sent the confirmation on the credit balance. In case of non-response, the auditor may examine subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes. Further non-response for negative confirmation request does not mean that there is some misstatement as negative confirmation request itself is to respond to the auditor only if the confirming party disagrees with the information provided in the request.

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COMPLETION AND REVIEW

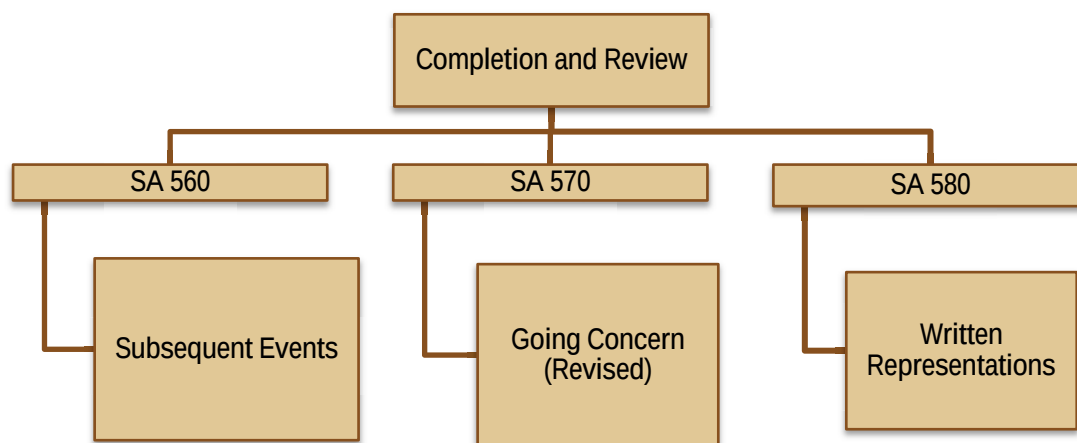


LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ❑ Refreshen up your knowledge about procedures relating to completion and review
- ❑ Glance through relevant SAs-SA 560, SA 570 and SA 580 pictorially
- ❑ Gain application-based knowledge of above SAs.
- ❑ Understand the concepts through use of analytical examples and case studies.
- ❑ Gain knowledge about varied practical situations for an auditor while performing such procedures

CHAPTER OVERVIEW



C.A. Sujatha M is an auditor of a company engaged in manufacturing energy-saving electric lights. As an auditor of the company, she already knew that a devastating fire had taken place in the plant of the company during the year gone by, and the entire plant building, machinery and inventories were gutted. Estimate of loss to the company's assets was to the tune of ₹ 50 crores. The company had lodged a claim with insurers, but there was no progress on the claim settlement front till the close of the year.

The company's operations have been shut down since then. The company had little money to reinvest in fresh assets on its own. The promoters had put certain personal properties for sale. However, due to the sluggish real estate market, no deals could fructify. Meanwhile, customers of the company had started procuring their requirements from other suppliers.

As an auditor of the company, she was in a predicament. The main question troubling her related to the ability of the company to restart its operations in such circumstances and to continue as a going concern. She had to complete the audit within the timelines. She was keeping her fingers crossed and adopted a "Wait and watch" policy to consider the impact of any developments regarding claim settlement. There were still four months left. She could wait.

Suddenly one day, she came to know that the forensic lab conducting the examination of samples taken from the fire site had given an adverse report casting doubt upon the genuineness of the claim itself. All hopes for the recovery of losses had dashed.

The management had provided her a future plan of action to restart the business. She was also provided with a “cash flow forecast” for coming periods. However, she was not convinced regarding expected cash flows. She was of the prima facie view that the company was not going to withstand such a huge loss in the absence of claim money, and its plans were too rosy and impracticable. The negative forensic lab report changed the whole situation.

However, on deeper scrutiny by management, the findings of the forensic lab appeared to be contradictory. The management found gaping loopholes in the said report. The company was earning good margins and was paying handsome taxes. It was in expansion mode. The demand for its products was also growing rapidly. In such a situation, why would one take such a criminal step? The management decided to take it heads on.

While performing her audit procedures, she checked for any updates on the claim. It became known to her that the management of the company had challenged the forensic lab reports by giving a point-wise rebuttal with the insurers. Even officers of the insurance company were not able to digest forensic lab reports. As the management provided video graphics and other digital evidence, the forensic lab was left red-faced. It seemed that extraneous considerations had prevailed in the course of the submission of their report.

The insurance company asked the forensic lab to reconsider their findings in light of the company’s submissions. A positive revised report was submitted by the lab to the insurance company. Now, doors had opened for settlement of the claim and resolution of the claim was in sight.

Performing audit procedures regarding subsequent events helped her to identify those conditions that either mitigate or otherwise affect the company’s ability to continue as a going concern. Since she was particular about performing procedures regarding subsequent events, she was able to identify mitigating factors affecting uncertainty associated with the outcome of the claim. In light of these developments, she could convince herself about the ability of the company to continue as a going concern.

After performing substantive procedures, certain procedures are still to be performed by the auditor before the audit report is issued. Some of such important procedures include dealing with the effect of subsequent events, obtaining sufficient appropriate evidence regarding the use of going concern assumption by management and obtaining written representations.



1. SA 560 SUBSEQUENT EVENTS

SA 560- " Subsequent Events"

Scope of the SA	Definitions	Objectives of the auditor	Events occurring between the date of the Financial Statements and 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 that become known to the auditor after the financial statements have been issued
This SA deals with auditor's responsibilities relating to subsequent events in an audit of financial statements.	Subsequent Events: Events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.	Obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements. Respond appropriately to the facts that become known to the auditor after the date of the auditor's report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.	1. The auditor shall perform audit procedures to ensure that all such events have been identified. 2. The auditor shall consider the auditor's risk assessment in determining the nature and extent of such procedures. 3. If such event is identified, determine whether such event is appropriately reflected in financial statements. 4. Obtain Written Representation that all such events have been adjusted or disclosed.	1. Discuss the matter with management or TCWG. 2. Determine whether the financial statements need amendment. 3. Inquire how management intends to address the matter in the financial statements. If management amends the financial statements, auditor should extend the audit procedures and 1. Either amend the audit report to include an additional date restricted to the amendment . 2.Or provide a new/ amended report including a statement in EOM/ OM para. If management doesn't amend the financial statements. 1. If audit report not yet provided to the management, modify the opinion. 2. If audit report has already been provided to the management, notify TCWG not to issue it to third parties. If still issued then take appropriate action to prevent reliance on the auditor's report.	1. Discuss the matter with management or TCWG. 2. Determine whether the financial statements need amendment. 3. Inquire how management intends to address the matter in the financial statements. Review if management has taken steps to inform about the situation to everyone in receipt of the previously issued financial statements. 1. If steps taken, issue new/ amended report with EOM/ OM para. If steps not taken, then take appropriate steps to prevent reliance on the auditor's report.

SA 560 deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. The objectives of auditor in this regard are to obtain sufficient appropriate evidence about whether such events are appropriately adjusted or disclosed in financial statements. Further, in case some facts have come to his knowledge after date of auditor's report, to respond to those facts such that had they been known to him at the date of the report, they may have caused him to amend the auditor's report.

TEST YOUR UNDERSTANDING 1

"Move Fast Limited" is engaged in the manufacturing of shoes and slippers located in Bahadurgarh in Haryana. Due to unprecedented rains in the area in the month of September 2022, many areas of the town got inundated due to the choking of sewer systems. As a result of the above, the company's premises located in town were also affected, resulting in damage of stocks.

The company has lodged a claim with the insurance company for ₹1 crore, and the same is shown as a claim receivable as of 31st March 2023, as the claim was not settled at year end.

The insurance surveyor appointed in the case submitted a report to the insurance company recommending a claim of ₹45 lacs in the month of April 2023. The company has also given its consent for the same, and the settled amount of ₹45 lacs was transferred to the bank account of the company on 15th May 2023.

You have just finished performing substantive procedures of the company by the end of May 2023. Is there any responsibility cast upon you as auditor of the company in the above situation?

TEST YOUR UNDERSTANDING 2

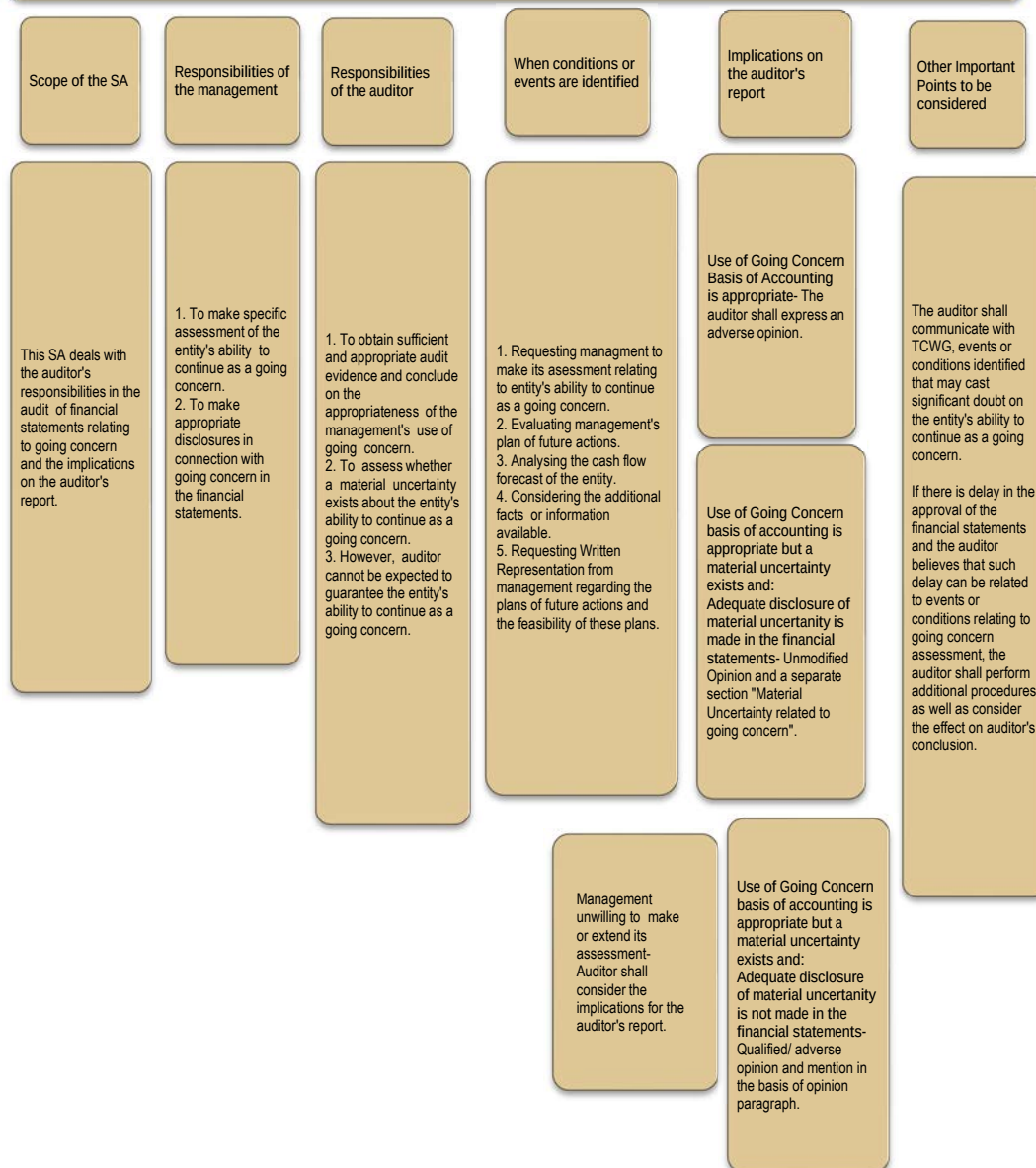
CA Anuj is the auditor of a listed company, and he is in the midst of conducting an audit of the said company for the financial year ending 31st March 2023. At a meeting of the Board of Directors held on 17th April 2023, a dividend of ₹1 crore is proposed to equity shareholders @ ₹10/- per share, and such a proposal has a good chance of being approved in the AGM of the company to be held after few months.

His audit procedures are near completion. He is contemplating finalizing the audit report by 31st July 2023. Is there any responsibility thrust upon him as auditor of the company?



2. SA 570 GOING CONCERN

SA 570- " Going Concern"



SA 570 Going Concern deals with the auditor's responsibilities in the audit of financial statements relating to going concern and the implications for the auditor's report.

The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding use of the going concern basis of accounting in the preparation of the financial statements by the management. On the basis of evidence obtained, it is concluded whether a material uncertainty exists relating to events or conditions that may cast a significant doubt on the entity's ability to continue as a going concern.

TEST YOUR UNDERSTANDING 3

CA. Somya is auditor of a company engaged in rearing of poultry birds and obtaining eggs therefrom. The company has performed very well since its incorporation in 2013. Its sales had also grown and the company had expanded its market from the native northern state of promoters to far-flung areas in eastern parts of country.

However, since last two years, company's fortunes have nosedived. First, due to the effects of the pandemic and then due to recurrent outbreaks of bird flu thrice in a span of two years. The company's sales have dipped from around ₹ 50 crores to ₹10 crores. Further, a major part of its livestock was also wiped off during bird flu. She is not optimistic about the going concern assumption followed by management.

The management now wants to start with new batches of birds. The earlier working capital facilities of the company granted by bank have also been restructured to support the business. She was informed that the repayments of restructured working capital term loans are to begin from ensuing year. No fresh credit facilities have been granted by the bank. The company also plans longer credits from animal feed suppliers.

The company plans to take additional measures to prevent the safety of live stocks, including aggressive vaccination, preventive health check-ups, and more frequent visits of veterinary staff.

The villagers in surrounding areas have accused the company of spreading air pollution.

The management has prepared a cash flow forecast for her examination. Discuss the approach to be adopted by her in examining the "going concern" assumption keeping in view above with specific reference to cash flow forecast.

TEST YOUR UNDERSTANDING 4

CA Sooraj finds that key financial ratios of a company, like current ratio, debt-service coverage ratio, inventory turnover ratio, and trade receivables turnover ratio, are in red and have deteriorated considerably as compared to last year. The company is also not able to pay to its creditors on time. The company is requesting time and again to its bankers to grant additional credit facilities, but bankers are not listening.

There have been significant losses to the company due to the lack of response of the company's products in the market. As a result of it, many products are sold at below cost price. There have been situations where the company is not able to pay the salaries of staff on time.

All these negative findings have led him to conclude that the use of going concern as the basis of accounting is not appropriate. He brings this matter to the knowledge of CFO of the company. What is reporting duty cast upon him in such a scenario?

The CFO informs him that the management, in turn, is ready to include in the disclosures the inappropriateness of its use of going concern assumption of accounting.

How should it impact the auditor's opinion in case management itself discloses the inappropriateness of its use of going concern assumption of accounting now?

 3. SA 580 WRITTEN REPRESENTATIONS

SA 580 Written representations deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance.

Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfilment of management's responsibilities or about specific assertions.

SA 580- " Written Representations"

Scope of the SA	Objectives of the auditor	Written Representation as Audit Evidence	Date & Periods covered by Written Representation	Important points to be considered
This SA deals with the auditor's responsibility to obtain written representation from management and, where appropriate, those charged with governance.	1. To obtain written representation from the management or TCWG that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor. 2. To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations. 3. To respond appropriately to written representation provided by management/ TCWG.	Although Written Representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own.	The date of Written Representation shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. Written Representation shall be for all financial statements and periods referred to in the auditor's report.	Doubts as to reliability of Written Representations: If written representations are inconsistent with other audit evidence, auditor shall perform audit procedures to resolve the matter. If the auditor concludes that the written representation are not reliable, the auditor shall take appropriate action in accordance with SA 705. Requested Written Representation not provided: Auditor shall discuss with the management, re-evaluate the integrity of management, take appropriate actions including the impact on audit report as per SA 705.

TEST YOUR UNDERSTANDING 5

Following is a written representation given by RES Limited to its statutory auditors i.e. M/s CTK & Associates for audit of financial year 2022-23. The audit was completed and report dated 31.7.23 was issued.

Point out, if there is any, anomaly in written representation reproduced below.

15th April, 2023

To

CTK & Associates

Chartered Accountants

Dear Sir,

This representation letter is provided in connection with your audit of the financial statements of RES Limited for the year ended March 31, 2023 for the purpose of expressing an opinion as to whether the financial statements give a true and fair view in accordance with the applicable accounting standards in India.

We confirm that (to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves):

Financial Statements

- We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated 17th August 2022 for the preparation of the financial statements in accordance with financial reporting Standards, in particular, the financial statements give a true and fair view in accordance with the applicable accounting standards in India.
- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable.
- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of applicable accounting standards in India. (SA 550)
- All events subsequent to the date of the financial statements and for which applicable accounting standards in India require adjustment or disclosure have been adjusted or disclosed. (SA 560)

- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter. (SA 450)

Information provided

- We have provided you with: -
 - Access to all information of which we are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
 - Additional information that you have requested from us for the purpose of the audit; and
 - Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.
- All transactions have been recorded in the accounting records and are reflected in the financial statements.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.
- We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves: -
 - Management;
 - Employees who have significant roles in internal control; or
 - Others where the fraud could have a material effect on the financial statements.
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.
- We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements.
- We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware. (SA 550)

Chief Financial Officer

Case Scenario 1

CA Sneha, a partner in M/s J & Associates, is carrying out a statutory audit of M/s ABC Stores Ltd. for the Financial Year 2022-23, and she is ready to sign her audit report on 01.07.2023. There are some written representations which are pending with the management of the company pertaining to such an audit, and she sent Deepak (her articled trainee), who is also a member of the engagement team, to the company's office for collection of the same.

On returning back, Deepak tells CA Sneha that major stocks of the company got destroyed because of a fire in their plant on 27.06.2023, and it has affected the company's operations badly. However, the business operations are likely to be resumed by management at an alternate place.

CA Sneha postponed the issuance of the audit report to consider the impact of such an event on the financial state of affairs of the company. She wants the management to disclose the impact of this unfortunate event in financial statements for the year 2022-23, to which management is disinclined. After the management's refusal, she issued her audit report on 15.07.2023.

The management of the company seeks an appointment from CA Sneha to discuss an important matter on 20.07.2023. They informed her that the company had lost a lawsuit filed against it by one of the creditors on 18.07.2023 in a fast-track court, and now the company has to pay the plaintiff a huge amount of ₹2 crores. The events causing this lawsuit arose after 31.03.2023.

CA Sneha is a bit perplexed, and her first question to the people from management visiting her office was whether audited financial statements have been made available to any third parties or filed with the regulator. The management responded negatively.

Now, CA Sneha wants them to amend the financial statements to include the impact of this lawsuit on the financial affairs of the company. This time, they agreed and amended the financial statements accordingly to cover the impact of both the events – that of the fire in the plant and losing the lawsuit, but they requested CA Sneha to issue a new audit report against the earlier one dated 15.7.2023.

The management amends the financial statements, which are finally approved on 25.7.2023. CA Sneha issues a new audit report.

Considering the above situation, answer the following questions: -

1. What should be the appropriate date of signing of the new audit report?
 - (a) 20.07.2023

- (b) Anytime between 15.07.2023 & 18.07.2023
 - (c) On or after 25.07.2023
 - (d) Anytime between 15.07.2023 & 25.07.2023
2. CA Sneha would have taken into account a lot of procedures to get knowledge of the events occurring after the balance sheet date up to the date of the audit report relating to the company. Which of the following does not fall under such audit procedures as per SA 560?
- (a) Obtaining an understanding of the management's procedures set up to identify subsequent events.
 - (b) Inquiring of the management w.r.t the occurrence of any such subsequent events.
 - (c) Reading the minutes of the meetings of the board held after the balance sheet date during this period.
 - (d) Getting the Interim financial statements prepared till the date of the audit report mandatorily as a condition to issue the audit report
3. W.r.t the first audit report dated 15.07.2023, which type of opinion was most likely provided by her?
- (a) Modified opinion
 - (b) Unqualified opinion
 - (c) Disclaimer of opinion
 - (d) Including a statement in Emphasis of Matter/Other matters para
4. W.r.t the new audit report issued, which type of opinion is most appropriate?
- (a) Disclaimer of opinion
 - (b) Unqualified opinion
 - (c) Adverse opinion
 - (d) Unqualified opinion and a statement in Emphasis of Matter/Other matters para.
5. The fire event occurring on 27.6.2023 in the company's plant requires the following action on part of management: -
- (a) Disclosure in notes to accounts
 - (b) Adjustment in financial statements
 - (c) Waiting for the insurance company to settle the claim
 - (d) Preparing financial statements afresh

Answers to Integrated Case Scenario 1

1. (c) 2. (d) 3. (a) 4. (d) 5. (a)

Case Scenario 2

CA Namit, a partner in M/s J & Associates, is carrying out a statutory audit of M/s XYZ Gears Ltd. for the Financial Year 2022-23 and is in the process of issuing an audit report. His articled trainee, Manpreet, is very curious about knowing the various facts relating to the consideration of Standards on Auditing while carrying out an audit and issuing the audit report.

She asks CA Namit about the relevance of the Going concern assumption in their audit and further reporting to which CA Namit explains to her that both parties have got their own responsibilities w.r.t this accounting assumption. The management of the company has its own set of responsibilities while reporting upon the same is a very strict and sensitive matter for the auditor as per the requirement of the relevant standard on auditing.

He tells Manpreet to prepare a list of procedures as she thinks that an auditor should carry out when he identifies that the company is facing a downfall in business never seen before due to newer technology in the market and other competitors having sprung up swiftly adopting new technology.

He finds that this condition may cast significant doubt on the company's ability to continue as a going concern.

Manpreet thinks and researches and hands over a list of audit procedures to CA Namit for a final discussion. CA Namit clarifies accordingly. CA Namit concludes that the use of a going concern basis of accounting is appropriate in this company's case, but a material uncertainty exists as to the future prospects of the current business. However, the management has made an appropriate disclosure w.r.t such material uncertainty in the financial statements.

Manpreet's list of audit procedures includes: -

- (I) Requesting management to make its assessment relating to the company's ability to continue as a going concern.
- (II) Evaluating management's plan of future actions.
- (III) Make a specific assessment of the company's ability to continue as a going concern.
- (IV) Analysing the cashflow forecast of the company.
- (V) Considering the additional facts or information available since the date of management's assessment

- (VI) Make appropriate disclosures in the financial statements in connection with going concerns.
- (VII) Requesting Written Representation from management regarding the plans of future actions and the feasibility of these plans.
- (VIII) Writing a para addressed to the stakeholders in the audit report citing the results of procedures adhered to relating to the going concern assumption.

Keeping in view above, answer the following questions: -

1. CA Namit tells Manpreet about the auditor's responsibilities in the above case on the matter under discussion. Which of the following doesn't fall under the auditor's responsibilities?
 - (a) Obtaining sufficient and appropriate audit evidence on the matter under discussion.
 - (b) Conclude on the appropriateness of the management's use of going concern.
 - (c) Assessing whether a material uncertainty exists about the company's ability to continue as a going concern.
 - (d) Guarantee the company's ability to continue as a going concern based upon his audit procedures.
2. Identify which set of audit procedures are relevant in the above case scenario as per the list prepared by Manpreet.
 - (a) (I), (II), (IV), (V) & (VII)
 - (b) (I), (III) & (V)
 - (c) (II), (IV), (VI), (VII) & (VIII).
 - (d) (I), (II), (III), (IV) & (V).
3. CA Namit's conclusion in the above case will lead him to give which type of audit opinion from the following?
 - (I) Modified opinion
 - (II) Unmodified opinion.
 - (III) A separate section "Material uncertainty wrt Going concern" in his audit report.
 - (a) (I) only
 - (b) (II) only

(c) (I) & (III)

(d) (II) & (III)

4. Consider the following statements: -

Statement I: - The Management is under a responsibility to make specific assessment of the company's ability to continue as a going concern.

Statement II: -. The Management is under a responsibility to make appropriate disclosures in connection with going concern in the financial statements.

(a) Statement I is correct only.

(b) Statement II is correct only as Statement I falls under the auditor's responsibilities.

(c) Both statements are correct.

(d) Both statements are incorrect.

5. Which of the following is most appropriate regarding "going concern" assumption?

(a) It signifies that company is reflecting net losses in its financial statements.

(b) It signifies that company is not modernising its plant and machinery.

(c) It signifies that company has no intention of curtailing materially the scale of its operations in foreseeable future.

(d) It signifies that assets are likely to be recorded at the prices they would fetch.

Answers to Integrated Case Scenario 2

1. (d) 2. (a) 3. (d) 4. (c) 5. (c)

Case Study

Infinity Hospitality Private Limited was established in 1996 and was in the business of running hotels in tourist destinations in state of Kerala. It took leased properties on long-term leases ranging from 10 to 12 years, most with a lock-in of a whole term. The terms did not cover the *force majeure clause*. The company was family-owned business and had created a good reputation as value for a money-budget hotel. Most of the time, hotels clocked 60 to 75% occupancy rate, and during the festive season/ vacations, hotel business clocked 100% Occupancy.

The capital structure of the company was debt oriented and over-leveraged.

Primary working capital was blocked in maintaining and upkeeping the leased properties, running the restaurant, leases, food and beverages, salary, Director's remuneration etc.

The owners looked at the business as a cash cow and did not plough back the funds to expand the business but were content with the decent profits the hotels were generating.

As the properties were leased and not owned, most of the cash flow generated from operations was used in servicing the property and huge loans from financial institutions. What was left was withdrawn as Directors' remuneration and dividend.

Everything was going on smoothly. However, there were flash floods in Kerala due to unprecedented rains. There were landslides and roads were blocked. The entire tourist season was washed away due to infrastructural challenges. Accessibility to resorts and hotels was badly hindered. Logistics support took time to reach in far flung areas. Visit to the "*The God's own country*" was last on the mind of tourists. The company was hardly trying to get back to some semblance of normalcy when pandemic struck. It was double whammy for the company.

The impact on travel, tourism and hospitality business was very severe. The management of Infinity Hospitality Private Limited believed that bad days would end soon and the business would be back to normal. They also were optimistic about the government coming up with support for the industry and were hopeful of negotiating with lessors and Financial Institutions for relief. They decided on humanitarian grounds not to terminate the employees and continued paying them a regular salary, maybe deferring 25% to be paid after one year. The immediate fallout was on the top line as suddenly, the business stopped.

The auditors, M/s XYZ and Associates, were conducting the audit of the company and were grappling with the situation and are seeking your guidance for the course of action they need to follow.

Theoretical Questions

Based on the case scenario, you are required to provide your answers to the following:-

1. *What additional audit procedures must the auditor undertake as per requirements of SA 570 based on the facts given in the case?*
2. *According to your judgment, what risk assessment procedures should the auditor consider for arriving at a conclusion based on the management assertion of the entity being Going Concern?*
3. *What should be approach of the auditor if the management agrees that the material uncertainty exists, but the entity is a Going Concern? Also discuss reporting requirements.*

4. *What if the auditor believes, on the basis of his additional audit procedures conducted to conclude that the entity is not a Going Concern, but the management is not accepting the same? What course of action the auditor needs to undertake?*
5. *What kind of written representation does the auditor need to obtain in case of the scenario covered in Q3 above?*

Multiple Choice Questions

1. *Which of the following is not a financial event/ condition that may cast significant doubt on companies ability to continue as a going concern as per SA 570?*
 - (a) *Change from credit to cash on delivery model with suppliers*
 - (b) *Arrears or discontinuance of dividend*
 - (c) *Opening of a new chain of hotels by renowned competitor near the entity's area*
 - (d) *Adverse key financial ratios*
2. *Please choose the mitigating measure as the management is unable to pay lease rentals.*
 - (a) *Cancel the lease*
 - (b) *Restructure the lease agreement and negotiate for deferment and relief*
 - (c) *Terminate the employees and pay the lessor*
 - (d) *All the above*
3. *Which one of the following is not a responsibility of the auditor relating to communicating events or conditions identified that may cast significant doubt on the entity's Going Concern assertion?*
 - (a) *Perform additional audit procedures to identify events/ conditions beyond 12 months from the date of financial statements*
 - (b) *Whether the events constitute a material uncertainty*
 - (c) *The adequacy of related discloses in the financial statements*
 - (d) *The implications for the auditor's report*
4. *Written Representation need to be mandatorily obtained from:*
 - (a) *Audit Committee*

- (b) *Client relationship Managers*
 - (c) *Company Secretary*
 - (d) *CFO*
5. *Which of the following is not main pillar of written representations?*
- (a) *The management responsibility for preparation of financial statement*
 - (b) *Assertion related to completeness*
 - (c) *Assertion related to access to data and information*
 - (d) *Written representation provides sufficient appropriate audit evidence*

Answers to Theoretical Questions

1. In the given case scenario the events and conditions have been identified which cast significant doubt on the entity's ability to continue as a Going Concern, the auditor needs to obtain sufficient appropriate audit evidence to determine whether or not material uncertainty and gather evidence including of mitigating factors. It can be done by performing following additional procedures: -
- Analysing and discussing cash flow, profit and other relevant forecast with management.
 - Analysing and discussing the entity's latest available interim financial statement.
 - Reading the terms of 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 party and assessing the financial ability of such parties to provide additional funds.
 - 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.
 - Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.
 - Evaluating management's plans for further actions in relation to its going concern assessment, whether the outcome of these plan is likely to improve the situation and whether the management's plans are feasible in the circumstances.
 - Evaluating management's plans for future actions may include inquiries of management as to its plan for future action, including, for example, its plan to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital.
 - Considering whether any additional facts or information have become available since the date on which management made its assessment.
 - Requesting written representation from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans.
2. When performing risk assessment procedures as required by SA-315, the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue the going concern. In so doing, the auditor shall consider whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern.
- The auditor shall discuss the assessment with management and determine whether management has identified events and conditions that, individually or collectively, cast significant doubt on the entity's ability to continue as a going concern and if so, management's plan to address them.
 - The auditor shall specifically draw attention of Management on following events or condition and get the response on how they plan to address them:

The company is debt heavy and over leveraged. The leased properties are having considerable lock-in period with absence of force majeure clause. There are no contingency reserves available with company. All these factors shall be taken into account while performing risk assessment procedures.

3. If the auditor concludes that the management's use of going concern basis of accounting is appropriate in the circumstances but a material uncertainty exists, the auditors shall determine whether the financial statements:
 - (a) Adequately disclose the principal events or conditions that make a significant doubt on the entity's ability to continue as a going concern and management's plan to deal with these events or conditions, and
 - (b) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on entity's ability to continue as a going concern and therefore, that it may be unable to realize its assets, and discharge its liabilities in the normal course of business.
 - (c) The disclosures may include:
 - i. Management's evaluation of the significance of the events or conditions relating to the entity's ability to meet its obligations; or
 - ii. Significant judgements made by management as a part of its assessment of the entity's ability to continue as a going concern
 - iii. Disclosures about the magnitude of the potential impact of the principal events or conditions, and the likelihood and timing of the occurrence.
 - iv. The auditor shall express an unmodified opinion and the auditor's reports shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to:
 - Draw attention to the note in the financial statement that discloses the events or conditions and
 - State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and the auditor's opinion is not modified in respect of the matter and how the matter was addressed in the audit.
4. If management has prepared financial statements using the Going Concern assertion to which auditor differs as according to his judgement, the Going Concern assertion by the management is not appropriate, then the auditor is required to express an adverse opinion.
5. The auditor needs to obtain written representation from management and where appropriate, those charged with governance, regarding their plans for future action and the feasibility of these plans.

Answers to Multiple Choice Questions

1. (c) 2 (b) 3 (a) 4 (d) 5 (d)

Key Takeaways

- Events occurring between the date of the financial statements and the date of the auditor's report and facts that become known to the auditor after the date of the auditor's report are known as subsequent events.
- Such events may be those that provide evidence of conditions that existed at the date of the financial statements and those that provide evidence of conditions that arose after the date of the financial statements.
- SA 560 deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements.
- The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified.
- Going concern is one of the fundamental accounting assumptions. The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.
- SA 570 Going Concern deals with the auditor's responsibilities in the audit of financial statements relating to going concern and the implications for the auditor's report.
- The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern. Management's assessment of the entity's ability to continue as a going concern is a key part of the auditor's consideration of management's use of the going concern basis of accounting.
- If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern through performing additional audit procedures, including consideration of mitigating factors.
- A written representation is a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this

context do not include financial statements, the assertions therein, or supporting books and records.

- Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal.
- SA 580 Written representations deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance.

FOR SHORTCUT TO ENGAGEMENT & QUALITY CONTROLS STANDARDS WISDOM:
SCAN ME !



Note: Content of SA 560 -Subsequent Event; SA 570- Going Concern and SA 580- Written Representation is covered in depth at Intermediate level. Thus, application part of above SAs may be discussed in the form of Case Study at Final level

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *Ramadhan & Co., are the Auditors of XYZ Company Ltd., for the year ended on 31/03/2023. The Audit Report for that year was signed by the Auditors on 04/05/2023. The Annual General Meeting was decided to be held during the month of August 2023. On 06/05/2023, the Company had received a communication from the Central Government that an amount of ₹ 5800 crore kept pending on account of incentives pertaining to Financial Year 2022-23 had been approved and the amount would be paid to the Company before the end of May 2023. To a query to Chief Financial officer of the Company by the Board, it was informed that this amount had not been recognised in the Audited Financial Statements in view of the same not being released before the close of the Financial Year and due to*

uncertainty of receipt. Now, having received the amount, the Board of Directors wished to include this amount in the Financial Statements of the Company for the Financial Year ended on 31/03/2023. On 08/05/2023, the Board amended the accounts, approved the same and requested the Auditor to consider this event and issue a fresh Audit Report on the Financial Statements for the year ended on 31/03/2023. Analyse the issues involved and give your views as to whether or not the Auditors could accede to the request of the Board of Directors.

2. *M/s Airlift Ltd., carrying on the business of Passenger Transportation by air is running into continuous financial losses as well as reduction in Sales due to stiff competition and frequent break down of its own aircrafts. The Financial Statements for the Year ended on 31/03/2023 are to be now finalized. The Management is quite uncertain as to its ability to continue in near future and has informed the Auditors that having seized of this matter, it had constituted a committee to study this aspect and to give suggestions for recovery, if any, from this bad situation. Till the study is completed, according to the Management, the issue involves uncertainty as to its ability to continue its business and it informs the Auditor that the fact of uncertainty clamping on the "Going Concern" would suitably be disclosed in notes to accounts. State the reporting requirement if any, in the Independent Auditor's Report in respect of this matter.*
3. *PRSH & Co is the statutory auditor of Make My Journey Ltd. The company is in the business of tours and travels. Annual turnover of the company is INR 2000 crores and profits are INR 190 crores. During the planning meeting of the management and the auditors, it was discussed that the management needs to provide written representation letter to the auditors for the preparation of the financial statements and for the completeness of the information provided to the auditor. At the time of closure of the audit, there has been some confusion about the requirements of the written representation letter. Management argued that representation need not be written, it can also be verbal which has been provided to the audit team during the course of their audit. Auditors have completed their documentation and hence in a way, representation based on verbal discussions with the auditors has also got documented. Auditors explained that this is mandatory to obtain written representation in accordance with the requirements of SA 580. However, still some confusion remains regarding the date and period covered by the written representation. You are required to advise about the date of and period covered by written representation in view of SA 580.*

Answers to Test your Understanding

1. The given situation provides evidence of conditions that existed at the date of financial statements. Initially, the company had lodged claim of ₹1 crore and the same is reflected as claim receivable in financial statements as on 31st March, 2023.

However, subsequent events occurring have provided evidence that claim was settled for ₹ 45 lacs only. Such settled amount has already been accepted by the company by providing its consent. Therefore, such events have provided fresh information about items included in financial statements.

Further, performance of substantive procedures has been finished implying that audit report is not yet issued.

Therefore, financial statements as on 31st March, 2023 should be adjusted to reflect fresh information emanating from described events and management should be asked to take appropriate action in this regard so that adjustment pertaining to above is properly reflected in financial statements in accordance with applicable financial reporting framework.

2. In the given situation, dividend has been proposed by Board of Directors on 17th April, 2023. It is an example of condition that arose after the reporting period. No liability exists for the company on reporting date because there is no obligation to pay at the reporting date in accordance with Ind AS 1.

Therefore, above situation does not require recognition of above proposed dividend in financial statements. It is an example of events which does not require adjustments. However, it should be disclosed in financial statements in notes to accounts. Therefore, it should be ensured that it is disclosed in notes to accounts in financial statements. He should verify in accordance with SA 560 that it is so disclosed in notes to accounts.

3. In accordance with SA 570, "Going Concern", if events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern by performing additional audit procedures, including consideration of mitigating factors.

Where the entity has prepared a cash flow forecast, and analysis of forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future actions, it includes

- (i) Evaluating the reliability of the underlying data generated to prepare the forecast and
- (ii) Determining whether there is adequate support for the assumptions underlying the forecast.

In the above situation, cash flow forecast has been prepared by management. Therefore, she should carefully evaluate assumptions underlying forecast and also reliability of data to prepare the forecast. For example: -

- She should verify assumption regarding fresh batch of livestock. The bankers have not provided fresh credit facilities. How funds from the same would be arranged? The reasonability of assumption in cash flow forecast needs to be looked into.
 - She needs to check loan sanction letters/agreement to verify when repayments are beginning to see their accuracy in cash flow forecasts.
 - The company plans to avail longer credits from animal feed suppliers. In the downturn situation of the company, how would suppliers extend longer credits? This is going to have effect on the cash flow forecast.
 - Whether company has accounted for increased expenditure on preventive health check-up, vaccination and more frequent visits of veterinary staff in cash flow forecast.
 - Since villagers have accused the company of spreading air pollution, how does the company plan to deal with the same? Whether any proposed expenditure in this regard is accounted for in the cash flow statement. She may also consider other implications of this issue and possible effect on cash flows.
4. If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the financial statements is inappropriate, the auditor shall express adverse opinion.
- The requirement for an auditor to express an adverse opinion applies regardless of whether or not the financial statements include disclosure of the inappropriateness of management's use of the going concern basis of accounting.
- Therefore, even if management discloses that its use of going concern assumption of accounting is inappropriate, it would have no impact on auditor's opinion. He would need to express adverse opinion.
5. The date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. As the auditor is concerned with

events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

In the given situation, written representation is dated 15th April 2023. The audit report is dated 31st July 2023. There is a considerable lag between date of written representations and date of audit report.

It could signify that all subsequent events after date of financial statements requiring adjustments or disclosure may not have been adjusted or disclosed in the financial statements by management.

As audit report is dated 31st July, 2023, it reflects that auditor has considered subsequent events occurring between date of financial statements and date of auditor's report. However, written representations pertain to 15th April 2023.

Hints /Answers to Theoretical Questions

1. Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued: As per SA 560, "Subsequent Events", the auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall
 - (i) Discuss the matter with management and, where appropriate, those charged with governance.
 - (ii) Determine whether the financial statements need amendment and, if so,
 - (iii) Inquire how management intends to address the matter in the financial statements.

If management amends the financial statements, the auditor shall carry out the audit procedures necessary in the circumstances on the amendment. Further, the auditor shall extend the audit procedures and provide a new auditor's report on the amended financial statements. However, the new auditor's report shall not be dated earlier than the date of approval of the amended financial statements.

In the instant case, XYZ Company Ltd. received an amount of rupees 5800 crore on account of incentives pertaining to year 2022-23 in the month of May 2023 i.e. after finalisation of

financial statements and signing of audit report. Board of Directors of XYZ Ltd. amended the accounts, approved the same and requested the Ramadhan & Co. (auditor) to consider this event and issue a fresh audit report on the financial statements for the year ended on 31.03.2023.

After applying the conditions given in SA 560, Ramadhan & Co. can issue new audit report subject to date of audit report which should not be earlier than the date of approval of the amended financial statements.

2. Reporting requirements in case of Uncertainty clamping on the Going Concern: As per SA 570 "Going Concern", if the auditor concludes that management's use of the going concern basis of accounting is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements : (i)adequately disclose the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and (ii) disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

If adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to:

- (i) Draw attention to the note in the financial statements that discloses the matters set out above; and
- (ii) State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

In the instant case, M/s Aircraft Ltd. is running into continuous financial losses as well as reduction in sales due to stiff competition and frequent break down of its own aircrafts and management of Aircraft Ltd. is uncertain as of its ability to continue in near future. Therefore, a committee has been constituted to study this aspect and till the time study is completed management accordingly decided to suitable disclose this aspect in notes to accounts. Therefore, the auditor should disclose about the material uncertainty and express an unmodified opinion and in his audit report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to draw attention to the note in the financial

statements that discloses the matters set out above; and state that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

3. As per SA 580, "Written Representations", as written representations are necessary audit evidence, the auditor's opinion cannot be expressed, and the auditor's report cannot be dated, before the date of the written representations. Furthermore, because the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

In some circumstances it may be appropriate for the auditor to obtain a written representation about a specific assertion in the financial statements during the course of the audit. Where this is the case, it may be necessary to request an updated written representation.

The written representations are for all periods referred to in the auditor's report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate. The auditor and management may agree to a form of written representation that updates written representations relating to the prior periods by addressing whether there are any changes to such written representations and, if so, what they are.

Situations may arise where current management were not present during all periods referred to in the auditor's report. Such persons may assert that they are not in a position to provide some or all of the written representations because they were not in place during the period. This fact, however, does not diminish such persons' responsibilities for the financial statements as a whole. Accordingly, the requirement for the auditor to request from them written representations that cover the whole of the relevant period(s) still applies.

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REPORTING

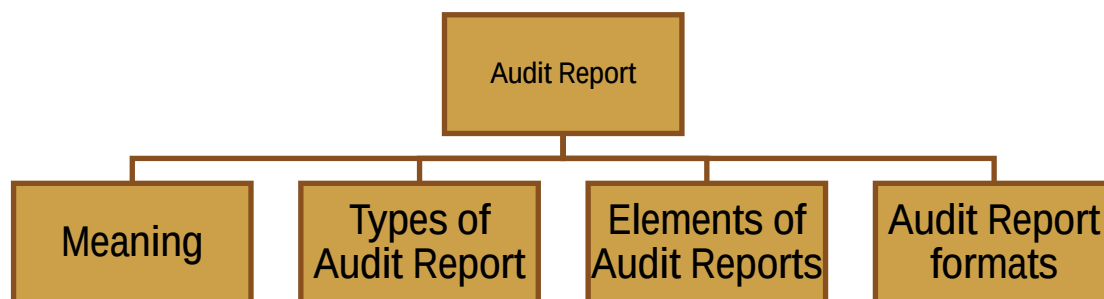


LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ❑ Understand the Reporting requirements and Different types of Un-Modified and Modified Audit Reports as per Standards of Auditing.
- ❑ Identify the different aspects of Reporting as per Standards of Auditing.
- ❑ Determine and apply knowledge of Reporting for further study and Professional Practice.

CHAPTER OVERVIEW



CA. A got an invitation to attend a seminar on “*Audit Conclusions and Reporting-Responsibilities of auditors*” in context of SA 700 series organized by local branch of WIRC of ICAI. Realizing importance of topic in context of heightened regulatory glare being continuously highlighted in media, he made it sure to attend the seminar. Eminent speakers brought out how significant it is to prepare an audit report in accordance with Standards on Auditing. Audit report is the document by means of which an auditor expresses opinion. Its significance, in context of an audit, is paramount.

Discussing threadbare such issues, one learned speaker underlined need for ‘expression of appropriate opinion’ by auditors in view of rapid changes in business environment. If modified opinion is warranted in accordance with SA 705, such an opinion must be expressed by auditors clearly explaining basis for such opinion. In case evidence points to misstatements impact of which is both material and pervasive, auditors should not hesitate to express adverse opinion in audit reports.

It was also made loud and clear that auditors should try to challenge matters such as key underlying assumptions. These should not be meekly accepted by the auditors as these have significant implications for audit report.

It was tried to be explained in context of “Going concern” assumption. Auditors should go all out to see that its use is appropriate in preparation of financial statements by the client by going through client’s assessment. If client has not made its assessment, auditor should quiz management regarding justification of it following such an assumption.

Such matters have immediate and direct implications for auditor's report. Like, if in auditor's judgment, use of going concern basis of accounting is inappropriate, adverse opinion needs to be expressed. Raising an alarm, it was clearly transmitted that such matters were too crucial to be taken lightly.

Accentuating value of Emphasis of Matter paragraphs, it was shared by another speaker how to use such paragraphs in audit reports. One fundamental requirement of using such a para in accordance with SA 706 is that such paragraph cannot be used in respect of matters for which modification of opinion is required. These paras are no substitute for modified opinion.

Underscoring increase in communicative value of audit reports by highlighting key audit matters identified during the course of audit, it was hammered that not only such matters are stated in accordance with SA 701, manner of addressing such matters by performing audit procedures is also stated in audit reports.

1. INTRODUCTION



Assuming you are an auditor and have concluded the audit field work, your next step will be issuance of the audit report. Issuance of Audit report is the culmination of the Audit Work. It is the most important deliverable for a Statutory Auditor. An audit report is very important medium of communication i.e. auditor's expert views on the financial statements and it has a significant bearing on the credibility of the Financial Statements. By expressing an opinion in the audit report, the auditor takes upon himself a great responsibility because a large number of stakeholders are likely to place reliance on the financial statements and are dependent on the Auditors Opinion on the financial statements. Therefore, the auditor is necessarily required to be careful, vigilant, and objective in the matter of preparation of his report. The auditor should endeavor to keep his report in accordance with the reporting requirements mandated by the

Standards on Auditing to bring about uniformity in the issuance of Audit Opinion.



2. THE AUDITOR'S REPORT ON FINANCIAL STATEMENTS

The SA 700 series is purely dedicated to the auditor's report to be issued by the auditor. There are following SAs which you need to be aware of:

Particulars	Head	Purpose
SA-700	Forming an Opinion and Reporting on Financial Statements	- Forming an opinion on the financial statements. - Form and content of the auditor's report. - Deals with Un-Modified (Clean) opinion of the Auditor.
SA-701	Communicating Key Audit Matters in the Independent Auditor's Report	- To enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. - To assist the user in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period.
SA-705	Modifications to the Opinion in the Independent Auditor's Report	- To issue an appropriate auditor's report when the auditor considers the modification of the audit opinion in the report is necessary. - To deal with the revised form and content when the modification of the opinion takes place.
SA-706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report	To draw user's attention to a matter or matters:- - Presented or disclosed in the financial statements and which is fundamental for the understanding of the user, or - Not presented or disclosed in the financial statement and which is relevant for the understanding of the user.



3. SA 700 FORMING AN OPINION AND REPORTING ON THE FINANCIAL STATEMENTS

It deals with the auditor's responsibility to form an opinion on the financial statements. It also deals with the form and content of the auditor's report issued as a result of an audit of financial statements.

Objective: As per SA 700 the objectives of the auditor are:

- (a) To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and
- (b) To express clearly that opinion through a written report.

3.1 Purpose

SA 700 applies to an audit of a complete set of general-purpose financial statements and is written in that context. The requirements of this SA are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally and the need to increase the value of auditor reporting by making the information provided in the auditor's report more relevant to users. This SA promotes consistency in the auditor's report but recognizes the need for flexibility to accommodate particular circumstances of individual jurisdictions. 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 recognized standards. It also helps to promote the user's understanding and to identify unusual circumstances when they occur.

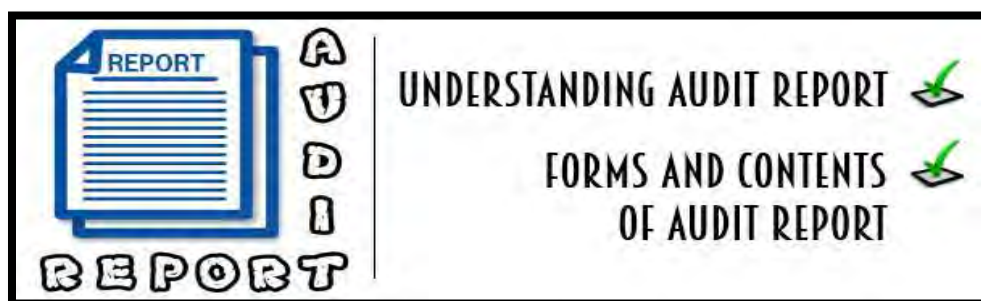


Image: Understanding Audit report, Forms and contents of Audit Report*

Forming an opinion on the Financial Statements

The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. In order to form that opinion, the auditor shall obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement whether due to fraud or error. Further, when the financial

* Source : accountlearning.com

statements are prepared in accordance with a fair presentation framework, the auditor shall also evaluate as to whether the financial statements achieve fair presentation by considering:

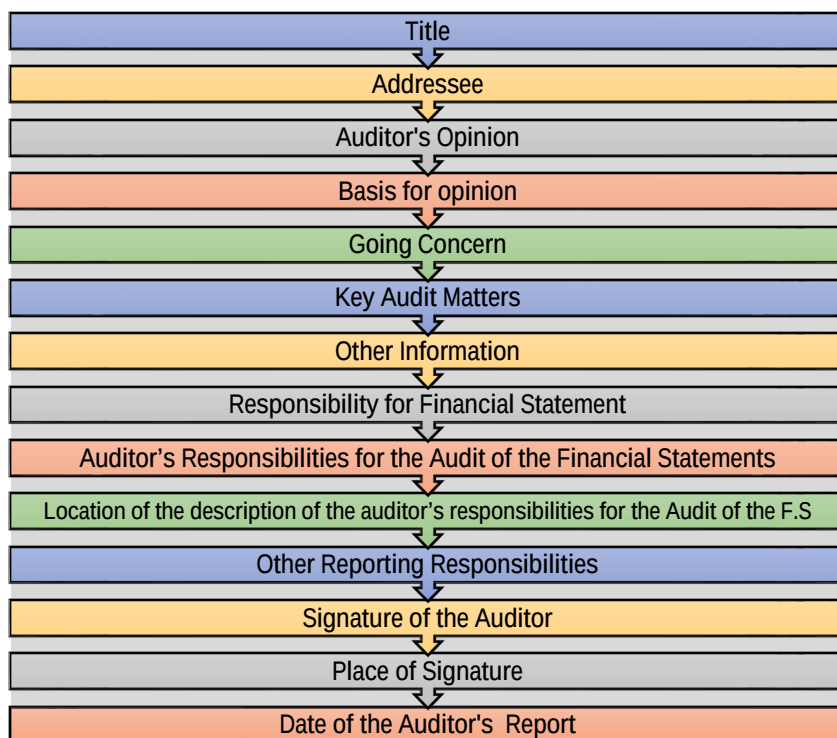
1. The overall presentation, structure and content of the financial statements; and
2. Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

In other words, the auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

In order to form that opinion, the auditor shall conclude whether he has obtained reasonable assurance that the financial statements as a whole are free from material misstatement whether due to fraud or error.

3.2 Basic Elements of the Auditor's Report

As per SA 700 "Forming an opinion and reporting on financial statements", the auditor's report shall be in writing and shall include the following basic elements, which ordinarily includes in case of Auditors' Report for Audits Conducted in Accordance with Standards on Auditing:



1. **Title:** The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor.



1. "Independent Auditor's Report," distinguishes the independent auditor's report from reports issued by others.

2. **Addressee:** The auditor's report shall be addressed as required by the circumstances of the engagement.



2. The report could be addressed to the Members of the Company in case of general purpose (statutory) financial statements and to the Board of Directors in case of special purpose financial statements.

3. **Auditor's Opinion:** The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."

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

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

When expressing an unmodified opinion on financial statements prepared in accordance with a fair presentation framework, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases, which are regarded as being equivalent:

- (i) In our opinion, the accompanying financial statements present fairly, in all material respects, [...] in accordance with [the applicable financial reporting framework]; or
- (ii) In our opinion, the accompanying financial statements give a true and fair view of [...] in accordance with [the applicable financial reporting framework].

When expressing an unmodified opinion on financial statements prepared in accordance with a compliance framework, the auditor's opinion shall be that the accompanying financial statements are prepared, in all material respects, in accordance with [the applicable financial reporting framework].

If the reference to the applicable financial reporting framework in the auditor's opinion is not to Accounting Standards, the auditor's opinion shall identify the origin of such other framework.

Extract of Independent Auditor's Report - Unmodified Opinion Paragraph

Opinion

We have audited the standalone financial statements of [REDACTED] (the "Company") which comprise the standalone balance sheet as at 31st March, 2023, and the standalone statement of profit and loss (including other comprehensive income), standalone statement of changes in equity and standalone statement of cash flows for the year ended 31st March, 2023, and notes to the standalone financial statements, including a summary of significant accounting policies and other explanatory information.

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid standalone financial statements give the information required by the Companies Act, 2013 ("Act") in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at 31st March, 2023, and its profit and other comprehensive loss, changes in equity and its cash flows for the year ended on that date.

Opinion

1. We have audited the accompanying standalone financial statements of [REDACTED] ('the Bank'), which comprise the Balance Sheet as at 31 March 2022, the Profit and Loss Account and the Cash Flow Statement for the year then ended, and a summary of the significant accounting policies and other explanatory information.
2. In our opinion and to the best of our information and according to the explanations given to us, the aforesaid standalone financial statements give the information required by the Banking Regulation Act, 1949 as well as the Companies Act, 2013 ('the Act') and circulars and guidelines issued by the Reserve Bank of India ('the RBI'), in the manner so required for banking companies and give a true and fair view, in conformity with the Accounting Standards specified under section 133 of the Act, read with the Companies (Accounting Standards) Rules, 2021 and other accounting principles generally accepted in India, of the state of affairs of the Bank as at 31 March 2022 and its profit and its cash flows for the year ended on that date.

4. **Basis for Opinion:** The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:

(a)	States that the audit was conducted in accordance with Standards on Auditing;
(b)	Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;
(c)	Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall refer to the Code of Ethics issued by ICAI
(d)	States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Extract of Independent Auditor's Report – Basis for Unmodified Opinion Paragraph

Basis for Opinion

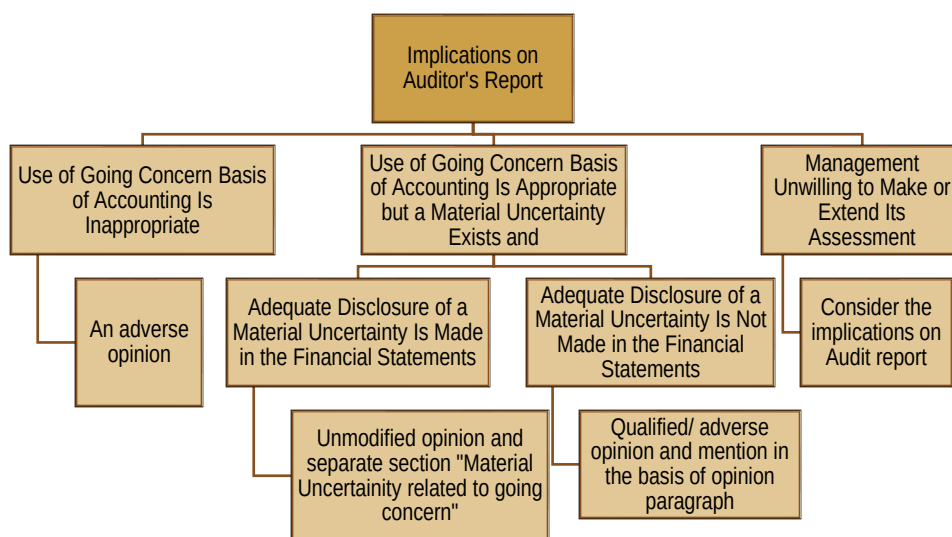
We conducted our audit in accordance with the Standards on Auditing (SAs) specified under Section 143(10) of the Act. Our responsibilities under those SAs are further described in the Auditor's Responsibilities for the Audit of the Standalone Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by the Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the standalone financial statements under the provisions of the Act and the Rules thereunder, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion on the standalone financial statements.

Basis for Opinion

3. We conducted our audit in accordance with the Standards on Auditing (SAs) specified under section 143(10) of the Act. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Standalone Financial Statements section of our report. We are independent of the Bank in accordance with the Code of Ethics issued by the Institute of Chartered Accountants of India ('ICAI') together with the ethical requirements that are relevant to our audit of the standalone financial statements under the provisions of the Act and the rules thereunder, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

5. **Going Concern:** Where applicable, the auditor shall report in accordance with SA 570. SA 570 deals with the auditor's responsibilities in the audit of financial statements relating to going concern and the implications for the auditor's report. The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.

Implications for the Auditor's Report:



I. **Use of Going Concern Basis of Accounting Is Inappropriate:** If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor shall express an adverse opinion.

II. **Use of Going Concern Basis of Accounting Is Appropriate but a Material Uncertainty Exists and:**

(A) **Adequate Disclosure of a Material Uncertainty Is Made in the Financial Statements:** If adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to:

- (i) Draw attention to the note in the financial statements that discloses the matters
- (ii) State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

Extract of Independent Auditor's Report – Material Uncertainty related to Going Concern

Material Uncertainty related to Going Concern

1. We draw attention to Note no. 10 of the consolidated financial results wherein the auditors of [REDACTED] have highlighted material uncertainty related to going concern of [REDACTED]. However, the accounts of [REDACTED] has been prepared on a Going concern basis for the reasons stated in the aforesaid note.
2. The auditors of certain subsidiaries and associates as stated in Note no. 11 of the consolidated financial results have highlighted material uncertainty related to going concern / emphasis of matter paragraphs / key audit matters related to going concern in their respective audit reports.
3. We draw attention to Note No. 13 of the consolidated financial results regarding the Group's ability to meet its obligations is dependent on certain events which may or may not materialise including restructuring of loans, time bound monetization of assets and realisation of regulatory / arbitration claims. There are material uncertainties which could impact the Group's ability to continue as a going concern. However, the Group is confident of meeting its obligations in the normal course of its business and accordingly, the consolidated financial results of the Group have been prepared on a going concern basis.

Our opinion on the consolidated financial results is not modified in respect of the above matters.

(B) **Adequate Disclosure of a Material Uncertainty Is Not Made in the Financial Statements:** If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall:

- (i) Express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705 (Revised); and
 - (ii) In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.
- (C) **Management Unwilling to Make or Extend Its Assessment:** If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor shall consider the implications for the auditor's report.

Note: Where the use of Going Concern Basis is appropriate then no special paragraph is required in the Auditors Report mentioning the fact.

ILLUSTRATION 1

CA Sameer is the statutory auditor of Tram Fram Ltd. for the FY 2022-23. While concluding the audit CA Sameer decided to issue an unmodified opinion, though he also concluded that a material uncertainty exists with respect to the company's ability to continue as a going concern on account of a pending litigation related to labour laws. He is of the view that the company has made appropriate disclosures with respect to such pending litigation in the notes to accounts annexed to the financial statements of Tram Fram Ltd. for the FY 2022-23. Explain how CA Sameer will deal with the above situation in his auditor's report (draft the relevant portion of the auditor's report.)

SOLUTION

Material Uncertainty Related to Going Concern

We draw attention to Note 10 in the financial statements, which indicates that the outcome of a litigation on account of labour laws is pending in case of the company during the year 31 March, 2023. As stated in Note 11, this event or condition, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

6. **Key Audit Matters:** For audits of complete sets of general purpose financial statements of listed entities, the auditor shall communicate key audit matters in the auditor's report in accordance with SA 701.

When the auditor is otherwise required by law or regulation or decides to communicate key audit matters in the auditor's report, the auditor shall do so in accordance with SA 701.

Definition of Key Audit Matters	Key Audit matter are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.

7. **Other Information:** Where applicable, the auditor shall report in accordance with SA 720 (Revised).
8. **Responsibilities for the Financial Statements:** The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." The auditor's report shall use the term that is appropriate in the context of the legal framework applicable to the entity and need not refer specifically to "management". In some entities, the appropriate reference may be to those charged with governance.

This section of the auditor's report shall describe management's responsibility for:

(a) Preparing the financial statements in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

(b) Assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate.

This section of the auditor's report shall also identify those responsible for the oversight of the financial reporting process, when those responsible for such oversight are different from those who fulfill the responsibilities described in next paragraph. In this case, the heading of this section shall also refer to "Those Charged with Governance" or such term that is appropriate in the context of the legal framework applicable to entity.

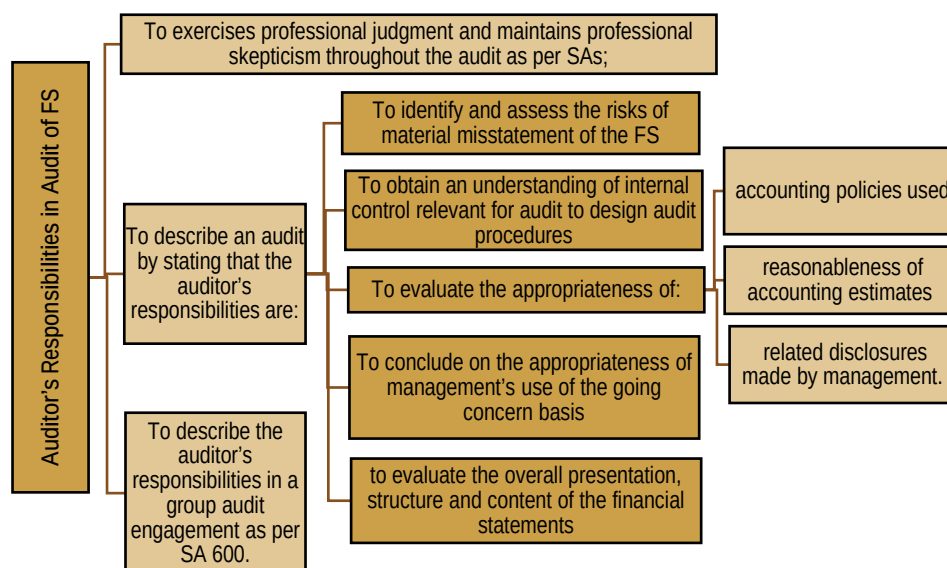
When the financial statements are prepared in accordance with a fair presentation framework, the description of responsibilities for the financial statements in the auditor's report shall refer to "the preparation and fair presentation of these financial statements" or "the preparation of financial statements that give a true and fair view," as appropriate in the circumstances.

9. **Auditor's Responsibilities for the Audit of the Financial Statements:** The auditors report shall include a section with the heading "Auditor's Responsibilities for the Audit of the Financial Statements."

(I) This section of the auditor's report shall:

(a)	State that the objectives of the auditor are to:
(i)	Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and
(ii)	Issue an auditor's report that includes the auditor's opinion.
(b)	State that reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists; and
(c)	State that misstatements can arise from fraud or error, and either:
(i)	Describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements; or
(ii)	Provide a definition or description of materiality in accordance with the applicable financial reporting framework.

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



- (a) State that, as part of an audit in accordance with SAs, the auditor exercises professional judgment and maintains professional skepticism throughout the audit; and

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

- (i) To identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error; to design and perform audit procedures responsive to those risks; and to obtain audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- (ii) To obtain an understanding of internal control relevant to the audit 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 the entity's internal control. In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, the auditor shall omit the phrase that the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.
- (iii) To evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- (iv) To conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. If the auditor concludes that a material uncertainty exists, the auditor is required to draw attention in the auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify the opinion. The auditor's conclusions are based on the audit evidence obtained up to the date of the auditor's report. However, future events or conditions may cause an entity to cease to continue as a going concern.
- (v) When the financial statements are prepared in accordance with a fair presentation framework, to evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

- (c) When SA 600, "Using the Work of Another Auditor", applies, further describe the auditor's responsibilities in a group audit engagement by stating, the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components is audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/branches/subsidiaries or other components audited by other auditors

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

- (a) State that the auditor communicates with those charged with governance regarding, among other matters:

-  the planned scope and timing of the audit and
-  significant audit findings,
-  including any significant deficiencies in internal control that the auditor identifies during the audit;

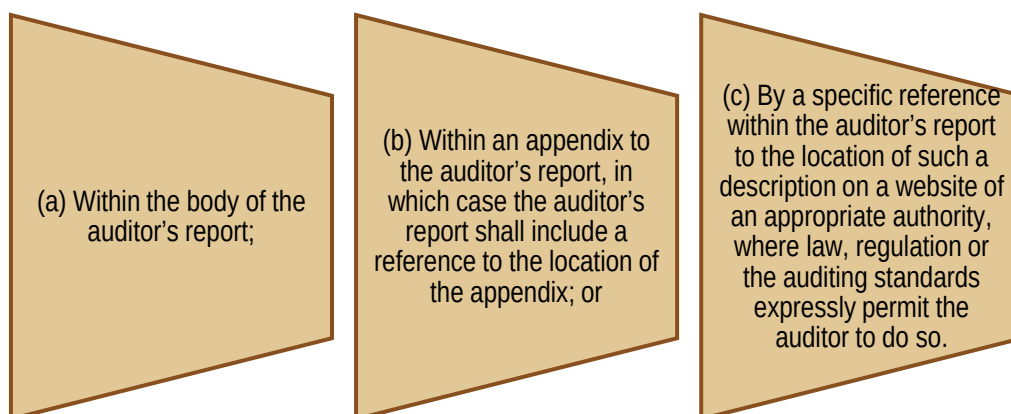
- (b) State that the auditor provides those charged with governance with a statement that the auditor has:

-  complied with relevant ethical requirements regarding independence and
-  communicate with them all relationships and
-  other matters that may reasonably be thought to bear on the auditor's independence, and where applicable, related safeguards; and

- (c) For audits of financial statements of all such entities for which key audit matters are communicated in accordance with SA 701, state that, from the matters communicated with those charged with governance, the auditor determines those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters.

In accordance with the requirements of SA 701, the auditor describes these matters in the auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, the auditor determines that a matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

10. Location of the description of the auditor's responsibilities for the audit of the financial statements: The description of the auditor's responsibilities for the audit of the financial statements required by this SA shall be included:



When the auditor refers to a description of the auditor's responsibilities on a website of an appropriate authority, the auditor shall determine that such description addresses, and is not inconsistent with, the requirements of this SA.

11. Other Reporting Responsibilities:

- (a) If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibilities under the SAs, these other reporting responsibilities shall be addressed in a separate section in the auditor's report with a heading titled "Report on Other Legal and Regulatory Requirements" or otherwise as appropriate to the content of the section, unless these other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the SAs in which case the other reporting responsibilities may be presented in the same section as the related report elements required by the SAs.
- (b) If other reporting responsibilities are presented in the same section as the related report elements required by the SAs, the auditor's report shall clearly differentiate the other reporting responsibilities from the reporting that is required by the SAs.
- (c) If the auditor's report contains a separate section that addresses other reporting responsibilities, the requirements of this SA shall be included under a section with a heading "Report on the Audit of the Financial Statements." The "Report on Other Legal and Regulatory Requirements" shall follow the "Report on the Audit of the Financial Statements."

- 12. Signature of the Auditor:** The auditor's report shall be signed. The report is signed by the auditor (i.e. the engagement partner) in his personal name. Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the

audit firm. The partner/proprietor signing the audit report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India. They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the audit reports signed by them.

The report is to be signed by the maker of the report. Normally, a chartered accountant in practice signs the report in the name he is registered as a practitioner. If he is an individual, it may be his individual name or the firm name of which he is the sole proprietor. For those members in practice as a partnership firm, it is usual for them to sign in the firm name. Under Section 145 read with Section 141(2) of the Companies Act, 2013, only the person appointed as an auditor of the company or, where a firm is so appointed, only the partner in the firm who is a chartered accountant, may sign the auditor's report or sign or authenticate any other document of the company required by law to be signed or authenticated by the auditor.

It is obvious that the person appointed makes the report; otherwise, the very essence of the appointment of a particular man or firm will be lost. In a profession, the particular skill and reputation of the practitioner counts considerably and if anybody else is allowed to make the report on behalf of the person appointed, then this confidence in the person will cease to be a factor. This has other implications also from the point of view of professional responsibility; it will create an unusual legal situation. It also has implications from the standpoint of the practitioner. If in respect of appointments held by him, the reports are made by others, gradually the goodwill of the practitioner will end and the clients may shift to the person actually making the report.

If A, B and C were in practice as ABC & Co. Chartered Accountants, any of A or B or C could sign as "ABC & Co." in his own hand. But now in view of the objection raised by the Department of Company Affairs to this practice, the Council of the Institute in the SA 700 "The Auditor's Report on Financial Statements" has recommended to the members who are in practice in partnership, that signature on or authentication of the auditor's report or any other document required to be signed or authenticated by the auditor should be made in the following manner.



3.

For ABC and Co.

Chartered Accountants

Firm Registration Number

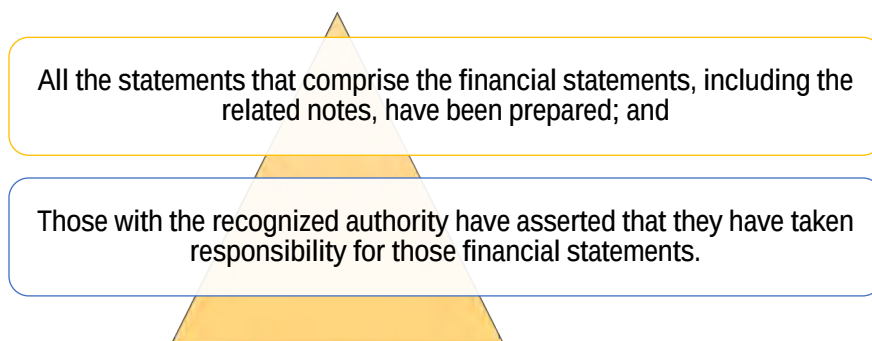
Signature

(Name of the Member Signing the Audit Report)

(Designation {Partner/Proprietor})

In addition to the provisions of the Companies Act, 2013 referred to above, Clause (12) of Part I of the First Schedule to the Chartered Accountants Act, 1949 provides that a chartered accountant in practice shall be deemed to be guilty of professional misconduct if he allows a person, not being a member of the Institute or a member not being his partner, to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements. The provision is intended to safeguard the professional purity by excluding non-chartered accountants from signing the aforesaid documents. By excluding chartered accountants who are not partners, it seeks to keep the line of professional responsibility clear. Partners are mutual agents and therefore, allowing a partner to sign does not interfere with the clarity of responsibility.

13. **Place of Signature:** The auditor's report shall name specific location, which is ordinarily the city where the audit report is signed.
14. **Date of the Auditor's Report:** The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that:



3.3 Auditor's Report Prescribed by Law or Regulation

If the auditor is required by law or regulation applicable to the entity to use a specific layout, or wording of the auditor's report, the auditor's report shall refer to Standards on Auditing only if the auditor's report includes, at a minimum, each of the following elements:

- (1) A title.
- (2) An addressee, as required by the circumstances of the engagement.
- (3) An Opinion section containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements.

- (4) An identification of the entity's financial statements that have been audited.
- (5) A statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall refer to the Code of Ethics issued by ICAI.
- (6) Where applicable, a section that addresses, and is not inconsistent with, the reporting requirements of SA 570.
- (7) Where applicable, a Basis for Qualified (or Adverse) Opinion section that addresses, and is not inconsistent with, the reporting requirements of SA 570 (Revised).
- (8) Where applicable, a section that includes the information required by SA 701, or additional information about the audit that is prescribed by law or regulation and that addresses, and is not inconsistent with, the reporting requirements in that SA 701.
- (9) A description of management's responsibilities for the preparation of the financial statements and an identification of those responsible for the oversight of the financial reporting process that addresses, and is not inconsistent with, the requirements.
- (10) A reference to Standards on Auditing and the law or regulation, and a description of the auditor's responsibilities for an audit of the financial statements that addresses, and is not inconsistent with, the requirements.
- (11) The auditor's signature.
- (12) The Place of signature
- (13) The date of the auditor's report.

Students may note that the Chartered Accountants need to ensure compliance with all the requirements relating to signature prescribed in the relevant law or regulation, SAs and relevant announcements/ clarifications issued by ICAI on the matter including the requirement to mention UDIN (mandatory from 1st July 2019) (UDIN – UNIQUE DOCUMENT IDENTIFICATION NUMBER). The requirement to mention UDIN is applicable both for manually and digitally signed reports/certificates including certificates uploaded online.

For detailed understanding, students may refer the following link:

<https://resource.cdn.icai.org/59024aasb48128.pdf>

3.4 Auditor's Report for Audits Conducted in Accordance with Both Standards on Auditing Issued by ICAI and International Standards on Auditing or Auditing Standards of Any Other Jurisdiction:

An auditor may be required to conduct an audit in accordance with, in addition to the Standards on Auditing issued by ICAI, the International Standards on Auditing or auditing standards of any other jurisdiction. If this is the case, the auditor's report may refer to Standards on Auditing in addition to the International Standards on Auditing or auditing standards of such other jurisdiction, but the auditor shall do so only if:

- (a) There is no conflict between the requirements in the ISAs or such auditing standards of other jurisdiction and those in SAs that would lead the auditor:
 - (i) to form a different opinion, or
 - (ii) not to include an Emphasis of Matter paragraph or Other Matter paragraph that, in the particular circumstances, is required by SAs; and
- (b) The auditor's report includes, at a minimum, each of the elements set out in Auditor's Report Prescribed by Law or Regulation discussed above when the auditor uses the layout or wording specified by the Standards on Auditing. However, reference to "law or regulation" in above paragraph shall be read as reference to the Standards on Auditing. The auditor's report shall thereby identify such Standards on Auditing.

When the auditor's report refers to both the ISAs or the auditing standards of a specific jurisdiction and the Standards on Auditing issued by ICAI, the auditor's report shall clearly identify the same including the jurisdiction of origin of the other auditing standards.

3.5 Supplementary Information Presented with the Financial Statements

If supplementary information that is not required by the applicable financial reporting framework is:	
presented with the audited financial statements, the auditor shall evaluate whether, in the auditor's professional judgment, supplementary information is nevertheless an integral part of the financial statements due to its nature or how it is presented. When it is an integral part of the financial statements, the supplementary information shall be covered by the auditor's opinion.	not considered an integral part of the audited financial statements, the auditor shall evaluate whether such supplementary information is presented in a way that sufficiently and clearly differentiates it from the audited financial statements. If this is not the case, then the auditor shall ask management to change how the unaudited supplementary information is presented. If management refuses to do so, the auditor shall identify the unaudited supplementary information and explain in the auditor's report that such supplementary information has not been audited.

For example:

4. When the notes to the financial statements include an explanation or the reconciliation of the extent to which the financial statements comply with another financial reporting framework, the auditor may consider this to be supplementary information that cannot be clearly differentiated from the financial statements. the auditor's opinion would also cover notes or supplementary schedules that are cross referenced from the financial statements.

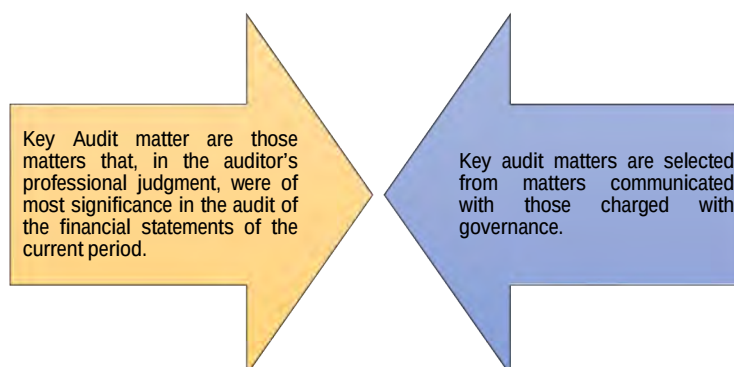
5. When an additional profit and loss account that discloses specific items of expenditure is disclosed as a separate schedule included as an appendix to the financial statements, the auditor may consider this to be supplementary information that can be clearly differentiated from the financial statements.

TEST YOUR UNDERSTANDING 1

The auditors of a listed company have affirmed in their audit report communication of significant audit findings including significant deficiencies in internal control of the company identified to those charged with governance. Where are such matters included in audit report of a listed company? Also dwell upon importance of such communication.

4. SA 701 COMMUNICATING KEY AUDIT MATTERS IN THE INDEPENDENT AUDITOR'S REPORT

SA 701 provides guidance regarding communication of Key Audit Matters. This SA deals with the auditor's responsibility to communicate key audit matters in the auditor's report. It is intended to address both the auditor's judgment as to what to communicate in the auditor's report and the form and content of such communication.



4.1 Purpose

The purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. Communicating key audit matters provides additional information to intended users of the financial statements ("intended users") to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Communicating key audit matters may also assist intended users in understanding the entity and areas of significant management judgment in the audited financial statements.

Objective	• To enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. • To assist the user in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period.

4.2 Scope

Communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not:

(a)	A substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;
(b)	A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);
(c)	A substitute for reporting in accordance with SA 570 (Revised) when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or

(d) A separate opinion on individual matters.

a substitute for disclosures in the financial statements;

a substitute for the auditor expressing a modified opinion in case of circumstances of a specific audit engagement as per SA 705;

a substitute for reporting in accordance with SA 570 or

a separate opinion on individual matters.

Applicability of SA 701

➤ This SA applies to audits of complete sets of general purpose financial statements of :

- ✎ listed entities and
- ✎ circumstances when the auditor otherwise decides to communicate key audit matters in the auditor's report and
- ✎ required by law or regulation to communicate key audit matters in the auditor's report

However, SA 705 (Revised) prohibits the auditor from communicating key audit matters when the auditor disclaims an opinion on the financial statements, unless such reporting is required by law or regulation

4.3 Determining Key Audit Matters

The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:

(a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315

(b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.

(c) The effect on the audit of significant events or transactions that occurred during the period.



6-10 Examples of Key Audit Matters:

- Assessment of Impairment,
- Provision for losses and contingencies,
- Valuation of financial instruments,
- Matters relating to Revenue recognition,
- Taxation matters (multiple tax jurisdictions, uncertain tax position, deferred tax assets).

4.4 Communicating Key Audit Matters

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

(a) Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements [of the current period]; and.

(b) These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters.

In case there are no Key Audit Matter to communicate, the auditors' report must specifically mention that by carrying a Key Audit Matter Paragraph and under which they shall mention that there are no Key Audit matter to communicate.

Extract of Independent Auditor's Report – Key Audit Matter

Key audit matter	How our audit addressed the key audit matter
The Bank is required to comply with the Master Circular dated 1 October, 2021 issued by the Reserve Bank of India ("RBI") on "Prudential Norms for Income Recognition, Asset Classification and Provisioning pertaining to Advances" (the "IRAC norms") and amendments thereto which prescribes the guidelines for identification and classification of Non-performing Assets ("NPAs") and the minimum provision required for such assets. The Bank is also required to apply its judgement to determine the identification and provision required against NPAs considering various quantitative as well as qualitative factors. The identification of NPAs is also affected by factors like stress and liquidity concerns in certain sectors. The provision for identified NPAs is estimated based on ageing and classification of NPAs, value of security, recovery estimates etc. and is also subject to the minimum provisioning norms specified by RBI. In addition, the Bank is also required to implement "Resolution Framework – 2.0: Resolution of COVID-19 related stress of Individuals and Small Businesses" and "Resolution Framework – 2.0: Resolution of COVID-19 related stress of Micro, Small and Medium Enterprises (MSMEs)" issued by the RBI on 5 May 2021 (collectively "Resolution Framework – 2.0"), and consider the same in identification of NPAs and measurement of provision against advances. Since the identification of NPAs and provisioning for advances requires considerable level of management estimation, application of various regulatory requirements and its significance to the overall audit, we have identified this as a key audit matter.	Our audit procedures included the following: • Understood the process and controls, and tested the design and operating effectiveness of key controls, including Information Technology based controls, and focused on the following: - Approval of new lending facilities in accordance with the Bank's credit policies - Performance of annual review/renewal of loan accounts. - Monitoring of credit quality which amongst other things includes the monitoring of overdue loan accounts, drawing power limit, pending security creation; - Identification and classification of NPAs in accordance with IRAC norms, other regulatory guidelines issued by the RBI and consideration of qualitative aspects; and - Assessment of adequacy of NPA provisions. • Tested the Bank's process for identification of loans with default events and/ or breach of other qualitative factors, and for a sample of performing loans, independently assessed as to whether there was a need to classify such loans as NPAs. • On a test check basis, verified the accounts classified by the Bank as Special Mention Accounts ('SMA') in RBI's Central Repository of Information on Large Credits ('CRILC'). • Inquired with the management of the Bank on sectors where there has been stress and the steps taken by the Bank to mitigate such sectorial risks.

The key audit matter	How the matter was addressed in our audit
As disclosed in note 25 to the standalone financial statements, revenue is measured net of any trade discounts and volume rebates to customers ("discounts and rebates"). Certain discounts and rebates for goods sold during the year are only finalised when the precise amounts are known, and revenue therefore includes an estimate of variable consideration. The variable consideration represents the portion of discounts and rebates that are not directly deducted on the invoice and involves estimation by the Company in recognition and measurement of such discounts and rebates. This includes establishing an accrual at year end, particularly in arrangements with customers involving varying terms which are based on annual contracts or shorter-term arrangements. In addition, the value and timing of promotions for products varies from period to period, and the activity can span beyond the year end. The unsettled portion of the variable consideration results in discounts and rebates due to customers as at year end. Therefore, there is a risk of revenue being overstated due to fraud through manipulation of discounts and rebates accruals recognised, resulting from pressure the Company may feel to achieve performance targets at the year end. We identified the evaluation of accrual for discounts and rebates as a key audit matter.	Our audit procedures included: • Understanding the process followed by the Company to determine the amount of accrual for discounts and rebates. • Evaluating the design and implementation and testing operating effectiveness of Company's general IT controls, key manual and application controls over the Company's IT systems including controls over rebates agreements / arrangements, rebate payments / settlements and Company's review over the rebate accruals. • Inspecting on a sample basis, key customer contracts. Based on the terms and conditions relating to discounts and rebates, assessing the Company's revenue recognition policies with reference to the requirements of the applicable accounting standards. • Performing substantive testing by selecting samples of discounts and rebates transactions recorded during the year as well as period end discounts and rebates accruals and matching the parameters used in the computation with the relevant source documents.

ILLUSTRATION 2

The following illustrates the presentation in the auditor's report if the auditor has determined there are no key audit matters to communicate:

Key Audit Matters

[Except for the matter described in the Basis for Qualified (Adverse) Opinion section or Material Uncertainty Related to Going Concern section,] We have determined that there are no [other] key audit matters to communicate in our report.] 1

5. SA 705 MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT

Modified Opinions: SA 705 deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700 (Revised), the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary.

5.1 Types of Modified Opinions:

Types of Modified Opinions as per SA 705:	(i) Qualified Opinion
	(ii) Adverse Opinion
	(iii) Disclaimer of Opinion

The decision regarding which type of modified opinion is appropriate depends upon:

- (a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and
- (b) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

5.2 Objective

The objective of the auditor is to express clearly an appropriately modified opinion on the financial statements that is necessary when:

- (a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

5.3 Circumstances When a Modification to the Auditor's Opinion is Required:

The auditor shall modify the opinion in the auditor's report when:

The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or	The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

5.4 Determining the Type of Modification to the Auditor's Opinion:

5.4.1 Qualified Opinion: The auditor shall express a qualified opinion when:

- (a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Illustrative Audit Opinion:**ILLUSTRATION 3**

XYZ Ltd. is a company engaged in the manufacture of cranes. CA Sudhir is the statutory auditor of the company for the FY 2022-23. The company has taken long term funding for fixed capital requirements and short-term funding for its working capital requirements. During the course of audit, CA Sudhir found that the company's financing arrangements are about to expire and the company is unable to re- negotiate or obtain the replacement financing. As such the company may be unable to realize its assets and discharge its liabilities in the normal course of business. Notes to accounts annexed to the financial statements discuss the magnitude of financing arrangements, the expiration and the total financing arrangements; however, the financial statements do not include discussion on the impact or the availability of refinancing. Thus, the financial statements (and notes thereto) do not fully disclose this fact. What kind of opinion should CA Sudhir issue in case of XYZ Ltd.?

SOLUTION

In the present case, XYZ Ltd. is unable to re- negotiate or obtain the replacement financing for its long term and short-term funding requirements. This situation indicates the existence of a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore, XYZ Ltd. may be unable to realize its assets and discharge its liabilities in the normal course of business. Further, the financial statements of XYZ Ltd. do not disclose this fact adequately.

Thus, the financial statements of XYZ Ltd. are materially misstated due to the inadequate disclosure of the material uncertainty. CA Sudhir will express a qualified opinion as the effects on the financial statements of this inadequate disclosure are material but not pervasive to the financial statements.

The relevant extract of the Qualified Opinion Paragraph and Basis for Qualified Opinion paragraph is as under:

Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the incomplete disclosure of the information referred to in the Basis for Qualified Opinion section of our report, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of XYZ Ltd. as at March 31, 2023, and profit/loss, for the year ended on that date.

Basis for Qualified Opinion

As discussed in Note 6, the Company's financing arrangements are about to expire and the Company has been unable to conclude renegotiations or obtain replacement financing. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. The financial statements do not adequately disclose this matter.

5.4.2 Adverse Opinion: The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

ILLUSTRATION 4

ABC Ltd. is a company engaged in the manufacture of iron and steel bars. PP & Associates are the statutory auditors of ABC Ltd. for the FY 2022-23. During the course of audit, CA Prakash, the engagement partner, found that the Company's financing arrangements have expired and the amount outstanding was payable on March 31, 2023. The Company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore it may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact. What opinion should CA Prakash express in case of ABC Ltd.?

SOLUTION

In the present case based on the audit evidence obtained, CA Prakash has concluded that a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, and the entity is considering bankruptcy. The financial statements of ABC Ltd. omit the required disclosures relating to the material uncertainty.

In such circumstances, CA Prakash should express an adverse opinion because the effects on the financial statements of such omission are material and pervasive.

The relevant extract of the Adverse Opinion Paragraph and Basis for Adverse Opinion paragraph is as under:

Adverse Opinion

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion section of our report, the accompanying financial statements do not present fairly, the financial position of the entity as at March 31, 2023, and of its financial performance and its cash flows for the year then ended in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India.

Basis for Adverse Opinion

The financing arrangements of ABC Ltd. has expired and the amount outstanding was payable on March 31, 2023. The entity has been unable to conclude re-negotiations or obtain replacement financing and is considering filing for bankruptcy. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. The financial statements do not adequately disclose this fact.

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



11. Draft Disclaimer of Opinion

We were engaged to audit the financial statements of ABC & Associates ("the entity"), which comprise the balance sheet as at March 31, 20XX, the statement of Profit and Loss, [the statement of changes in equity (where applicable)] and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying financial statements of the entity. Because of the significance of the matters described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

ILLUSTRATION 5

MNO Ltd. is a power generating company having its plants in the north eastern states of the country. For the FY 2022-23, M/s PRT & Associates are the statutory auditors of the company. During the course of audit, the audit team was unable to obtain sufficient appropriate audit evidence about a single element of the consolidated financial statements. That is, the auditor was also unable to obtain audit evidence about the financial information of a joint venture investment (in XYZ Ltd.) that represents over 90% of the entity's net assets. What kind of opinion should the statutory auditors issue in such case?

SOLUTION

M/s PRT & Associates are unable to obtain sufficient appropriate audit evidence about the financial information of a joint venture investment that represents over 90% of the entity's net assets. The possible effects of this inability to obtain sufficient appropriate audit evidence are both material and pervasive to the consolidated financial statements.

Therefore, the statutory auditor should issue a disclaimer of opinion.

The relevant extract of the Disclaimer of Opinion Paragraph and Basis for Disclaimer of Opinion paragraph is as under:

Disclaimer of Opinion

We do not express an opinion on the accompanying financial statements of MNO Ltd. Because of the significance of the matters described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Basis for Disclaimer of Opinion

The Group's investment in its joint venture XYZ Company is carried at ₹ 95 crores on the Group's consolidated balance sheet, which represents over 90% of the Group's net assets as at March 31, 2023. We were not allowed access to the management and the auditors of XYZ Company, including XYZ Company's auditors' audit documentation. As a result, we were unable to determine whether any adjustments were necessary in respect of the Group's proportional share of XYZ Company's assets that it controls jointly, its proportional share of XYZ Company's liabilities for which it is jointly responsible, its proportional share of XYZ's income and expenses for the year, (and the elements making up the consolidated statement of changes in equity) and the consolidated cash flow statement.

What is Pervasive: Pervasive is a term used in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence.

Pervasive effects on the financial statements are those that in the auditor's judgment:

- Are not confined to specific elements, accounts or items of the financial statements;
- If so confined, represent or could represent a substantial proportion of the financial statements; or
- In relation to disclosures, are fundamental to users' understanding of the financial statements.

Pervasive, therefore, is that which is not localised to any one or two elements of a financial statements, but the impact is across various elements of the financial statements.

For example, if sufficient appropriate audit evidence is not available for say Inventory but the other elements are properly supported by documentary evidence then the non-availability of information on Inventory is localized to possible misstatement of inventory but has no impact on the other elements like trade receivables, PPE, loans, Trade payables etc.

Therefore, it is necessary to ascertain whether the impact of misstatement is pervasive or not pervasive.

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

If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.

If management refuses to remove the limitation, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity, and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

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

- (a) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor shall qualify the opinion; or
- (b) If the auditor concludes that the possible effects on the financial statements 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, the auditor shall:
 - (i) Withdraw from the audit, where practicable and possible under applicable law or regulation; or
 - (ii) If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.

5.6 If the auditor decides to withdraw

When the auditor decides to withdraw before withdrawing, the 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.

5.6.1 Where Auditors' withdrawal is not permitted: The listing agreement and the Securities and Exchange Board of India's directive on the resignation of auditor does not permit withdrawing from the engagement without issuing the audit / review report. The said directive contained in circular no. CIR/CFD/CMD1/114/2019 dated October 18, 2019 issued by the Securities and Exchange Board of India inter-alia provides that

If the auditor proposes to resign:

- a) within 45 days from the end of any of the quarters of a period covered under the appointment, then the auditor shall, before such resignation, issue the audit / limited review report for such quarter.
- b) after 45 days from the end any of the quarters of a period covered under the appointment, then we shall, before such resignation, issue the audit / Limited review report for such quarter as well as the next quarter.
- c) If the Limited review report has been issued for all the three quarters, then the auditor shall issue the audit report for the full year before resigning from the engagement.

ICAI announcement on the Resignation of Auditor: The ICAI has made an announcement that the auditor of an unlisted company shall not mention “professional pre-occupation” as a reason for the resignation. The auditor shall mention the reasons clearly for the resignation in the resignation letter issued to the Company.

5.7 Other Considerations Relating to an Adverse Opinion or Disclaimer of Opinion

When the auditor considers it necessary to express an adverse opinion or disclaim an opinion on the financial statements as a whole, the auditor's report shall not also include an unmodified opinion with respect to the same financial reporting framework on a single financial statement or one or more specific elements, accounts or items of a financial statement. To include such an unmodified opinion in the same report in these circumstances would contradict the auditor's adverse opinion or disclaimer of opinion on the financial statements as a whole.

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

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

What special consideration are required for expressing Qualified Opinion?

When the auditor expresses a qualified opinion due to a material misstatement in the financial statements, the auditor shall state that, in the auditor's opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion section:

- (a) When reporting in accordance with a fair presentation framework, the accompanying financial statements present fairly, in all material respects (or give a true and fair view of) [...] in accordance with [the applicable financial reporting framework]; or
- (b) When reporting in accordance with a compliance framework, the accompanying financial statements have been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

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.

ILLUSTRATION 6

CA Yash is the statutory auditor of Laksmi Vardhan Limited for the FY 2022-23. In respect of loans and advances of ₹ 55,00,000/- given to Sarvagya Private Limited, the Company has not furnished any agreement to CA Yash and in absence of the same, he is unable to verify the terms of repayment, chargeability of interest and other terms.

What kind of opinion should CA Yash give in such situation?

SOLUTION

In the present case, with respect to loans and advances of ₹ 55,00,000/- given to Sarvagya Private Limited, the Company has not furnished any agreement to CA Yash. In absence of such agreement, CA Yash is unable to verify the terms of repayment, chargeability of interest and other terms. For an auditor, while verifying any loans and advances, one of the most important audit evidences is the loan agreement. Therefore, the absence of such document in the present case, tantamount to a material misstatement in the financial statements of the company. However, the inability of CA Yash to obtain such audit evidence is though material but not pervasive so as to require him to give a disclaimer of opinion.

Thus, in the present case, CA Yash should give a qualified opinion

The relevant extract of the Qualified Opinion Paragraph and Basis for Qualified Opinion paragraph is as under:

Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the possible effects of the matter described in the Basis for Qualified Opinion section of our report, the financial statements of Laksmi Vardhan Limited give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as on 31.03.2023 and profit/ loss for the year ended on that date.

Basis for Qualified Opinion

The Company is unable to furnish the loan agreement with respect to loans and advances of ₹ 55,00,000/- given to Sarvagya Private Limited. Consequently, in absence of such agreement, we are unable to verify the terms of repayment, chargeability of interest and other terms.

What special consideration needed for expressing Adverse Opinion?

When the auditor expresses an adverse opinion, the auditor shall state that, in the auditor's opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion section:

- (a) When reporting in accordance with a fair presentation framework, the accompanying financial statements do not present fairly (or give a true and fair view of) [...] in accordance with [the applicable financial reporting framework]; or
- (b) When reporting in accordance with a compliance framework, the accompanying financial statements have not been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

ILLUSTRATION 7

In the financial year 2022-23, MSD Ltd. faced an extraordinary event (earthquake), which destroyed a lot of business activity of the company. These circumstances indicate material uncertainty on the company's ability to continue as going concern. Due to such event it may not be possible for the company to realize its assets or pay off the liabilities during the regular course of its business. The financial statement and notes to the financial statements of the company do not disclose this fact. What kind of opinion should the statutory auditor of MSD Ltd. issue in such circumstances?

SOLUTION

In the present case, there exists a material uncertainty that cast a significant doubt on the company's ability to continue as going concern and the same is not disclosed in the financial statements of MSD Ltd.

As such, the financial statements of MSD Ltd. for the FY 2022-23 are materially misstated and the effect of the misstatement is so material and pervasive on the financial statements that giving only a qualified opinion will be insufficient and therefore the statutory auditor of MSD Ltd. should issue an adverse opinion.

The relevant extract of the Adverse Opinion Paragraph and Basis for Adverse Opinion paragraph is as under:

Adverse Opinion

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion section of our report, the accompanying financial statements do not present fairly, the financial position of MSD Ltd. as at March 31, 2023, and of its financial performance and its cash flows for the year then ended in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India.

Basis for Adverse Opinion

MSD Ltd. has faced an extraordinary event (earthquake), which destroyed a lot of business activity of the company. Due to such event it may not be possible for the company to realize its assets or pay off the liabilities during the regular course of its business. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. The financial statement and notes to the financial statements of the company do not disclose this fact.

What special consideration is required for expressing Disclaimer of Opinion?

When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall:

- (a) State that the auditor does not express an opinion on the accompanying financial statements;
- (b) State that, because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
- (c) Amend the statement required in SA 700 (Revised), which indicates that the financial statements have been audited, to state that the auditor was engaged to audit the financial statements.

ILLUSTRATION 8

CA Abhimanyu is the statutory auditor of PQR Ltd. for the FY 2022-23. During the course of audit CA Abhimanyu noticed the following:

1. *With respect to the debtors amounting to ₹150 crores, no balance confirmation was received by the audit team. Further, there have been defaults on the payment obligations by debtors on the due dates during the year under audit. The Company has created a provision for doubtful debts to the tune of ₹25 Cr. during the year under audit. The Company has stated that the provision is based on receivables which are older than 36 months, which according to the audit team is inadequate and as such the audit team is unable to ascertain the carrying value of trade receivables.*
2. *Further, in respect of Inventories (which constitutes 40% of the total assets of the company), during the reporting period, the management has not undertaken physical verification of inventories at periodic intervals. Also, the Company has not*

maintained adequate inventory records at the factory. The audit team was unable to undertake the physical inventory count as such the value of inventory could not be verified.

Under the above circumstances what kind of opinion should CA Abhimanyu give?

SOLUTION

In the present case, CA Abhimanyu is unable to obtain sufficient and appropriate audit evidence with respect to the following:

1. The balance confirmation with respect to debtors amounting to ₹ 150 crores is not available. Further there has been default in payment by the debtors and the provision so made is not adequate. The audit team is also unable ascertain the carrying value of trade receivables.
2. With respect to 40% of the company's inventory, neither the physical verification has been done by the management nor are adequate inventory records maintained. The audit team is also unable to undertake the physical inventory count as such the value of inventory could not be verified.

In the above two circumstances the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

Thus, CA Abhimanyu should give a Disclaimer of Opinion.

The relevant extract of the Disclaimer of Opinion Paragraph and Basis for Disclaimer of Opinion paragraph is as under:

Disclaimer of Opinion

We do not express an opinion on the accompanying financial statements of PQR Ltd. Because of the significance of the matters described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Basis for Disclaimer of Opinion

We are unable to obtain balance confirmation with respect to the debtors amounting to ₹ 150 crores. Further, there have been defaults on the payment obligations by debtors on the due dates during the year under audit. The Company has created a provision for doubtful debts to the tune of ₹25 Cr. during the year under audit which is inadequate in the circumstances of the company. The carrying value of trade receivables could not be ascertained.

Further, in respect of Inventories (which constitutes 40% of the total assets of the company), during the reporting period, the management has not undertaken physical verification of inventories at periodic intervals. Also, the Company has not maintained adequate inventory records at the factory. We were unable to undertake the physical inventory count and as such the value of inventory could not be verified.

Unless required by law or regulation, when the auditor disclaims an opinion on the financial statements, the auditor's report shall not include a Key Audit Matters section in accordance with SA 701.

What is the Basis for Modification of Opinion (Qualified/Disclaimer /Adverse)?

When the auditor modifies (Qualification/ Disclaimer/ Adverse) the opinion as above on the financial statements, the auditor shall, in addition to the specific elements required by SA 700 (Revised):

- (a) Amend the heading "Basis for Opinion" to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate; and
- (b) Within this section, include a description of the matter giving rise to the modification.

If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements (including quantitative disclosures in the notes to the financial statements), the auditor shall include in the Basis for Opinion section, a description and quantification of the financial effects of the misstatement, unless impracticable. If it is not practicable to quantify the financial effects, the auditor shall so state in this section.

If there is a material misstatement of the financial statements that relates to narrative disclosures, the auditor shall include in the Basis for Opinion section an explanation of how the disclosures are misstated.

If there is a material misstatement of the financial statements that relates to the non- disclosure of information required to be disclosed, the auditor shall:

- (a) Discuss the non-disclosure with those charged with governance;
- (b) Describe in the Basis for Opinion section the nature of the omitted information; and
- (c) Unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information.

If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the Basis for Opinion section the reasons for that inability.

When the auditor expresses a qualified or adverse opinion, the auditor shall amend the statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion to include the word "qualified" or "adverse", as appropriate.

When the auditor disclaims an opinion on the financial statements, the auditor's report shall not include following elements required under SA 700

- (a) A reference to the section of the auditor's report where the auditor's responsibilities are described; and
- (b) A statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Even if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor shall describe in the Basis for Opinion section the reasons for any other matters of which the auditor is aware that would have required a modification to the opinion, and the effects thereof.

How Auditor should give description of Auditor's Responsibilities for the Audit of the Financial Statements When the Auditor Disclaims an Opinion on the Financial Statements?

When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by SA 700 (Revised) to include only the following:

- (a) A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report;
- (b) A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
- (c) The statement about auditor independence and other ethical responsibilities required in SA 700.

Matrix to be considered to determine what type of modified opinion should be used by the Auditor: When the auditor concludes that there exists a material misstatement which precludes the auditor from issuing an un-modified opinion, the auditor must determine which type of modified opinion is to be issued by the auditor as per SA 705 – Modifications to the Opinion in the Independent Auditors Report. The following matrix assists the auditor in determining the type of modified opinion.

Nature of Matter Giving Rise to the Modification:	Auditor's judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements	
	Material but not pervasive	Material and pervasive
Financial Statements are materially misstated	Qualified Opinion	Adverse Opinion
Inability to obtain Sufficient appropriate audit evidence	Qualified Opinion	Disclaimer of Opinion

5.9 Communication with Those Charged with Governance

When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the wording of the modification. The Auditor is required to discuss and deliberate with those charged with governance the audit findings and the type of misstatements.

6 SA 706 EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTER PARAGRAPHS IN THE INDEPENDENT AUDITOR'S REPORT

6.1 Objective

The objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:

- (a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or
- (b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Emphasis of Matter paragraph – A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Other Matter paragraph – A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

6.2 When to give emphasis of Matter Paragraphs in the Auditor's Report?

If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided:

- (a) The auditor would not be required to modify the opinion in accordance with SA 705 (Revised) as a result of the matter; and
- (b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.



12. These circumstances may include:

- When a financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation.
- To alert users that the financial statements are prepared in accordance with a special purpose framework.
- When facts become known to the auditor after the date of the auditor's report and the auditor provides a new or amended auditor's report (i.e., subsequent events).

6.3 When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

- (a) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";
- (b) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and
- (c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

When to issue other Matter Paragraphs in the Auditor's Report?

If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, the auditor shall include an Other Matter paragraph in the auditor's report, provided:

- (a) This is not prohibited by law or regulation; and
- (b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

When the auditor includes an Other Matter paragraph in the auditor's report, the auditor shall include the paragraph within a separate section with the heading "Other Matter," or other appropriate heading.



13. Circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:

- An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.
- Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

ILLUSTRATION 9

In respect of the audit of BDS Ltd., the statutory auditor of the company noticed some matters. The statutory auditor wants to draw the user's attention towards such matters, though his opinion is not modified in respect of such matters. Draft the relevant paragraphs of the audit report for the following matters:

- i. *The company has a plan to resume its construction activities with respect to one of its thermal power project, The activity of such power plant was suspended in the*

FY 2020-21. The thermal power project comprises of the plant and equipment amounting to ₹5.95 crore and capital work in progress of ₹147.50 crore.

- ii. *The financial statements of 5 branches are included in the Standalone Financial Statements of BDS Ltd. whose financial statements reflect total assets of ₹90 crores as at 31.03.2023 and total revenue from operations of ₹40 crores for the year ended on that date. The financial statements of these branches have been audited by the branch auditors.*

SOLUTION

Emphasis of Matter

We draw attention to the following note of the standalone financial statements:

Note 27 regarding the plans of the Company to resume construction/developmental activities of a thermal power project. The carrying amounts related to the project as at 31st March, 2023 comprise of plant and equipment of ₹ 5.95 crore and capital work in progress of ₹ 147.50 crore.

Our opinion is not modified in respect of this matter.

Other Matter

We did not audit the financial statements of 5 branches included in the Standalone Financial Statements of the company whose financial statements reflect total assets of ₹ 90 crores as at 31.03.2023 and total revenue from operations of ₹ 40 crores for the year ended on that date. The financial statements of these branches have been audited by the branch auditors whose reports have been furnished to us, and our opinion in so far as it relates to the amounts and disclosures included in respect of these branches, is based solely on the report of the branch auditors.

Our opinion is not modified in respect of this matter.

Is there any duty to communicate with Those Charged with Governance?

If the auditor expects to include an Emphasis of Matter or an Other Matter paragraph in the auditor's report, the auditor shall communicate with those charged with governance regarding this expectation and the wording of this paragraph.

Extract of Independent Auditor's Report – Emphasis of Matter Para & Other Matter**Emphasis of Matter Paragraph**

We draw attention to Note no. 7 of the Statement wherein during the quarter ended September 30, 2022, the Board of Directors of [REDACTED] decided to provide for interest on borrowings which were previously not recognised in the books of account for the reasons stated in the said note. Accordingly, the figures for the previous periods / years of other current financial liability, finance cost, profit / (loss) before tax, Earnings per share and Other equity has been impacted on such restatement. Consequently the figures of the consolidated financial results of the Holding Company also stand restated. The effect of the restatement in the consolidated financial results has been disclosed in Note 7 of the Statement. Our conclusion on the Statement is not modified in respect of this matter.

Other Matters

1. The consolidated financial results include the audited financial results of 32 subsidiaries, whose financial statements / financial information reflect total assets of Rs. 8,30,863 lakhs as at March 31, 2023, total revenue of Rs. 5,698 lakhs and Rs. 24,372 lakhs, net loss after tax of Rs. 20,604 lakhs and Rs. 52,472 lakhs and total comprehensive loss of Rs. 20,641 lakhs and Rs. 52,514 lakhs for the quarter and year ended March 31, 2023 respectively and cash outflows of Rs. 4,678 lakhs for the year ended March 31, 2023, as considered in the consolidated financial results, which have been audited by their respective independent auditors. The consolidated financial results also includes the Group's share of net loss after tax of Rs. Nil and Rs. Nil and total comprehensive income of Rs. Nil and Rs. Nil for the quarter and year ended March 31, 2022 respectively as considered in the consolidated financial results in respect of 3 associates, which have been audited by their respective independent auditors. The independent auditors' reports on financial statements / financial information of these entities have been furnished to us and our opinion on the consolidated financial results, in so far as it relates to the amounts and disclosures included in respect of these entities, is based solely on the report of such auditors and the procedures performed by us are as stated in paragraph above.

Our opinion on the consolidated financial results is not modified in respect of the above matters with respect to our reliance on the work done and the reports of the other auditors.

2. The consolidated financial results include the results for the quarter ended March 31, 2023 and March 31, 2022 being the balancing figures between the audited figures in respect of the full financial year and the published unaudited year to date figures up to the third quarter of the respective financial year which were subject to limited review by us.

Note: Students are advised to refer Illustration of Emphasis of Matter Para as given in appendix at the end of the Chapter.

Relationship between Emphasis of Matter Paragraphs and Key Audit Matters in the Auditor's Report	
Key audit matters— Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance. [SA 701]	Emphasis of Matter paragraph – A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements. [SA 706]
Matters that are determined to be key audit matters in accordance with SA 701 may also be, in the auditor's judgment, fundamental to users' understanding of the financial statements. In such cases, in communicating the matter as a key audit matter in accordance with SA 701, the auditor may wish to highlight or draw further attention to its relative importance. Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit and may also assist them in understanding the entity and areas of significant management judgment in the audited financial statements.	A widespread use of Emphasis of Matter paragraphs may diminish the effectiveness of the auditor's communication about such matters. Use of Emphasis of Matter paragraphs is not a substitute for a description of individual key audit matters where SA 701 is applicable. There may be a matter that is not determined to be a key audit matter in accordance with SA 701 (i.e., because it did not require significant auditor attention), but which, in the auditor's judgment, is fundamental to users' understanding of the financial statements (e.g., a subsequent event). If the auditor considers it necessary to draw users' attention to such a matter, the matter is included in an Emphasis of Matter paragraph in the auditor's report in accordance with this SA.
The communication of key audit matters in the auditor's report may also provide intended users a basis to further engage with management and those charged with governance about certain matters relating to the entity, the audited financial statements, or the audit that was performed.	The auditor may do so by presenting the matter more prominently than other matters in the Key Audit Matters section (e.g., as the first matter) or by including additional information in the description of the key audit matter to indicate the importance of the matter to users' understanding of the financial statements.

SA-706

Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

Scope

- This SA deals with additional communication in the auditor's report when the auditor considers it necessary to draw users' attention to a matter or matters
- (a) presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements; or
- (b) other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Objectives

- The objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:
 - (a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or
 - (b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Definitions

- **Emphasis of Matter paragraph** : A paragraph included in the auditor's report that refers to a *matter appropriately presented or disclosed* in the financial statements that, in the *auditor's judgment*, is of such importance that it is *fundamental to users* understanding of the financial statements.
- **Other Matter paragraph**: A paragraph included in the auditor's report that refers to a matter *other than those presented or disclosed* in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Requirements

- **Emphasis of Matter Paragraphs in the Auditor's Report**
 - When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:
 - (a) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";
 - (b) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and
 - (c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.
- **Other Matter Paragraphs in the Auditor's Report**
 - If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, the auditor shall include an Other Matter paragraph in the auditor's report, provided:
 - (a) This is not prohibited by law or regulation; and
 - (b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.
 - The auditor shall include the paragraph within a separate section with the heading "Other Matter," or other appropriate heading.
- **Communication with Those Charged with Governance**
 - If the auditor expects to include an *Emphasis of Matter* or an *Other Matter paragraph* in the auditor's report, the auditor shall communicate with those charged with governance regarding this expectation and the wording of this paragraph.



7. DISTINCTION BETWEEN NOTES ON ACCOUNTS AND QUALIFICATIONS

As a general practice, the management would normally prefer to explain their view point and assessment on all matters involving difference of opinion between them and the auditors by way of notes in the financial statements, for better understanding of the facts of the matters by users of financial statements. Such notes represents management's stand on the matter while the auditor records his disagreement on the matters by way of qualifications in the auditor's report.

Students should note that client and auditor are two separate independent parties and in real life situations, at times, the client management may insist upon the auditor for not modifying his audit opinion considering the management has disclosed full facts and assessment of the matter through notes on the financial statements. However, the auditor needs to exercise his professional judgement and assess if the disclosure alone would suffice or in case, he also needs to modify his audit report by either inserting a qualification or Emphasis of matter. {it is clarified that emphasis of matter is not a substitute for modification of opinion}.

The Emphasis of Matter is to be made in respect of something which is appropriately presented and for which the auditor has obtained sufficient appropriate audit evidence.

Once auditor concludes that modification of his report in relation to the specific matter under question, is warranted, he may choose to refer to the specific note given by the management and thereafter, continue explaining more facts and his assessment on the matter including quantification and impact on the various financial statements captions, to the extent possible.

The Auditor must express the nature of qualification, in a clear and unambiguous manner. Where the Auditor answers any of the statutory affirmations in the negative or with a qualification, his report shall state the reasons for such answer. All qualifications should be contained in the Auditor's Report.

Where the company has committed an irregularity resulting in a breach of law, the Auditor should bring the same to the notice of the shareholders by properly qualifying his report. A quantified opinion should be expressed as "except for" for the effects of the matter to which the qualification related. 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.

Notes – Report Relationship – Where notes of a qualificatory nature appear in the accounts, the Auditors should state all qualifications independently in their report so that the user can assess the significance of these qualifications. A reference to the notes to Accounts in the Auditors' Report does

not automatically become a qualification. The report must categorically state the matter from the auditor's standpoint and not from the management stand point.

Note : Students are advised to refer examples/illustrative formats given at the end of the Chapter for better understanding of the differences.

Test your Understanding 2

Below is draft extract of audit report of a listed company. Para (A) below reflects certain matter stated in audit report communicated with CFO of company and Para (B) is in nature of auditor's response to said matter.

(A) The Company recognizes revenues when the control of goods is transferred to the customer at the net consideration which the Company expects to receive for those goods from customers in accordance with contracts terms and conditions.

The terms of sales arrangements based on the terms and conditions of relevant contract and nature of discount and rebates create complexities that require judgment in determining revenues.

(B) We read the Company's revenue recognition policy and assessed its compliance in terms of Ind AS 115 "Revenue from contracts with customers".

We assessed design and tested the operating effectiveness of internal controls related to sales and rebates/discounts.

We tested on a sample basis that revenue has been recognized in the proper period with reference to the supporting documents including confirmations from customers.

From description given above, identify what auditors are trying to report and under what heading such matter should be reflected in audit report of the company?

TEST YOUR UNDERSTANDING 3

PTD Limited is engaged in business of executing construction contracts for its clients. There are non-current receivables outstanding in financial statements of the company as on 31st March, 2023 for ₹500 crore. Such amounts represent claims raised by the company on its clients relating to cost overruns necessitated due to delays caused by clients, change in work specifications and related matters. Besides negotiations, the company has also gone for arbitration in some of the said cases. The management of company has considered above amounts to be fully recoverable as stated in notes to accounts.

CA. Piyush, auditor of the company, has relied only upon management representation in this regard. Besides, he has decided to include the said matter in "Emphasis of Matter" Paragraph in audit report. How do you view decision to include above matter in "Emphasis of Matter" Paragraph by auditor of the company?



8. DISTINCTION BETWEEN AUDIT REPORT AND CERTIFICATE

The term 'report' is used where an expression of opinion is involved. The term 'certificate' is preferable where the auditor comments on or verifies facts such as a verification of investment by inspection or the checking of ballot papers on a poll in a company meeting. Under the Companies Act, 2013, a number of situations are there where an auditor is required to issue a certificate rather than a report, like under Section 66 of the Companies Act, 2013, an auditor is required to file a certificate in the tribunal where company is proposing for the reduction of capital. However, the report under Section 143 of the Companies Act, 2013, is an opinion-based report and is not a certificate.



9. COMMUNICATION TO MANAGEMENT AND THOSE CHARGED WITH GOVERNANCE

As per SA 260 Communication with Those Charged with Governance, it is auditor's responsibility to communicate with those charged with governance in an audit of financial statements 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.

The auditor shall determine the appropriate person(s) within the entity's governance structure with whom to communicate. If the auditor communicates with a subgroup of those charged with governance, for example, an audit committee, or an individual, the auditor shall determine whether the auditor also needs to communicate with the governing body.

9.1 When All of Those Charged with Governance Are Involved in Managing the Entity

In some cases, all of those charged with governance are involved in managing the entity, for example, a small business where a single owner manages the entity and no one else has a governance role. In these cases, if matters required by this SA are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the

matters need not be communicated again with those same person(s) in their governance role. These matters are noted in paragraph 16(c). The auditor shall nonetheless be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity.

9.2 Matters to Be Communicated

The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that:

- (a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; and
- (b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

9.3 Planned Scope and Timing of the Audit

The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit, which includes communicating about the significant risks identified by the auditor.

9.4 Significant Findings from the Audit

The auditor shall communicate with those charged with governance:

(a)	The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;
(b)	Significant difficulties, if any, encountered during the audit;
(c)	Unless all of those charged with governance are involved in managing the entity: i. Significant matters arising during the audit that were discussed, or subject to correspondence, with management; and ii. Written representations the auditor is requesting;
(d)	Circumstances that affect the form and content of the auditor's report, if any; and
(e)	Any other significant matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process.



10. REPORTING REQUIREMENTS IN CASE OF COMPARATIVE INFORMATION

SA 710 Comparative Information-Corresponding Figures and Comparative Financial Statements deals with auditor's responsibility regarding comparative information in an audit of financial statement. There are two different broad approaches to the auditor's responsibilities in respect of comparative information: Corresponding figures and Comparative financial statement.

The essential audit reporting differences between the approaches are:

- (a) For corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas
- (b) For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

The objectives of the auditor are to obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework; and to report in accordance with the auditor's reporting responsibilities.

10.1 Audit Procedures for Comparative Information:

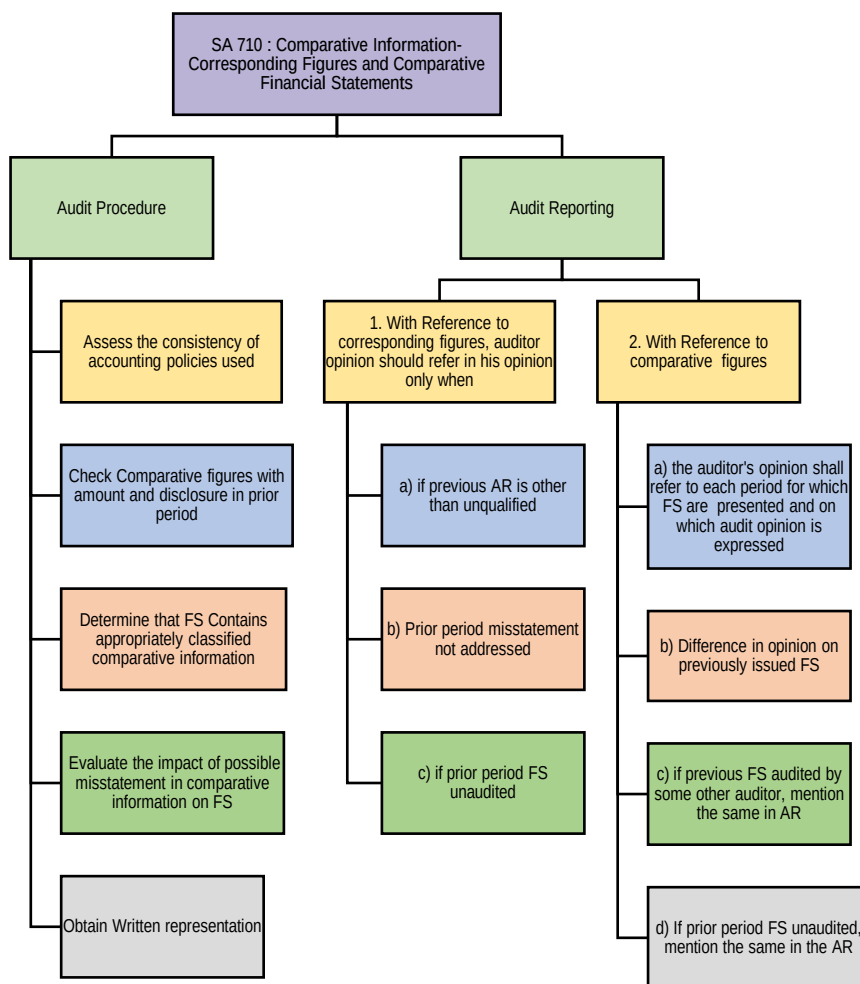
- (a) **Perform Specific audit Procedure:** For determining that the financial statement contains appropriately classified comparative information, the auditor should:
 - Ensure that comparative information agrees with the amount and other disclosure presented in the prior period.
 - The accounting policies applied are consistent with those applied in current period.
 - If there have been any changes in the application of accounting policies than they are properly disclosed and presented.
- (b) **Evaluating the impact on financial statement:** If the auditor becomes aware of any possible misstatement in the comparative information, then:
 - He should perform the necessary audit procedures to obtain sufficient audit evidence.
 - If the auditor had audited the prior period's financial statement than he should follow the relevant requirements of SA 560.

- (c) **Written Representation:** As required by SA 580, the auditor should also request written representation. He should also obtain a specific written representation regarding any prior period item that is disclosed in current year's financial statement.

10.2 Audit Reporting

(a)	With Reference to Corresponding Figures: When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the following circumstances: • If the auditor's report of the previous period contains other than an unqualified opinion. • If the auditor is of the opinion, and he has sufficient evidence in this regard, that a material misstatement exists in the financial statement of prior period, which was not addressed earlier. If the prior period financial statement are not audited, than he should obtain sufficient audit evidence that the opening balance does not contain any material misstatement.
(b)	With Reference to Comparative Financial Statement: When comparative financial statement are presented - • The auditor's opinion shall refer to each period for which the financial statements are presented. • When reporting on current period's audit, if the auditor's opinion on such prior period financial statement differs from the opinion previously issued on such financial statement, the auditor shall disclose the substantive reason for the different opinion in other matter paragraph in his report. • If the auditor concludes that a material misstatement is present in the previously audited figures of financial statement, he should report it to the appropriate level of the management and request that the predecessor auditor be informed. If then the prior years statements are amended with new report by the predecessor auditor, then the auditor shall report only on the current period.
(c)	Reporting treatment common to both (for corresponding figures and comparative information): (i) If the financial statement of the prior period were audited by a predecessor auditor, the auditor (is permitted by law or regulation to refer to the predecessor audit report – on case of corresponding figures and decides to do so) shall state in his audit report: • That the financial statement of the prior period were audited by a predecessor auditor; • The type of the opinion expressed by the predecessor auditor; • The date of that audit report.

- (ii) If the prior period financial statement were not audited than he shall report the same in other matter paragraph in his audit report that the corresponding/comparative figures are unaudited. However, the disclosure does not relieve him from his responsibility of obtaining sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.



11. SA 720 THE AUDITOR'S RESPONSIBILITIES RELATING TO OTHER INFORMATION

This Standard on Auditing (SA) deals with the auditor's responsibilities relating to other information, whether financial or non-financial information (other than financial statements and the auditor's

report thereon), included in an entity's annual report. An entity's annual report may be a single document or a combination of documents that serve the same purpose.

This SA requires the auditor to read and consider the other information because other information that is materially inconsistent with the financial statements or the auditor's knowledge obtained in the audit may indicate that there is a material misstatement of the financial statements or that a material misstatement of the other information exists, either of which may undermine the credibility of the financial statements and the auditor's report thereon. Such material misstatements may also inappropriately influence the economic decisions of the users for whom the auditor's report is prepared.

This SA does not apply to preliminary announcements of financial information; or securities offering documents, including prospectuses.

Important Definition :

- (a) *Annual report* – A document, or combination of documents, prepared typically on an annual basis by management or those charged with governance in accordance with law, regulation or custom, the purpose of which is to provide owners (or similar stakeholders) with information on the entity's operations and the entity's financial results and financial position as set out in the financial statements. An annual report contains or accompanies the financial statements and the auditor's report thereon and usually includes information about the entity's developments, its future outlook and risks and uncertainties, a statement by the entity's governing body, and reports covering governance matters.
- (c) *Other information* – Financial or non-financial information (other than financial statements and the auditor's report thereon) included in an entity's annual report.

11.1 Objective

The objectives of the auditor, having read the other information, are:

- (a) To consider whether there is a material inconsistency between the other information and the financial statements;
- (b) To consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit;
- (c) To respond appropriately when the auditor identifies that such material inconsistencies appear to exist, or when the auditor otherwise becomes aware that other information appears to be materially misstated; and
- (d) To report in accordance with this SA.

Other information may include amounts or other items that are intended to be the same as, to summarize, or to provide greater detail, about amounts or other items in the financial statements, and other amounts or other items about which the auditor has obtained knowledge in the audit. Other information may also include other matters.

11.2 Obtaining the Other Information

The auditor shall:

- (a) Determine, through discussion with management, which document(s) comprises the annual report, and the entity's planned manner and timing of the issuance of such document(s);
- (b) Make appropriate arrangements with management to obtain in a timely manner and, if possible, prior to the date of the auditor's report, the final version of the document(s) comprising the annual report; and
- (c) When some or all of the document(s) determined in (a) will not be available until after the date of the auditor's report, request management to provide a written representation that the final version of the document(s) will be provided to the auditor when available, and prior to its issuance by the entity, such that the auditor can complete the procedures required by this SA.

Reading and Considering the Other Information

The auditor shall read the other information and, in doing so shall:

- (a) Consider whether there is a material inconsistency between the other information and the financial statements. As the basis for this consideration, the auditor shall, to evaluate their consistency, compare selected amounts or other items in the other information (that are intended to be the same as, to summarize, or to provide greater detail about, the amounts or other items in the financial statements) with such amounts or other items in the financial statements; and (Ref: Para. A25–A29)
- (b) Consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit, in the context of audit evidence obtained and conclusions reached in the audit. (Ref: Para. A30–A36)

While reading the other information in accordance with above, the auditor shall remain alert for indications that the other information not related to the financial statements or the auditor's knowledge obtained in the audit appears to be materially misstated.

11.3 Responding When a Material Inconsistency Appears to Exist or Other Information Appears to Be Materially Misstated

If the auditor identifies that a material inconsistency appears to exist (or becomes aware that the other information appears to be materially misstated), the auditor shall discuss the matter with management and, if necessary, perform other procedures to conclude whether:

- (a) A material misstatement of the other information exists;
- (b) A material misstatement of the financial statements exists; or
- (c) The auditor's understanding of the entity and its environment needs to be updated.

11.4 Responding When the Auditor Concludes That a Material Misstatement of the Other Information Exists

11.4.1 If the auditor concludes that a material misstatement of the other information exists, the auditor shall request management to correct the other information. If management:

- (a) Agrees to make the correction, the auditor shall determine that the correction has been made; or
- (b) Refuses to make the correction, the auditor shall communicate the matter with those charged with governance and request that the correction be made.

11.4.2 If the auditor concludes that a material misstatement exists in other information obtained prior to the date of the auditor's report, and the other information is not corrected after communicating with those charged with governance, the auditor shall take appropriate action, including:

- (a) Considering the implications for the auditor's report and communicating with those charged with governance about how the auditor plans to address the material misstatement in the auditor's report.
- (b) Withdrawing from the engagement, where withdrawal is possible under applicable law or regulation.

11.4.3 If the auditor concludes that a material misstatement exists in other information obtained after the date of the auditor's report, the auditor shall:

- (a) If the other information is corrected, perform the procedures necessary in the circumstances; or
- (b) If the other information is not corrected after communicating with those charged with governance, take appropriate action considering the auditor's legal rights and obligations, to seek to have the uncorrected material misstatement appropriately brought to the attention of users for whom the auditor's report is prepared.

11.5 Responding When a Material Misstatement in the Financial Statements Exists or the Auditor's Understanding of the Entity and Its Environment Needs to Be Updated

If, as a result of performing the procedures discussed in 11.2, the auditor concludes that a material misstatement in the financial statements exists or the auditor's understanding of the entity and its environment needs to be updated, the auditor shall respond appropriately in accordance with the other SAs.

11.6 Reporting

The auditor's report shall include a separate section with a heading "Other Information", or other appropriate heading, when, at the date of the auditor's report:

- (a) For an audit of financial statements of a listed entity, the auditor has obtained, or expects to obtain, the other information; or
- (b) For an audit of financial statements of an unlisted corporate entity, the auditor has obtained some or all of the other information. (Ref: Para. A52)

When the auditor's report is required to include an Other Information section, this section shall include:

- (a) A statement that management is responsible for the other information;
- (b) An identification of:
 - (i) Other information, if any, obtained by the auditor prior to the date of the auditor's report; and
 - (ii) For an audit of financial statements of a listed entity, other information, if any, expected to be obtained after the date of the auditor's report;
- (c) A statement that the auditor's opinion does not cover the other information and, accordingly, that the auditor does not express (or will not express) an audit opinion or any form of assurance conclusion thereon;
- (d) A description of the auditor's responsibilities relating to reading, considering and reporting on other information as required by this SA; and
- (e) When other information has been obtained prior to the date of the auditor's report, either:
 - (i) A statement that the auditor has nothing to report; or
 - (ii) If the auditor has concluded that there is an uncorrected material misstatement of the other information, a statement that describes the uncorrected material misstatement of the other information.

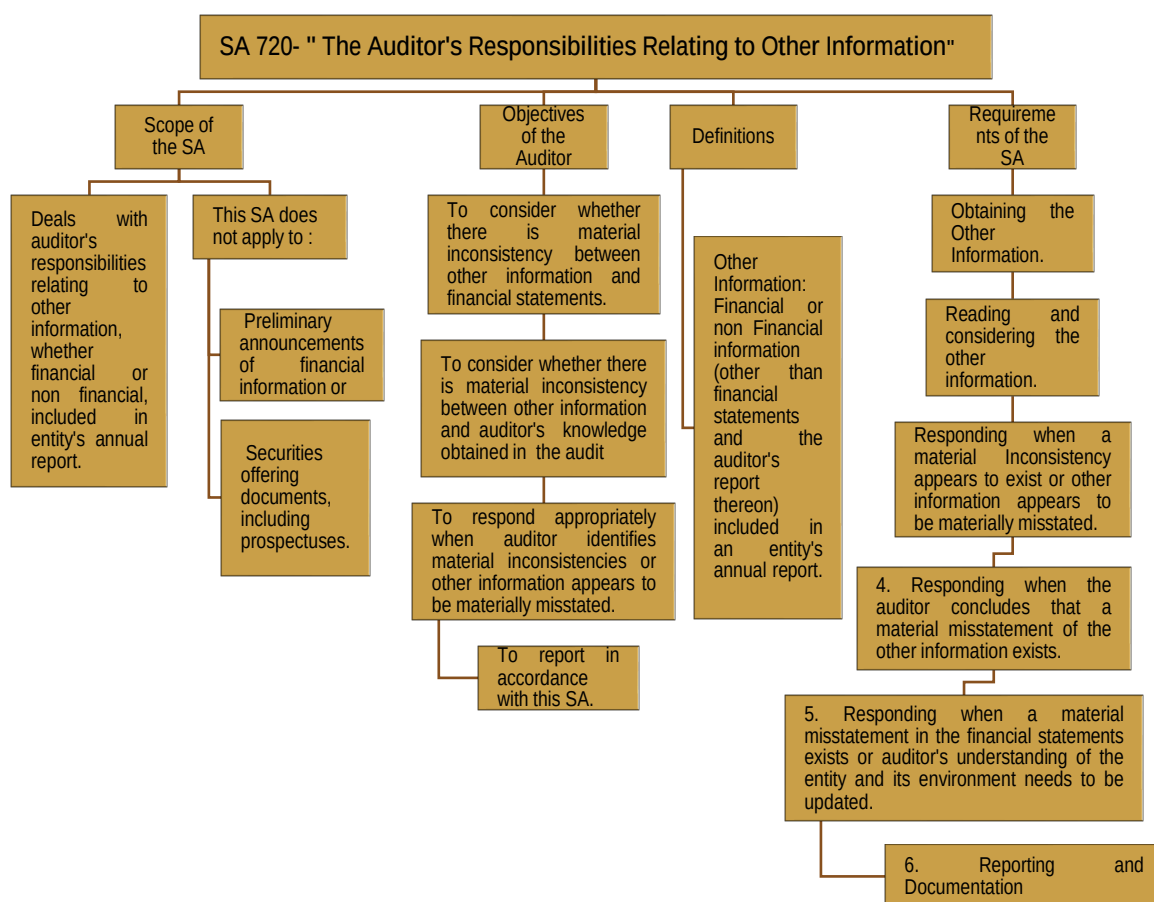
When the auditor expresses a qualified or adverse opinion in accordance with SA 705 (Revised), Modifications to the Opinion in the Independent Auditor's Report the auditor shall consider the implications of the matter giving rise to the modification of opinion for the statement required.

11.7 Reporting Prescribed by Law or Regulation

If the auditor is required by a relevant law or regulation to refer to the other information in the auditor's report using a specific layout or wording, the auditor's report shall refer to Standards on Auditing only if the auditor's report includes, at a minimum:

- (a) Identification of the other information obtained by the auditor prior to the date of the auditor's report;
- (b) A description of the auditor's responsibilities with respect to the other information; and
- (c) An explicit statement addressing the outcome of the auditor's work for this purpose.

(Note: Students are advised to refer Series of SA 700 on Audit Reporting and Conclusion for better understanding)





12. DUTIES OF AUDITORS

Sections 143 of the Companies Act, 2013 specifies the duties of an auditor of a company in a quite comprehensive manner. It is noteworthy that scope of duties of an auditor has generally been extending over all these years.

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

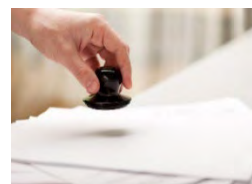
- (a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;
- (b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;
- (c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;
- (d) whether loans and advances made by the company have been shown as deposits;
- (e) whether personal expenses have been charged to revenue account;
- (f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

The opinion of the Research Committee of the Institute of Chartered Accountants of India on section 143(1) is reproduced below:

“The auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied. In such a case, the content of the Auditor’s Report will remain exactly the same as the auditor has to inquire and apply his mind to the information elicited by the enquiry, in deciding whether or not any reference needs to be made in his report. In our opinion, it is in this light that the auditor has to consider his duties under section 143(1).”

Therefore, it could be said that the auditor should make a report to the members in case he finds answer to any of these matters in adverse.

2. **Duty to Sign the Audit Report:** As per section 145 of the Companies Act, 2013, the person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document of the company, in accordance with the provisions of sub-section (2) of section 141 and the qualifications, observations or comments on financial transactions or matters, which have any adverse effect on the functioning of the company mentioned in the auditors' report shall be read before the company in general meeting and shall be open to inspection by any member of the company.



3. **Duty to comply with Auditing Standards:** As per sub-section (9) of section 143 of the Companies Act, 2013, every auditor shall comply with the auditing standards. Further, as per sub-section 10 of section 143 of the Act, the Central Government may prescribe the standards of auditing or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority. Students may note that until any auditing standards are notified, any standard, or standards of auditing specified by the Institute of Chartered Accountants of India shall be deemed to be the auditing standards.

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

- (a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;
- (b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
- (c) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditors has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;
- (d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;
- (e) whether, in his opinion, the financial statements comply with the accounting standards;
- (f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;

- (g) whether any director is disqualified from being appointed as a director under sub-section (2) of the section 164;
- (h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;
- (i) whether the company has adequate internal financial controls with reference to financial statements in place and the operating effectiveness of such controls;

(Note: Clause (i) of Sub-Section (3) of Section 143 shall not apply to a private company:- (i) which is a one person company or a small company; or (ii) which has turnover less than rupees fifty crores as per latest audited financial statement and which has aggregate borrowings from banks or financial institutions or anybody corporate at any point of time during the financial year less than rupees twenty five crore)

- (j) such other matters as may be prescribed. Rule 11 of the Companies (Audit and Auditors) Rules, 2014 prescribes the other matters to be included in auditor's report. The auditor's report shall also include their views and comments on the following matters, namely:-
 - (1) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;
 - (2) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;
 - (3) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.
 - (4) (i) Whether the management has represented that, to the best of its knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been advanced or loaned or invested (either from borrowed funds or share premium or any other sources or kind of funds) by the company to or in any other person(s) or entity(ies), including foreign entities ("Intermediaries"), with the understanding, whether recorded in writing or otherwise, that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries;

- (ii) Whether the management has represented, that, to the best of its knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been received by the company from any person(s) or entity(ies), including foreign entities ("Funding Parties"), with the understanding, whether recorded in writing or otherwise, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries; and
 - (iii) Based on such audit procedures that the auditor has considered reasonable and appropriate in the circumstances, nothing has come to their notice that has caused them to believe that the representations under sub-clause (i) and (ii) contain any material mis-statement.
- (5) Whether the dividend declared or paid during the year by the company is in compliance with section 123 of the Companies Act, 2013.
- (6) Whether the company has used such accounting software for maintaining its books of account which has a feature of recording audit trail (edit log) facility and the same has been operated throughout the year for all transactions recorded in the software and the audit trail feature has not been tampered with and the audit trail has been preserved by the company as per the statutory requirements for record retention.]

Audit Trail means, a step-by-step sequential record which provides evidence of the documented history of financial transactions to its source. An auditor can trace every step of, the financial data of a particular transaction right from the general ledger to its source document with the help of the audit trail.

Note: Students may refer Guidance note on Reporting under section 143(3)(f) and (h) of the Companies Act, 2013 for better understanding.]

The Companies (Amendment) Act, 2017 effective 12-09-2018 inserted Section 197(16) of the Companies Act, 2013 that requires as under:

"The auditor of the company shall, in his report under section 143, make a statement as to whether the remuneration paid by the company to its directors is in accordance with the provisions of this section, whether remuneration paid to any director is in excess of the limit laid down under this section and give such other details as may be prescribed".

As per Advisory issued by ICAI on 09-09-2019, the aforesaid reporting requirement for auditors of public companies needs to be covered in auditor's report under the Section "Report on Other Legal and Regulatory Requirements". Accordingly, auditors of public companies are advised to comply with the aforesaid reporting requirements in their auditor's reports.

5. Duty to report on frauds:

A. Reporting to the Central Government - As per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.

In this regard, Rule 13 of the Companies (Audit and Auditors) Rules, 2014 has been prescribed. Sub-rule (1) of the Rule 13 states that if an auditor of a company, in the course of the performance of his duties as statutory auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of ₹ 1 crore or above, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government.

The manner of reporting the matter to the Central Government is as follows:

- (a) the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;
- (b) on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days from the date of receipt of such reply or observations;
- (c) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;

- (d) the report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;
- (e) the report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and
- (f) the report shall be in the form of a statement as specified in Form ADT-4.

B. Reporting to the Audit Committee or Board - Sub-section (12) of section 143 of the Companies Act, 2013 further prescribes that in case of a fraud involving lesser than the specified amount [i.e. less than ₹ 1 crore], the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed.

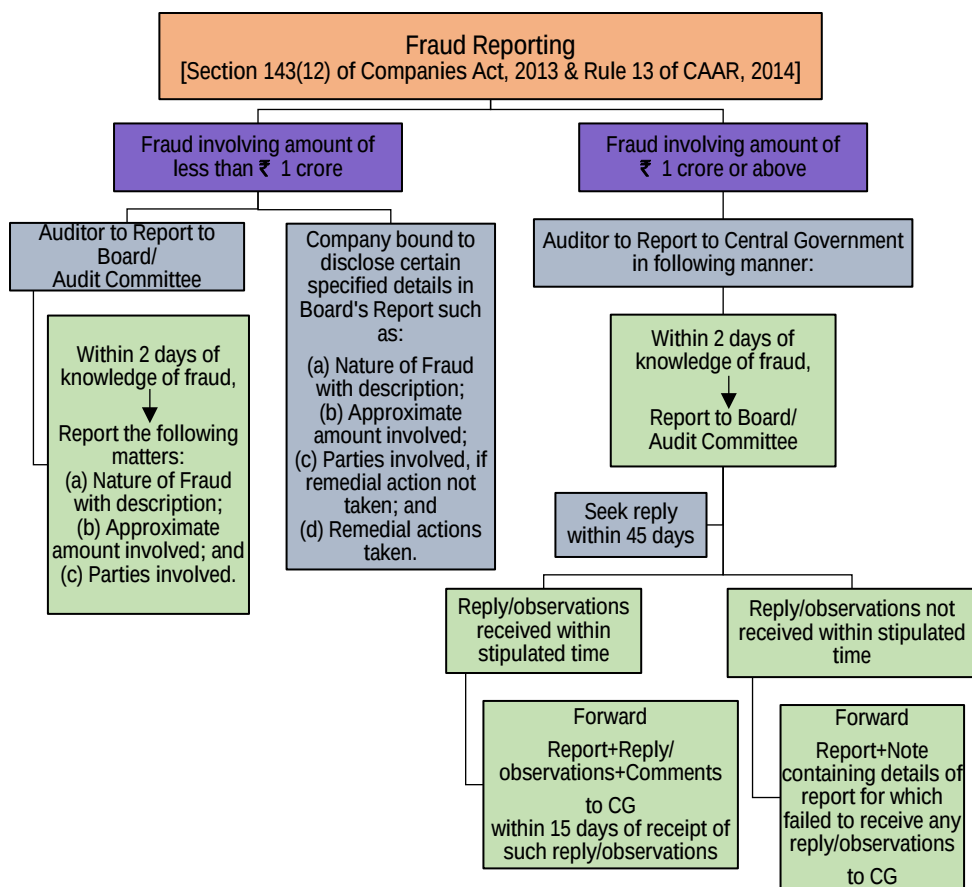
In this regard, sub-rule (3) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that in case of a fraud involving lesser than the amount specified in sub-rule (1) [i.e. less than ₹ 1 crore], the auditor shall report the matter to Audit Committee constituted under section 177 or to the Board immediately but not later than 2 days of his knowledge of the fraud and he shall report the matter specifying the following:

(a) Nature of Fraud with description;	(b) Approximate amount involved; and	(c) Parties involved.

C. Disclosure in the Board's Report: Sub-section (12) of section 143 of the Companies Act, 2013 furthermore prescribes that the companies, whose auditors have reported frauds under this sub-section (12) to the audit committee or the Board, but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed.

In this regard, sub-rule (4) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that the company is required to disclose in the Board's Report the following details of each of the fraud reported to the Audit Committee or the Board under sub-rule (3) during the year:

(a) Nature of Fraud with description;	(b) Approximate Amount involved;
(c) Parties involved, if remedial action not taken; and	(d) Remedial actions taken.



Sub-section (13) of section 143 of the Companies Act, 2013 safeguards the act of fraud reporting by the auditor if it is done in good faith. It states that no duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter above if it is done in good faith.

It is very important to note that the provisions regarding fraud reporting shall also apply, mutatis mutandis, to a cost auditor and a secretarial auditor during the performance of his duties under section 148 and section 204 respectively. If any auditor, cost accountant or company secretary in practice does not comply with the provisions of sub-section (12) of section 143, he shall be liable to a penalty of five lakh rupees in case of a listed company and a penalty of one lakh rupees in case of any other company.

The auditor is also required to report under clause (xi) of paragraph 3 of Companies (Auditor's Report) Order, 2020 [CARO, 2020] on whether any fraud by the company or any fraud on the Company has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

The Auditing and Assurance Standards Board of the ICAI has issued the Guidance Note on Reporting on Fraud under Section 143(12) of the Companies Act, 2013 to provide guidance to the members on this reporting requirement.

The definition of fraud as per SA 240 and the explanation of fraud as per Section 447 of the 2013 Act are similar, except that under section 447, fraud includes 'acts with an intent to injure the interests of the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss.' However, an auditor may not be able to detect acts that have intent to injure the interests of the company or cause wrongful gain or wrongful loss, unless the financial effects of such acts are reflected in the books of account/financial statements of the company.

For example,

- (i) an auditor may not be able to detect if an employee is receiving pay-offs for favoring a specific vendor, which is a fraudulent act, since such pay-offs would not be recorded in the books of account of the company;
- (ii) if the password of a key managerial personnel is stolen and misused to access confidential/restricted information, the effect of the same may not be determinable by the management or by the auditor;

Therefore, the auditor shall consider the requirements of the SAs, insofar as it relates to the risk of fraud, including the definition of fraud as stated in SA 240, in planning and performing his audit procedures in an audit of financial statements to address the risk of material misstatement due to fraud.

[Note: Students may refer Guidance note on Reporting on Fraud under Section 143(12) of the Companies Act, 2013 for detailed knowledge.]

6. Duty to report on any other matter specified by Central Government: The Central Government may, in consultation with the National Financial Reporting Authority (NFRA), by general or special order, direct, in respect of such class or description of companies, as may be specified in the order, that the auditor's report shall also include a statement on such matters as may be specified therein.

As per the notification dated 29.03.2016, till the time NFRA is constituted, the Central Government may hold consultation required under this sub-section with the Committee chaired by an officer of the rank of Joint Secretary or equivalent in the MCA and the Committee shall have the representatives from the ICAI and Industry Chambers and also special invitees from the National Advisory Committee on Accounting Standards (NACAS) and the office of the C&AG. However, by virtue of notification dated 21st March 2018, in exercise of the powers conferred by sub-section (3)

of section 1 of the Companies Act, 2013 (18 of 2013), the Central Government hereby appoints the 21st March, 2018 as the date on which the provisions of subsections (3) and (11) of section 132 of the said Act shall come into force.

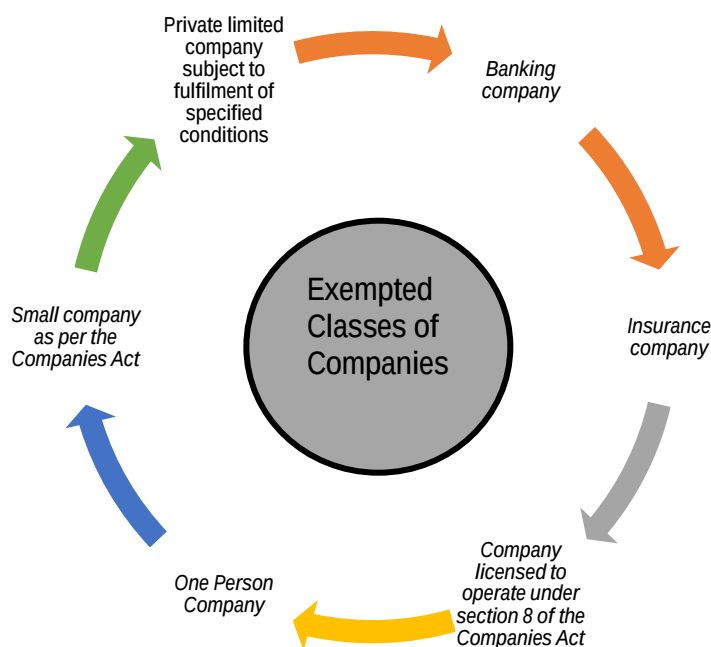
7. Duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor are discussed separately in this chapter.

8. Duty to state the reason for qualification or negative report: As per sub-section (4) of section 143, where any of the matters required to be included in the audit report is answered in the negative or with a qualification, the report shall state the reasons there for.

12.1 Reporting Under CARO, 2020

In exercise of the powers conferred by section 143(11) of the Companies Act, 2013, the Central Government, after consultation with the National Financial Reporting Authority constituted under section 132 of the Companies Act, 2013, has issued the Companies (Auditor's Report) Order, 2020, (CARO, 20) dated 25th February, 2020.

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



- (i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);
- (ii) an insurance company as defined under the Insurance Act, 1938 (4 of 1938);
- (iii) a company licensed to operate under section 8 of the Companies Act;
- (iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act and a small company as defined under clause (85) of section 2 of the Companies Act; and
- (v) a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than rupees one crore as on the balance sheet date and which does not have total borrowings exceeding rupees one crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding rupees ten crore during the financial year as per the financial statements.

2. **Auditor's report to contain matters specified in paragraphs 3 and 4** - Every report made by the auditor under section 143 of the Companies Act, 2013 on the accounts of every company audited by him, to which this Order applies, for the financial year, shall in addition, contain the matters specified in paragraphs 3 and 4, as may be applicable.

It may be noted that the Order shall not apply to the auditor's report on consolidated financial statements except clause (xxi) of paragraph 3.

3. **Matters to be included in the auditor's report** - The auditor's report on the accounts of a company to which this Order applies shall include a statement on the following matters, namely:-

- (i) (a) (A) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of Property, Plant and Equipment;
- (B) whether the company is maintaining proper records showing full particulars of intangible assets;
- (b) whether these Property, Plant and Equipment have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;
- (c) whether the title deeds of all the immovable properties (other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) disclosed in the financial

statements are held in the name of the company, if not, provide the details thereof in the format below:-

Description of property	Gross carrying value	Held in name of	Whether promoter, director or their relative or employee	Period held – indicate range, where appropriate	Reason for not being held in name of company*
-	-	-	-	-	*also indicate if in dispute

- (d) whether the company has revalued its Property, Plant and Equipment (including Right of Use assets) or intangible assets or both during the year and, if so, whether the revaluation is based on the valuation by a Registered Valuer; specify the amount of change, if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment or intangible assets;
 - (e) whether any proceedings have been initiated or are pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and rules made thereunder, if so, whether the company has appropriately disclosed the details in its financial statements;
- (ii)
- (a) whether physical verification of inventory has been conducted at reasonable intervals by the management and whether, in the opinion of the auditor, the coverage and procedure of such verification by the management is appropriate; whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and if so, whether they have been properly dealt with in the books of account;
 - (b) whether during any point of time of the year, the company has been sanctioned working capital limits in excess of five crore rupees, in aggregate, from banks or financial institutions on the basis of security of current assets; whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details;
 - (iii) whether during the year the company has made investments in, provided any guarantee or security or granted any loans or advances in the nature of loans, secured or unsecured, to companies, firms, Limited Liability Partnerships or any other parties, if so,-

- (a) whether during the year the company has provided loans or provided advances in the nature of loans, or stood guarantee, or provided security to any other entity [not applicable to companies whose principal business is to give loans], if so, indicate-
 - (A) the aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to subsidiaries, joint ventures and associates;
 - (B) the aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to parties other than subsidiaries, joint ventures and associates;
 - (b) whether the investments made, guarantees provided, security given and the terms and conditions of the grant of all loans and advances in the nature of loans and guarantees provided are not prejudicial to the company's interest;
 - (c) in respect of loans and advances in the nature of loans, whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;
 - (d) if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;
 - (e) whether any loan or advance in the nature of loan granted which has fallen due during the year, has been renewed or extended or fresh loans granted to settle the overdues of existing loans given to the same parties, if so, specify the aggregate amount of such dues renewed or extended or settled by fresh loans and the percentage of the aggregate to the total loans or advances in the nature of loans granted during the year [not applicable to companies whose principal business is to give loans];
 - (f) whether the company has granted any loans or advances in the nature of loans either repayable on demand or without specifying any terms or period of repayment, if so, specify the aggregate amount, percentage thereof to the total loans granted, aggregate amount of loans granted to Promoters, related parties as defined in clause (76) of section 2 of the Companies Act, 2013;
- (iv) in respect of loans, investments, guarantees, and security, whether provisions of sections 185 and 186 of the Companies Act have been complied with, if not, provide the details thereof;

- (v) in respect of deposits accepted by the company or amounts which are deemed to be deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act and the rules made thereunder, where applicable, have been complied with, if not, the nature of such contraventions be stated; if an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not;
- (vi) whether maintenance of cost records has been specified by the Central Government under sub-section (1) of section 148 of the Companies Act and whether such accounts and records have been so made and maintained;
- (vii) (a) whether the company is regular in depositing undisputed statutory dues including Goods and Services Tax, provident fund, employees' state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;
- (b) where statutory dues referred to in sub-clause (a) have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned (a mere representation to the concerned Department shall not be treated as a dispute);
- (viii) whether any transactions not recorded in the books of account have been surrendered or disclosed as income during the year in the tax assessments under the Income Tax Act, 1961 (43 of 1961), if so, whether the previously unrecorded income has been properly recorded in the books of account during the year;
- (ix) (a) whether the company has defaulted in repayment of loans or other borrowings or in the payment of interest thereon to any lender, if yes, the period and the amount of default to be reported as per the format below:-

Nature of borrowing, including debt securities	Name of lender*	Amount not paid on due date	Whether principal or interest	No. of days delay or unpaid	Remarks, if any
	*lender wise details to be provided in case of defaults to banks,				

	financial institutions and Government.				

- (b) whether the company is a declared wilful defaulter by any bank or financial institution or other lender;
- (c) whether term loans were applied for the purpose for which the loans were obtained; if not, the amount of loan so diverted and the purpose for which it is used may be reported;
- (d) whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated;
- (e) whether the company has taken any funds from any entity or person on account of or to meet the obligations of its subsidiaries, associates or joint ventures, if so, details thereof with nature of such transactions and the amount in each case;
- (f) whether the company has raised loans during the year on the pledge of securities held in its subsidiaries, joint ventures or associate companies, if so, give details thereof and also report if the company has defaulted in repayment of such loans raised;
- (x) (a) whether moneys raised by way of initial public offer or further public offer (including debt instruments) during the year were applied for the purposes for which those are raised, if not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;
- (b) whether the company has made any preferential allotment or private placement of shares or convertible debentures (fully, partially or optionally convertible) during the year and if so, whether the requirements of section 42 and section 62 of the Companies Act, 2013 have been complied with and the funds raised have been used for the purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of non-compliance;
- (xi) (a) whether any fraud by the company or any fraud on the company has been noticed or reported during the year, if yes, the nature and the amount involved is to be indicated;
- (b) whether any report under sub-section (12) of section 143 of the Companies Act has been filed by the auditors in Form ADT-4 as prescribed under rule 13 of Companies (Audit and Auditors) Rules, 2014 with the Central Government;
- (c) whether the auditor has considered whistle-blower complaints, if any, received during the year by the company;

- (xii) (a) whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1:20 to meet out the liability;
- (b) whether the Nidhi Company is maintaining ten per cent. unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;
- (c) whether there has been any default in payment of interest on deposits or repayment thereof for any period and if so, the details thereof;
- (xiii) whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act where applicable and the details have been disclosed in the financial statements, etc., as required by the applicable accounting standards;
- (xiv) (a) whether the company has an internal audit system commensurate with the size and nature of its business;
- (b) whether the reports of the Internal Auditors for the period under audit were considered by the statutory auditor;
- (xv) whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act have been complied with;
- (xvi) (a) whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 (2 of 1934) and if so, whether the registration has been obtained;
- (b) whether the company has conducted any Non-Banking Financial or Housing Finance activities without a valid Certificate of Registration (CoR) from the Reserve Bank of India as per the Reserve Bank of India Act, 1934;
- (c) whether the company is a Core Investment Company (CIC) as defined in the regulations made by the Reserve Bank of India, if so, whether it continues to fulfil the criteria of a CIC, and in case the company is an exempted or unregistered CIC, whether it continues to fulfil such criteria;
- (d) whether the Group has more than one CIC as part of the Group, if yes, indicate the number of CICs which are part of the Group;
- (xvii) whether the company has incurred cash losses in the financial year and in the immediately preceding financial year, if so, state the amount of cash losses;
- (xviii) whether there has been any resignation of the statutory auditors during the year, if so, whether the auditor has taken into consideration the issues, objections or concerns raised by the outgoing auditors;
- (xix) on the basis of the financial ratios, ageing and expected dates of realisation of financial assets and payment of financial liabilities, other information accompanying the

financial statements, the auditor's knowledge of the Board of Directors and management plans, whether the auditor is of the opinion that no material uncertainty exists as on the date of the audit report that company is capable of meeting its liabilities existing at the date of balance sheet as and when they fall due within a period of one year from the balance sheet date;

- (xx) (a) whether, in respect of other than ongoing projects, the company has transferred unspent amount to a Fund specified in Schedule VII to the Companies Act within a period of six months of the expiry of the financial year in compliance with second proviso to sub-section (5) of section 135 of the said Act;
- (b) whether any amount remaining unspent under sub-section (5) of section 135 of the Companies Act, pursuant to any ongoing project, has been transferred to special account in compliance with the provision of sub-section (6) of section 135 of the said Act;
- (xxi) whether there have been any qualifications or adverse remarks by the respective auditors in the Companies (Auditor's Report) Order (CARO) reports of the companies included in the consolidated financial statements, if yes, indicate the details of the companies and the paragraph numbers of the CARO report containing the qualifications or adverse remarks.

4. Reasons to be stated for unfavourable or qualified answers-

- (a) Where, in the auditor's report, the answer to any of the questions referred to in paragraph 3 is unfavourable or qualified, the auditor's report shall also state the basis for such unfavourable or qualified answer, as the case may be.
- (b) Where the auditor is unable to express any opinion on any specified matter, his report shall indicate such fact together with the reasons as to why it is not possible for him to give his opinion on the same.



13. ILLUSTRATIVE AUDIT REPORTS

Example 1- Illustration of Emphasis of Matter Para

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Standalone Financial Statements

Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 20X1, and the statement of Profit & Loss,

(statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information (in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at *(location of branches)*)¹³.

In our opinion, and to the best of our information and according to the explanations given to us the aforesaid financial statements, *give a true and fair view*, in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31st, 2XXX and profit/loss, *(changes in equity)* and its cash flows for the year ended on that date.

Basis for Opinion

We conducted our audit in accordance with Standards on Auditing (SAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements as per the *ICAI's Code of Ethics and the provisions of the Companies Act, 2013*, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Emphasis of Matter

We draw attention to Note X of the financial statements, which describes the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with SA 701.]

Other Matter

The financial statements of ABC Company for the year ended March 31, 20X0, were audited by another auditor who expressed an unmodified opinion on those statements on March 31, 20X1.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised) given in Auditing Pronouncement.]

Auditor's Responsibilities for the Audit of the Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).]

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).]

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature

(Name of the Member Signing the Audit Report)

(Designation)

Example 2- Illustration of Emphasis of Matter in a situation when the business of one of the Indian branch office of an existing foreign company- ABC Limited is being transferred by way of slump sale to another newly incorporated subsidiary company in India- XYZ Private Limited

Relevant Note given by the management in the financial statements of India Branch Office of ABC Limited

"During the year, ABC Limited ('the Company') has incorporated a private limited company ('XYZ Private Limited') in India for the purpose of furtherance of the Company's objectives and has entered into a Business Transfer Agreement dated October 5, 2016 with XYZ Private Limited for transfer of all assets and liabilities alongwith the business of India Branch Office to XYZ Private Limited on going concern basis effective April 01, 2016. Further, the Reserve Bank of India (RBI) vide letter No. dated December 22, 2016 has also granted approval for transfer of assets and liabilities and business of India Branch Office to XYZ Private Limited.

ABC Limited has confirmed that it shall provide continuing financial and operational support to its Branch Office in India for its operations during the transitional period and loss incurred post the date of transfer of business to XYZ Private Limited, if any, shall be borne by ABC Limited

The current year financial statements of India Branch Office have been prepared on the basis that the Branch Office does not continue to be a going concern and all its assets are carried in the books of accounts at the values likely to be recovered at the time of closure of operations, to the extent ascertainable at the time of preparation of these financial statements".

INDEPENDENT AUDITOR'S REPORT

To the Members of India Branch Office of ABC Limited

Report on the Audit of the Standalone Financial Statements

Opinion

We have audited the standalone financial statements of India Branch Office of ABC Limited ("the Company"), which comprise the balance sheet as at March 31, 20X1, and the statement of Profit & Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information.

In our opinion, and to the best of our information and according to the explanations given to us the aforesaid financial statements, *give a true and fair view*, in conformity with the accounting principles generally accepted in India, of the state of affairs of the India Branch Office of the Company as at March 31st, 2XXX and profit/loss, (*changes in equity*) and its cash flows for the year ended on that date.

Basis for Opinion

We conducted our audit in accordance with Standards on Auditing (SAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements as per the *ICAI's Code of Ethics and the provisions of the Companies Act, 2013*, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Emphasis of Matter

We draw attention to Note XX regarding India Branch Office management's intention to close the operations of the Branch Office subject to regulatory approvals. Accordingly, the financial statements have been prepared on the basis that the India Branch Office does not continue to be a going concern and provisions have been made in the books of account for the losses arising or likely to arise on account of closure of operations including the losses on the realizability of current assets.

Our opinion is not modified in respect of this matter.

Example 3- Qualified Opinion

Relevant Notes given by the management in the financial statements of ABC Limited

- (a) During the year, the management circulated request for confirmation to key vendors of maintenance expenses and has written-back the liabilities recorded in earlier years of ₹ 2 crores that have not been claimed by these vendors and have also not been responded to management's request for confirmation. The management is confident that the balances are no longer payable and that no further adjustments are required to the financial statements in this regard.
- (b) During the year, the management has undertaken detailed assessment regarding advances of ₹_____ paid to certain project managers including ₹_____ paid during earlier years. The Company has incurred expenses on account of travel expense at various sites in cash and has closing balance of ₹1.75 crores against which management has obtained confirmation from respective project managers for balances aggregating ₹ 0.65 crores and has provided balance amount of ₹1.1 crores as provision for doubtful advances. The management is confident that the expenditure incurred is towards business operations of the Company and that no further adjustments are required to the financial statements in this regard.

Report on the Audit of the Standalone Financial Statements**Qualified Opinion**

We have audited the standalone financial statements of ABC Limited ("the Company"), which comprise the balance sheet as at March 31, 20X1, and the statement of Profit & Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information.

In our opinion, and to the best of our information and according to the explanations given to us the aforesaid financial statements, *subject to the matters discussed in Basis for Qualified Opinion paragraph below, the consequential impact, if any, whereof is not quantifiable, give a true and fair view*, in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31st, 2XXX and profit/loss, (*changes in equity*) and its cash flows for the year ended on that date.

Basis for Qualified Opinion

- (a) As stated in Note XX of the financial statements, the management has during the year circulated request for confirmation to key vendors of maintenance expenses and written-back

the liabilities recorded in earlier years of ₹ 2 crores considering that these balances have not been claimed by these vendors and they have also not responded to management request for confirmation. In the absence of balance confirmation of these vendors, we are unable to comment upon such write back of ₹2 crores and any further adjustments that may be required to the financial statement in this regard.

- (b) Attention is invited to Note ____ which explains management assessment regarding advances of ₹ ____ paid to certain project managers including ₹ ____ paid during earlier years. The Company has incurred expenses on account of travel at various sites in cash and has closing balance of ₹1,75 crores against which management has obtained confirmation from respective project managers for balances aggregating ₹ 0.65 crores and has provided balance amount of ₹1.1 crores as provision for doubtful advances. Further, for such transactions, the Company has not complied with provision for deduction of taxes at source.

We strongly recommend that management should undertake these transactions through banking channels and in the absence of any confirmations, we are unable to confirm the completeness of expenses as at year- end and consequential adjustment required to closing tax liabilities and interest thereupon, if any.

We conducted our audit in accordance with Standards on Auditing (SAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements as per the *ICAI's Code of Ethics and the provisions of the Companies Act, 2013*, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion, except for the matters, discussed above.

Note: Students are advised to refer Illustrations of Independent Auditor's Reports on Financial Statements given in SA 700.

Illustration 1: An auditor's report on financial statements of a listed entity prepared in accordance with a fair presentation framework

Illustration 2: An auditor's report on consolidated financial statements of a listed company prepared in accordance with a fair presentation framework

Illustration 3 – Auditor's Report on Financial Statements of an Unlisted Company Prepared in Accordance with a Fair Presentation Framework

Illustration 4 – Auditor's Report on Financial Statements of a Non Corporate Entity Prepared in Accordance with a Fair Presentation Framework

Illustration – Auditor's Report on Financial Statements of Non Corporate Entity Prepared in Accordance with a General Purpose Compliance Framework

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity, other than a listed company under the Companies Act 2013, required by law or regulation. The audit is not a group audit (i.e., SA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with the Financial Reporting Framework (XYZ Laws) of Jurisdiction X (that is, a financial reporting framework, encompassing law or regulation, designed to meet the common financial information needs of a wide range of users, but which is not a fair presentation framework).
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with SA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- The auditor has no other reporting responsibilities required under local law.

Opinion

We have audited the financial statements of ABC & Associates (the entity), which comprise the balance sheet as at March 31, 20X1, and the Profit and Loss Account (and the cash flow statement)¹ for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

¹ Where applicable.

In our opinion, the accompanying financial statements of the entity are prepared, in all material respects, in accordance with XYZ Laws.

Basis for Opinion

We conducted our audit in accordance with Standards on Auditing (SAs). Our responsibilities under those Standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the entity in accordance with the ethical requirements that are relevant to our audit of the financial statements, and we have fulfilled our other responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Responsibilities of Management and Those Charged with Governance for the Financial Statements²

Management is responsible for the preparation of the financial statements in accordance with XYZ Law and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the entity's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the entity's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 40(b) of this SA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 40(c) explains that when law, regulation or national auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

² Or other terms that are appropriate in the context of the legal framework of the particular entity.

As part of an audit in accordance with SAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit 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 the entity's internal control.³
Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the entity to cease to continue as a going concern.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

Illustration – Qualified Opinion due to a Material Misstatement of the Financial Statements

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a listed company (registered under the Companies Act, 2013) using a fair presentation framework.
- The financial statements are prepared by management of the entity in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013 (a general purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.⁴

³ This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.

⁴ SA 210, *Agreeing the Terms of Audit Engagements*

- Inventories are misstated. The misstatement is deemed to be material but not pervasive to the financial statements (i.e., a qualified opinion is appropriate).
- The relevant ethical requirements that apply to the audit are the ICAI's Code of Ethics and the provisions of the Companies Act, 2013.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).
- Key audit matters have been communicated in accordance with SA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013.

Report on the Audit of the Standalone Financial Statements⁵

Qualified Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 20XX, and the statement of Profit and Loss, (*statement of changes in equity*)⁶ and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information (in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (*location of branches*))⁷.

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the aforesaid financial statements give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31st, 2XXX and profit/loss, (*changes in equity*) and its cash flows for the year ended on that date.

Basis for Qualified Opinion

The Company's inventories are carried in the Balance Sheet at ₹ XXX. Management has not stated the inventories at the lower of cost and net realizable value but has stated them solely at cost, which constitutes a departure from the Accounting Standards prescribed under section 133 of the Companies Act, 2013. The Company's records indicate that, had management stated the inventories

⁵ The sub-title "Report on the Audit of the Standalone Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

⁶ As may be applicable.

⁷ As may be applicable.

at the lower of cost and net realizable value, an amount of ₹ xxx would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by ₹ xxx, and income tax, net income and shareholders' funds would have been reduced by ₹ xxx, ₹ xxx and ₹ xxx, respectively.

We conducted our audit in accordance with Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the Code of Ethics issued by the Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and we have fulfilled our other ethical responsibilities in accordance with these requirements and the ICAI's Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Note : Students are advised to refer Illustrations of Auditor's Reports with Modifications to the Opinion given in SA 705.

- Illustration 2: An auditor's report containing an adverse opinion due to a material misstatement of the consolidated financial statements.
- Illustration 3: An auditor's report containing a qualified opinion due to the auditor's inability to obtain sufficient appropriate audit evidence regarding a foreign associate.
- Illustration 4: An auditor's report containing a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence about a single element of the consolidated financial statements.

Illustration – Disclaimer of Opinion due to the Auditor's Inability to Obtain Sufficient Appropriate Audit Evidence about Multiple Elements of the Financial Statements

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- *Audit of a complete set of financial statements of an entity other than a company incorporated under the Companies Act, 2013, using a fair presentation framework. The audit is not a group audit (i.e., SA 600, does not apply).*
- *The financial statements are prepared by management of the entity in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India (a general purpose framework).*
- *The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.*
- *The auditor was unable to obtain sufficient appropriate audit evidence about multiple*

elements of the financial statements, that is, the auditor was also unable to obtain audit evidence about the entity's inventories and accounts receivable. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the financial statements.

- *The relevant ethical requirements that apply to the audit are ICAI's Code of Ethics and applicable law/regulation*
- *Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.*
- *A more limited description of the auditor's responsibilities section is required.*
- *In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under relevant law/ regulation.*

Report on the Audit of the Financial Statements⁸

Disclaimer of Opinion

We were engaged to audit the financial statements of ABC & Associates ("the entity"), which comprise the balance sheet as at March 31, 20XX, the statement of Profit and Loss, *(the statement of changes in equity)*⁹ and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying financial statements of the entity. Because of the significance of the matters described in the *Basis for Disclaimer of Opinion* section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Basis for Disclaimer of Opinion

We were not appointed as auditors of the Company until after March 31, 20X1 and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at March 31, 20X0 and 20X1, which are stated in the Balance Sheets at ` xxx and ` xxx, respectively. In addition, the introduction of a new computerized accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm

⁸ The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

⁹ Where applicable.

or verify by alternative means accounts receivable included in the Balance Sheet at a total amount of ` xxx as at March 31, 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the statement of Profit and Loss (*and statement of cash flows*)¹⁰.

Auditor's Responsibilities for the Audit of the Financial Statements

Our responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report. However, because of the matters described in the *Basis for Disclaimer of Opinion* section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

We are independent of the entity in accordance with the ethical requirements in accordance with the requirements of the Code of Ethics issued by ICAI and the ethical requirements as prescribed under the laws and regulations applicable to the entity.

Illustration of an Auditor's Report that Includes a Key Audit Matters Section, an Emphasis of Matter Paragraph, and an Other Matter Paragraph

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- *Audit of a complete set of financial statements of a listed company (registered under the companies Act, 2013) using a fair presentation framework.*
- *The financial statements are prepared by management of the entity in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013 (a general purpose framework).*
- *The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.*
- *The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.*
- *The relevant ethical requirements that apply to the audit are those of the ICAI's Code of Ethics and the provisions of the Companies Act, 2013.*
- *Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).*
- *Between the date of the financial statements and the date of the auditor's report, there was*

¹⁰ Where applicable.

a fire in the entity's production facilities, which was disclosed by the entity as a subsequent event. In the auditor's judgment, the matter is of such importance that it is fundamental to users' understanding of the financial statements. The matter did not require significant auditor attention in the audit of the financial statements in the current period.

- *Key audit matters have been communicated in accordance with SA 701.*
- *Corresponding figures are presented, and the prior period's financial statements were audited by a predecessor auditor. The auditor is not prohibited by law or regulation from referring to the predecessor auditor's report on the corresponding figures and has decided to do so.*
- *Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.*
- *In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013.*

Report on the Audit of the Standalone Financial Statements¹¹

Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 20X1, and the statement of Profit & Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information (in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at *(location of branches)*)¹².

In our opinion, and to the best of our information and according to the explanations given to us the aforesaid financial statements, *give a true and fair view*, in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31st, 2XXX and profit/loss, *(changes in equity)* and its cash flows for the year ended on that date.

Basis for Opinion

We conducted our audit in accordance with Standards on Auditing (SAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements as per the ICAI's Code of

¹¹ ¹ The sub-title "Report on the Audit of the Standalone Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

¹² As may be applicable

Ethics and the provisions of the Companies Act, 2013, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Emphasis of Matter¹³

We draw attention to Note X of the financial statements, which describes the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.

Illustration of an Auditor's Report Containing a Qualified Opinion Due to a Departure from the Applicable Financial Reporting Framework and that Includes an Emphasis of Matter Paragraph

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- *Audit of a complete set of financial statements of an company other than a listed company (registered under the Companies Act, 2013) using a fair presentation framework..*
- *The financial statements are prepared by management of the entity in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013 (a general purpose framework).*
- *The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.*
- *A departure from the applicable financial reporting framework resulted in a qualified opinion.*
- *The relevant ethical requirements that apply to the audit are the ICAI's Code of Ethics and the provisions of the Companies Act, 2013.*
- *Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).*
- *Between the date of the financial statements and the date of the auditor's report, there was a fire in the entity's production facilities, which was disclosed by the entity as a subsequent event. In the auditor's judgment, the matter is of such importance that it is fundamental to users' understanding of the financial statements. The matter did not require significant auditor attention in the audit of the financial statements in the current period.*

¹³ As noted in paragraph A16, an Emphasis of Matter paragraph may be presented either directly before or after the Key Audit Matters section based on the auditor's judgment as to the relative significance of the information included in the Emphasis of Matter paragraph.

- *The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with SA 701.*
- *Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.*
- *In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013.*

Report on the Audit of the Standalone Financial Statements¹⁴

Qualified Opinion

We have audited the standalone financial statements of ABC Limited ("the Company"), which comprise the balance sheet as at March 31, 20X1, and the statement of Profit and Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information (in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at *(location of branches)*)².

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the aforesaid financial statements present fairly, in all material respects, or *give a true and fair view* in conformity with the accounting principles generally accepted in India of the state of affairs of the Company as at March 31st, 2XXX and profit/loss, *(changes in equity)* and its cash flows for the year ended on that date.

Basis for Qualified Opinion

The Company's short-term marketable securities are carried in the statement of financial position at xxx. Management has not marked these securities to market but has instead stated them at cost, which constitutes a departure from the Accounting Standards prescribed in section 133 of the Companies Act, 2013. The Company's records indicate that had management marked the marketable securities to market, the Company would have recognized an unrealized loss of ₹xxx in the statement of comprehensive income for the year. The carrying amount of the securities in the statement of financial position would have been reduced by the same amount at March 31, 20X1, and income tax, net income and shareholders' equity would have been reduced by ₹xxx, ₹xxx and ₹xxx, respectively.

¹⁴ The sub-title "Report on the Audit of the Standalone Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

We conducted our audit in accordance with Standards on Auditing (SAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the ICAI's Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Emphasis of Matter – Effects of a Fire

We draw attention to Note X of the financial statements, which describes the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.

Note: Students may refer remaining paras of Audit Report like Key Audit Matters para etc., from the illustrative format given above.

Integrated Case Scenario

CA. Raghav is in midst of finalizing audit reports of five clients. On reviewing each file, it is noticed as under: -

[A] In case of a company engaged in business of selling of agricultural products which are outside ambit of GST, engagement team has found that substantial part of revenues of the company (about 80%) is generated through cash sales. However, there is no proper system and internal control to verify accuracy of revenues generated through cash sales. Therefore, team has been unable to verify such revenues generated through cash sales.

[B] TS Limited has been dragged to court by BS Limited for stealing its trade secrets using cyber theft and filed a claim for ₹50 crore. On reviewing audit file of TS Limited, CA Raghav finds that legal opinion of company's standing counsel is ambiguous. There are precedent case laws both in favour and against on such issue. The financial statements of TS Limited are silent on this litigation matter.

[C] It is noticed on review of audit file of a client that net profit before tax was ₹2 crore on a turnover of ₹100 crore. There is an export receivable from a chain of stores outstanding in financial statements of ₹3 crore for which there is no chance of recovery. The said chain of stores has gone bankrupt. There is also no hope of recovering money through ECGC (Export credit Guarantee Corporation) due to certain technical issues. Debt has not been written off by the client despite being communicated to client.

[D] On reviewing file of a small finance bank, it was noticed that team has drafted following para proposed to be included under Emphasis of Matter paragraph: -

"Concerns are raised regarding "Going Concern" status of the Bank. However, the Bank feels that it continues to remain a "Going Concern" in view of reasons stated in note 10.

Our opinion is not modified in respect of this matter."

[E] On reviewing file of a client, it is noticed that team was not informed about finished goods of ₹1 crore lying at a location taken on rent in February 2023. The said issue was flagged at time of reconciling inventories by the team. Hence, team could not attend physical inventory counting. The alternative procedures cannot be performed in absence of adequate records pertaining to above location. Total inventories reflected in financial statements is ₹ 8 crores. PBT of client is ₹10 crores.

Based upon above, answer the following questions: -

1. As regards description regarding revenues generated through cash sales of a company, which of the following statements is most appropriate in terms of SA 705?

- (a) Qualified opinion will be issued and basis for qualified opinion will also be provided.
- (b) Adverse opinion will be issued and basis for adverse opinion will also be provided.
- (c) A disclaimer of opinion will be issued and basis for disclaimer of opinion will also be provided. Besides, statement in audit report will be changed from "financial statements have been audited" to "auditor was engaged to audit financial statements."
- (d) A disclaimer of opinion will be issued and basis for disclaimer of opinion will also be provided. Besides, statement in audit report will be changed from "financial statements have been audited" to "financial statements have not been audited."

2. Considering litigation matter of TS Limited, which of the following statements is most appropriate in this regard?

- (a) Unmodified opinion needs to be expressed by auditor.
- (b) It amounts to non-disclosure of a material contingent liability by the company. Adverse opinion needs to be expressed by auditor.
- (c) It amounts to non-disclosure of a material contingent liability by the company. Qualified opinion needs to be expressed by auditor.
- (d) The company has not made a material provision resulting in material misstatement. Adverse opinion needs to be expressed by auditor.

3. Considering description of issue regarding non-recoverability of export receivable of ₹3 crore from a chain of stores, which type of opinion is appropriate to be issued in audit report?

- (a) Disclaimer of opinion
- (b) Unmodified opinion
- (c) Qualified opinion
- (d) Adverse opinion

4. As regards matter of going concern in respect of a small finance Bank, which of the following statements is most appropriate?

- (a) The para drafted by team is proper and in accordance with SA 570 since auditor has decided to give unmodified opinion.
- (b) The para drafted by team is proper and in accordance with SA 570 since matter has been disclosed in notes to accounts by bank management.
- (c) Instead of giving emphasis of matter paragraph, separate paragraph on 'Material Uncertainty Related to Going Concern' in report should be given in accordance with SA 570.
- (d) Separate paragraph on 'Material Uncertainty Related to Going Concern' under the heading "Emphasis of matter" paragraph in report should be given in accordance with SA 570.

5. Regarding issue of not informing team regarding inventory of finished goods lying at a location taken on rent in February 2023, which type of opinion is appropriate to be issued in case of this client?

- (a) Modified opinion
- (b) Qualified opinion
- (c) Unmodified opinion
- (d) Either Modified or Qualified opinion

Key Takeaways

- SA 700 deals with the auditor's responsibility to form an opinion on the financial statements. It also deals with the form and content of the auditor's report issued as a result of an audit of financial statements.

- The objectives of the auditor in accordance with SA 700 are to form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained and to express clearly that opinion through a written report.
- As per SA 700, the auditor's report shall be in writing and shall include the basic elements which ordinarily includes in case of auditors' Report for audits conducted in accordance with Standards on Auditing
- SA 701 deals with the auditor's responsibility to communicate key audit matters in the auditor's report. It is intended to address both the auditor's judgment as to what to communicate in the auditor's report and the form and content of such communication.
- The purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period.
- It is mandatory to communicate key audit matters in audits of complete sets of general purpose financial statements of listed entities in accordance with SA 701.
- SA 705 deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700, the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary.
- The auditor shall express a qualified opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements or the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.
- The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.
- The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

- SA 706 deals with additional communication in the auditor's report when the auditor considers it necessary to draw users' attention to a matter or matters presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements or draw users' attention to any matter or matters other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.
- "Emphasis of Matter" paragraph is a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.
- "Other Matter Paragraph" is a paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.
- SA 710 deals with the auditor's responsibilities regarding comparative information in an audit of financial statements.
- Comparative information refers to the amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.
- SA 720 deals with the auditor's responsibilities relating to other information, whether financial or non-financial information (other than financial statements and the auditor's report thereon), included in an entity's annual report.
- SA 720 requires the auditor to read and consider the other information because other information that is materially inconsistent with the financial statements or the auditor's knowledge obtained in the audit may indicate that there is a material misstatement of the financial statements or that a material misstatement of the other information exists, either of which may undermine the credibility of the financial statements and the auditor's report thereon. Such material misstatements may also inappropriately influence the economic decisions of the users for whom the auditor's report is prepared.

FOR SHORTCUT TO ENGAGEMENT & QUALITY CONTROLS STANDARDS
WISDOM: SCAN ME !



TEST YOUR KNOWLEDGE

Theoretical Questions

1. *Under the applicable Standards on Auditing, in what circumstances does the report of the statutory auditor require modifications? What are the types of modifications possible to the said report?*
2. *Write a short note on Emphasis of matter paragraph in Audit Reports.*
3. *Write a short note on Certificate for Special Purpose vs. Audit Report.*
4. *Compare and explain the following:*
 - (i) *Reporting to Shareholders vs. Reporting to those Charged with Governance*
 - (ii) *Audit Qualification vs. Emphasis of Matter.*
5. *"When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the Opinion section." As an expert you are required to brief the special considerations required for expressing:*
 - (a) *Qualified Opinion;*
 - (b) *Adverse Opinion and*
 - (c) *Disclaimer of Opinion.*

6. *ADKS & Co LLP are the newly appointed statutory auditors of PKK Ltd. During the course of audit, the statutory auditors have come across certain significant observations which they believe could lead to material misstatement of financial statements. Management has a different view and does not concur with the view of the statutory auditors. Considering this the statutory auditors are determining as to how to address these observations in terms of their reporting requirement. Please advise.*
7. *KPI Ltd is a joint venture of KPI Inc, a company based in US, and OPQ Ltd, a company based in Japan (hereinafter referred to as 'JV partners'). KPI Ltd was registered in India and is operating as a marketing support company for KPI Inc. All the costs of KPI Ltd are incurred in India and entire revenue of KPI Inc is generated in USD. The entire funding requirements of KPI Ltd are taken care of by the JV partners. Since KPI Ltd is based in India, hence it is also required to get its financial statements audited.*

The company appointed new auditors for the audit of the financial statements for the year ended 31 March 2023 after doing all appointment formalities wherein auditors are required to ensure compliance with Standards on Auditing and Internal Standards on Auditing.

As an expert you are required to advise the auditor about the requirements regarding auditor's report for audits conducted in accordance with both Standards on Auditing issued by ICAI and International Standards on Auditing.

8. *TUV Ltd. is a company engaged in the business of manufacture of spare parts. Saroj & Associates are the statutory auditors of the company for the FY 2022-23. During the course of audit, CA Saroj noticed that the company had a major customer, namely, Korean Mart from South Korea. Owing to an outbreak of war and subsequent destruction leading to government ban on import and export in South Korea, the demand from Korean Mart for the products of TUV Ltd. ended for an unforeseeable time period. When discussed with the management, CA Saroj was told that the company is in the process of identifying new customers for their products. CA Saroj understands that though the use of going concern assumption is appropriate but a material uncertainty exists with respect to the identification of new customers. This fact is duly reflected in the financial statements of TUV Ltd. for the FY 2022-23. How should CA Saroj deal with this matter in the auditor's report for the FY 2022-23?*
9. *Sun Moon Ltd. is a power generating company which uses coal as raw material for its power generating plant. The company has been allotted coal blocks in the state of Jharkhand and Odisha. During the FY 2022-23, a scam regarding allotment of coal blocks was unveiled leading to a ban on the allotment of coal blocks to various companies including Sun Moon Ltd. This happened in the month of December 2023 and as such entire power generation*

process of Sun Moon Ltd, came to a halt in that month. As a result of such ban, and the resultant stoppage of the production process, many key managerial personnel of the company left the company. There were delays in the of payment of wages and salaries and the banks from whom the company had taken funds for project financing also decided not to extend further finance or to fund further working capital requirements of the company.

Further, when discussed with the management, the statutory auditor understood that the company had no action plan to mitigate such circumstances. Further, all such circumstances were not reflected the financial statements of Sun Moon Ltd. What course of action should the statutory auditor of the company consider in such situation?

10. *CA Omkar is the statutory auditor of Sabhyata Ltd. for the FY 2022-23. The company is engaged in the business of manufacture of floor tiles. During the course of audit, CA Omkar obtained certain audit evidence which were not consistent with the affirmation made in the financial statements. Discuss as to how CA Omkar should deal with the situation in the auditor's report.*

Answers to Test your Understanding

1. Such matters are in nature of auditor's responsibilities and are stated in "The Auditor's Responsibilities for the Audit of the Financial Statements" section of the auditor's report in accordance with SA 700. Communication of significant audit findings and deficiencies identified in internal control to those charged with governance is one of important responsibilities of auditor.

Such communication assists those charged with governance in fulfilling their responsibility to oversee the financial reporting process and in fulfilling their oversight responsibilities.

2. The above matter is in nature of Key audit matter and should be stated under heading "Key audit matters" in audit report. Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.

SA 701 states that the auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, significant auditor judgments relating to areas in the financial statements that involved significant management judgment including

accounting estimates that have been identified as having high estimation uncertainty be taken into account.

The above described matter relates to revenue recognition and creation of complexities requiring judgment in revenues. Further, the description also describes how the matter was addressed by auditors by performing various audit procedures in accordance with SA 701.

3. In accordance with SA 706, Emphasis of Matter Paragraph is a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

As per SA 706, the objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to: -

- (a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements or
- (b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Further, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided the auditor would not be required to modify the opinion in accordance with SA 705 as a result of the matter.

In the given situation, auditor has relied upon management representation letter only. He has not performed any other audit procedures like verifying contracts with customers, status of arbitration proceedings etc. Since management representations by themselves do not constitute sufficient appropriate evidence, performing necessary audit procedures may lead auditor to conclude that modification in opinion is necessary. In such circumstances, matter cannot be included in Emphasis of matter Paragraph.

Therefore, auditor should form his opinion by performing necessary audit procedures and obtaining sufficient appropriate evidence. It is only when he concludes that modification of opinion is not required as a result of said matter in terms of SA 705, the said matter may be included in Emphasis of Matter paragraph.

Answers to Case Study

1. (c)
2. (c)
3. (d)
4. (c)
5. (b)

Answers to Theoretical Questions

1. Refer Para 5.
2. Refer Para 6.
3. **Certificate for Special Purpose vs. Audit Report:** A certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. The term 'certificate' is, therefore, used where the auditor verifies the accuracy of facts. An auditor may thus, certify the circulation figures of a newspaper or the value of imports or exports of a company. An auditor's certificate represents that he has verified certain figures and is in a position to vouch safe their accuracy as per his examination of documents and books of account. A report, on the other hand, is a formal statement usually made after an enquiry, examination or review of specified matters under report and includes the reporting auditor's opinion thereon. Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein. On the other hand, when a reporting auditor gives a report, he is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill. The 'report' involves expression of opinion which may differ from one professional to another. There is no question of exactitude in case of a report since the information contained therein is based on estimates and involves judgement element.
4. (i) **Reporting to Shareholders vs. Reporting to those Charged with Governance:**

REPORT	
Reporting to Shareholders	Reporting to those Charged with Governance
Section 143 of the Companies Act, 2013 deals with the provisions relating to reporting to Shareholders. Thus, it is a	Standard on Auditing 260 deals with the provisions relating to reporting to those Charged with Governance.

Statutory Audit Report which is addressed to the members.	
Statutory Audit Report is on true and fair view and as per prescribed Format.	It is a reporting on matters those charged with governance like scope of audit, audit procedures, audit modifications, etc.
Statutory Audit Reports are in public domain.	Reporting to those Charged with Governance is an internal document i.e., private report.

(ii) Audit Qualification vs. Emphasis of Matter:

REPORT	
Audit Qualification	Emphasis of Matter
Standard on Auditing 705 "Modifications to the Opinion in the Independent Auditor's Report", deals with the provisions relating to Audit Qualification.	Standard on Auditing 706 "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report" deals with the provisions relating to Emphasis of Matter.
Audit Qualifications are modifications to the opinion of the Auditors opinion where the auditor concludes that there is a material misstatement in the financial statement due to which the modification to the opinion of the auditor is necessary.	- Emphasis of Matter is a paragraph which is included in auditor's report to draw users' attention to important matter(s) which are already disclosed in Financial Statements and are fundamental to users' for understanding of Financial Statements. - The Emphasis of matter pre-supposes that there is Sufficient Appropriate audit evidence and the matter has been correctly disclosed.
Audit Qualifications are given when auditor has concluded that the financial statements are materially misstated or do not confirm to the financial reporting framework. Depending upon the	Emphasis of Matter is a paragraph which is issued when the auditor feels that it is necessary to invite attention to a particular matter which has been appropriately disclosed in the financial

nature of material misstatement being pervasive or otherwise the appropriate type of modified opinion is issued.	statements which in the opinion of the auditor is necessary for better understanding of the financial statement.

5. Refer Para 5.8
6. As per SA 705 (Revised), if the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement or the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement, the auditor shall modify the opinion in his report.

The auditor in such a case needs to determine the modification as follows:

- (i) Qualified Opinion: The auditor shall express a qualified opinion when:
 - (a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
 - (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.
- (ii) Adverse Opinion: The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements
- (iii) Disclaimer of Opinion: The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. 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.

If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.

If management refuses to remove the limitation, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity, and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

7. Refer Para 3.4
8. As per SA 570, "Going Concern", loss of a major market or a key customer is one of the operating indicators that may cast significant doubt on the company's ability to continue as a going concern.

In the present case, TUV Ltd. has a key customer in South Korea from which the demand for its products has ended on account of outbreak of war, subsequent destruction and government ban on import and export in South Korea. Further, the company has not yet identified new customers and is in the process of doing the same. As such, the identification of new customer is a material uncertainty that cast a significant doubt on the company's ability to continue as a going concern.

However, this matter is duly disclosed by the management of TUV Ltd. in the financial statements for the year ended 31.03.2023.

As such, considering that the going concern assumption is appropriate but a material uncertainty exists with respect to identification of new customer, CA Saroj should:

- (1) Express an unmodified opinion and
- (2) Include in his audit report, a separate section under the heading "Material Uncertainty Related to Going Concern" to:
 - (i) Draw attention to the note in the financial statements that discloses the matters and
 - (ii) State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

Thus, CA Saroj should deal with this matter in his auditor's report in the above mentioned manner.

9. SA 570 - "Going Concern" deals with the auditor's responsibilities in the audit of financial statements relating to going concern and the implications for the auditor's report.

The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.

When the use of Going Concern Basis of Accounting Is Inappropriate i.e. if the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor shall express an adverse opinion.

Also when adequate Disclosure of a Material Uncertainty Is Not Made in the Financial Statements the auditor shall:

- (i) Express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705 (Revised); and
- (ii) In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

In the present case, the following circumstances indicate the inability of Sun Moon Ltd. to continue as a going concern:

- Ban on the allotment of coal blocks
- Halt in power generation
- Key Managerial Personnel leaving the company.
- Banks decided not to extend further finance and not to fund the working capital requirements of the company.
- Non availability of sound action plan to mitigate such circumstances.

Therefore, considering the above factors it is clear that the going concern basis is inappropriate for the company. Further, such circumstances are not reflected in the financial statements of the company. As such, the statutory auditor of Sun Moon Ltd. should:

- (1). Express an adverse opinion in accordance with SA 705 (Revised) and
- (2). In the Basis of Opinion paragraph of the auditor's report, the statutory auditor should state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

The auditor is also required to report as per clause (xix) of CARO 2020 that on the basis of the financial ratios, ageing and expected dates of realisation of financial assets and payment of financial liabilities, other information accompanying the financial statements, the auditor's knowledge of the Board of Directors and management plans, whether the auditor is of the opinion that no material uncertainty exists as on the date of the audit report that company is capable of meeting its liabilities existing at the date of balance sheet as and when they fall due within a period of one year from the balance sheet date.

10. SA 705 (Revised) deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700, the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary.

The decision regarding which type of modified opinion is appropriate depends upon:

- (a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and
- (b) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

Further, the auditor shall modify the opinion in the auditor's report when the auditor concludes that based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement.

In the present case, during the course of audit, CA Omkar obtained certain audit evidence which were not consistent with the affirmation made in the financial statements. Therefore, CA Omkar should modify his report in accordance with SA 705- "Modifications to The Opinion In The Independent Auditor's Report.

CA Omkar should issue either a qualified opinion or an adverse opinion depending upon the circumstances of the case:

- (a) CA Omkar shall express a qualified opinion when, having obtained sufficient appropriate audit evidence, he concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements
- (b) CA Omkar shall express an adverse opinion, when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Thus, since CA Omkar has obtained audit evidence which are inconsistent with the affirmations made in the financial statement, CA Omkar should modify his opinion as per the circumstances of the case.