

NATURE, OBJECTIVE AND SCOPE OF AUDIT



LEARNING OUTCOMES

After studying this chapter, you would be able to understand-

- ◆ Meaning, nature and scope of audit
- ◆ Objectives of audit
- ◆ Inherent Limitations of audit
- ◆ Benefits of audit
- ◆ Meaning of assurance engagements
- ◆ Difference between reasonable assurance engagement and limited assurance engagement
- ◆ Meaning and basic purpose of engagement and quality control standards
- ◆ Practicality of above concepts by studying through examples and case studies

CHAPTER OVERVIEW



Sameer, a young CA aspirant, takes interest in events happening around him. Business and financial dealings of corporate world interest him very much. He regularly reads a newspaper publishing mainly business and economic news. He also keeps track of particularly such news on social media handles.

During last one year or so, he has seen audited financial results of many companies listed on stock exchanges being published in newspaper. He also visited web sites of some companies to go through their annual reports. The annual reports also, *inter alia*, contained audit reports signed by Chartered Accountants as auditors of companies.

He was also eagerly tracking financial results of an IT company. The annual audited results of the company were declared on one Friday evening. However, shares of company took a beating on Monday as soon as markets opened. Curiosity led him to find reason for such an adverse market reaction. He got to know that audited profits of company were below market expectations and auditors had remarked adversely on some matters which was not taken kindly by markets.

One of his uncles was expanding business and needed funds to meet business expansion requirements. Anticipating urgent financial needs, he approached a bank. Credit officer of bank requested for audited financial statements of past years of business to consider his loan application.

He was also thinking that companies must be paying taxes on profits shown in their audited financial statements. A few months back, he was reading a news report pointing out substantial increase in direct tax collections of government as highlighted in Union Budget.

Higher taxes paid by companies on basis of audited results may have been a significant contributing factor of such increase in direct tax collections, he thought in his mind. He was wondering upon enormous responsibility of auditors in this regard. He kept on pondering over significant role of auditors in economy and nation building.

1. INTRODUCTION

What do such real-life situations highlight? Such instances underline importance of auditing in today's complex business environment. Be it investors desirous of investing their money in companies, shareholders anxious to know financial position of companies they have invested in, banks or financial institutions willing to lend funds to credit-worthy organizations, governments desirous of collecting taxes from trade and industry in accordance with applicable laws, trade unions negotiating with corporate managements for better wages or insurance companies wanting to settle property claims caused by fire or other disasters- range of diverse users in equally diverse fields rely upon audited financial statements.

Can you figure out reason behind such reliance? It is due to the fact that audited financial statements provide confidence to users of financial statements; audited financial statements provide *assurance* to users who may take their decisions on

the basis of such audited financial statements. *Herein* lies the importance of auditing. You can very well understand how significant is role of auditing profession and auditors in modern world involving multitude of economic activities being carried out in equally dynamic legal and regulatory environments.

Here, comes a vital question. What do we mean by auditing? What is its nature and scope? What it includes and What it does not? What are its limitations? We shall try to find out answers to these questions in succeeding paras.



2. ORIGIN OF AUDITING

Before we get to understand meaning and nature of auditing, let's travel back in time to know about origin of auditing. Auditing has existed even in ancient times in many societies of world including India. The reference to auditing is found in Kautilya's *Arthshastra* even in 4th century BC. It talks about fixed accounting year, a process for closure of accounts and audit for the same. Concepts of periodical checking and verification existed even in those times. Even there are references in his monumental work to misstatements in financial statements due to abuse of power. Wasn't he far ahead of his times?

The word "audit" originates from Latin word "*audire*" meaning "to hear". In medieval times, auditors used to hear the accounts read out to them to check that employees were not careless and negligent. Industrial revolution in Europe led to astronomical expansion in volume of trade and consequently demand of auditors.

Coming to more recent history, the first Auditor General of India was appointed in British India in 1860 having both accounting and auditing functions. Later on, office of Auditor General was given statutory recognition. Presently, Comptroller and Auditor General of India is an independent constitutional authority responsible for auditing government receipts and expenditures.

The Institute of Chartered Accountants of India was established as a statutory body under an Act of Parliament in 1949 for regulating the profession of Chartered Accountancy in the country.



3. MEANING AND NATURE OF AUDITING

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

An incisive analysis of above meaning of auditing brings out following points clearly: -

- ♦ Audit is an *independent* examination of financial information.

Independence, here, implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him. The auditor should be independent of entity whose financial statements are subject to audit so that he can form an opinion without being affected by any influence. Independence increases auditor's ability to act objectively without creeping in of any biases.

Consider, for example, a person who requests his brother, a Chartered Accountant, to audit accounts of his proprietary concern and issue a report. Can CA audit accounts of concern in which his brother is sole proprietor? No, he cannot. It is due to the fact that there would be no independence in such a case due to relationship by birth between CA and his brother. He would be subject to influence from his brother.

Take another case where a CA has invested in shares of a company. Can he audit accounts of such a company in which he holds shares? The answer is resounding NO. It is due to the fact that by holding shares of the company, his own self-interest gets involved. His own money is invested in the company and he may not be able to form judgment independently on the financial statements of the company.

- ♦ The entity whose financial information is examined need not necessarily be profit oriented like in case of a business. It can be a non-profit organization like an NGO or a charitable trust. Audit can be undertaken in respect of any organization be it a small, medium or large. Further, it can be conducted for any entity irrespective of its legal structure *i.e.* such an entity may be a proprietary concern, a partnership firm, a LLP, a private company, a public company, a society or a trust.
- ♦ The purpose of audit is to express an opinion on the financial statements.

Understand that preparation and presentation of financial statements of an entity is responsibility of management of entity. The auditor expresses *an opinion* on financial statements by means of *written audit report*.

In doing so, he has to see that financial statements would not mislead anybody by ensuring that: -

- the accounts have been drawn up with reference to entries in the books of account;
- the entries in the books of account are adequately supported by sufficient and appropriate evidence;
- none of the entries in the books of account has been omitted in the process of compilation;
- the information conveyed by the statements is clear and unambiguous;
- the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and
- the statement of accounts presents a true and fair picture of the operational results and of the assets and liabilities.

Auditing provides assurance. Its basic nature *lies* in providing assurance to users - providing confidence to users of financial statements. Such an assurance lends credibility to financial statements. Audited financial statements provide confidence to users that financial information reflected in financial statements can be relied upon.

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

Auditing is interdisciplinary in nature. It draws from diverse subjects including accountancy, law, behavioural science, statistics, economics and financial management and makes use of these subjects. Since audit of financial statements is concerned with financial information, a sound knowledge of accounting principles is a fundamental requirement for an auditor of financial statements to conduct audit and express an opinion. Similarly, good knowledge of business laws and various taxation laws helps auditor to understand financial statements in a better way in accordance with applicable laws.

During course of audit, auditor has to interact with lot of persons for seeking

information and making inquiries. This can be done only if one has knowledge of human behaviour. Auditors use statistical methods to draw samples in a scientific manner. It is not possible for an auditor to check each and every transaction. So, use of statistical methods to draw samples for conducting audit is made.

Knowledge of subject like economics helps auditor to be familiar with overall economic environment in which specific business is operating. Financial management deals with issues such as funds flow, working capital management, ratio analysis etc. and an auditor is expected to be knowledgeable about these for applying some of audit procedures and carrying out audit effectively. Besides, knowledge of financial markets comprised in study of financial management is expected from a professional auditor.



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

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

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

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

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

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

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

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



5. OBJECTIVES OF AUDIT

In conducting audit of financial statements, objectives of auditor in accordance with SA-200 "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing" are: -

- (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
- (b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

An analysis of above brings out following points clearly: -

- (1) Auditor's objective is to obtain a *reasonable assurance* whether financial statements as a whole are free from material misstatement whether due to fraud or error.

Reasonable assurance is to be distinguished from absolute assurance. Absolute assurance is a complete assurance or a guarantee that financial statements are free from material misstatements. However, reasonable assurance is not a complete guarantee. Although it is a high-level of assurance but it is not complete assurance.

Audit of financial statements is carried out by the auditor with professional competence and skills in accordance with Standards on Auditing. Audit procedures are applied in accordance with SAs, audit evidence is obtained and evaluated. On basis of that, conclusions are drawn and opinion is formed. It leads to high level of assurance which is called as *reasonable assurance* but it is not absolute assurance.

- (2) Misstatements in financial statements can occur due to fraud or error or both. The auditor seeks to obtain reasonable assurance whether financial statements *as a whole* are free from material misstatements caused by fraud or error. He has to see effect of misstatements on financial statements as a whole, in totality.
- (3) Obtaining reasonable assurance that financial statements as a whole are free from material misstatements enables the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.
- (4) The opinion is reported and communicated in accordance with audit findings through a written report as required by Standards on Auditing. (*You would be studying about these in subsequent parts of this Chapter*).

An Overview of Objectives of Audit

Checkbox	Objectives of audit
✓	Obtaining a reasonable assurance that financial statements as a whole are free from material misstatement due to fraud or error
✓	Gaining a reasonable assurance leads to formation of opinion whether financial statements are prepared, in all material respects, in accordance with applicable financial reporting framework
✓	To report on the financial statements
✓	Reporting of opinion in accordance with audit findings
✓	Communication of reporting
✓	Reporting and communication in accordance with Standards on Auditing



6. SCOPE OF AUDIT-WHAT IT INCLUDES

Scope refers to *range or reach* of something. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. Users of financial statements may be shareholders, employees, customers, government and regulatory authorities, bankers etc. Enhancing of degree of confidence is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

(*Applicable financial reporting framework* means a framework adopted in the preparation and presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.)

For example, *in case of companies in India*, financial reporting framework is provided under Schedule III of Companies Act, 2013.

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

(1) Coverage of all aspects of entity

Audit of financial statements should be organized adequately to cover all aspects of the entity relevant to the financial statements being audited.

(2) Reliability and sufficiency of financial information

The auditor should be reasonably satisfied that information contained in underlying accounting records and other *source* data (like bills, vouchers, documents etc.) is *reliable and sufficient* basis for preparation of financial statements.

The auditor makes a judgment of reliability and sufficiency of financial information by making a study and assessment of accounting systems and internal controls and by carrying out appropriate tests, enquiries and procedures.

(3) Proper disclosure of financial information

The auditor should also decide whether relevant information is properly disclosed in the financial statements. He should also keep in mind applicable statutory requirements in this regard.

It is done by ensuring that financial statements properly summarize transactions and events recorded therein and by considering the judgments made by management in preparation of financial statements.

The management responsible for preparation and presentation of financial statements makes many judgments in this process of preparing and presenting financial statements. For example, *choosing of appropriate accounting policies* in relation to various accounting issues like choosing method of charging depreciation on fixed assets or choosing appropriate method for valuation of inventories.

The auditor evaluates selection and consistent application of accounting policies by management; whether such a selection is proper and whether chosen policy has been applied consistently on a period-to-period basis.

Understand that financial statements of an entity are prepared on historical financial information basis. "*Historical financial information*" means information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

For example, when purchases and sales are reflected in financial statements of an entity, these are examples of historical financial information. These are about transactions which have occurred in past.

Since financial statements are prepared on the basis of historical financial information, it is logical that audit of financial statements is also based upon such historical financial information. Therefore, audit of financial statements is based upon historical financial information.

6.1 Scope of audit-What it does not include

Auditor is not expected to perform duties which fall outside domain of his competence. For example, physical condition of certain assets like that of sophisticated machinery cannot be determined by him. Similarly, it is not expected from an auditor to determine suitability and life of civil structures like buildings. These require different skillsets which may be performed by qualified engineers in their respective fields.

An auditor is not an expert in authentication of documents. The genuineness of documents cannot be authenticated by him because he is not an expert in this field.

An audit is not an official *investigation* into alleged wrong doing. He does not have any specific legal powers of search or recording statements of witness on oath which may be necessary for carrying out an official investigation.

Audit is distinct from investigation. Investigation is a critical examination of the accounts with a special purpose. For example, if fraud is suspected and it is specifically called upon to check the accounts whether fraud really exists, it takes character of investigation.

The objective of audit, on the other hand, as has already been discussed, is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion.

The scope of audit is general and broad whereas scope of investigation is specific and narrow.

An Overview of Scope of Audit

Check box	Scope of audit of financial statements
✓	Coverage of all aspects of entity relevant to the financial statements being audited.
✓	Reliability and Sufficiency of financial information
✓	Proper disclosure of financial information
✓	Expression of an opinion on financial statements

X	Responsibility of preparation and presentation of financial statements
X	Duties outside scope of competence of auditor
X	Expertise in authentication of documents
X	Investigation

Test Your Understanding 1

Lalji Bhai has purchased shares of a company listed on NSE. The audited financial statements of the company provide picture of healthy financial performance having robust turnover, low debt and good profits. On above basis, he is absolutely satisfied that money invested by him is safe and there is no chance of losing his money. Do audited results and audit reports of companies provide such assurance to investors like Lalji Bhai? Is thinking of Lalji Bhai correct?

Test Your Understanding 2

Good deeds Limited is engaged in business of recycling of wastes from dumping grounds of municipal corporation of Indore to usable manure. It is, in this way, also, helping to make the city clean.

During course of audit by Zoha & Zoha, a firm of auditors, it is observed by auditors that company has received a notice from Central Bench of National Green Tribunal for not following certain environmental regulations involving imposition of hefty monetary penalty on the company. The company is yet to reply to the notice. The auditors point out that same is not stated in notes to accounts in financial statements. The company points out that auditors are going beyond scope of their work. Does such a matter fall within scope of audit?

Test Your Understanding 3

A huge fire broke out in NOIDA plant of KT Limited. Plant assets comprising building, machinery and inventories were insured from branch of a public sector insurance company. Apart from an insurance surveyor who was deputed for assessing loss, the regional office of insurance PSU also appointed a CA for verification of books of accounts/ financial records of the company and circumstances surrounding the loss. He was also requested to submit an early report. Would the report by CA in nature of audit report?



7. INHERENT LIMITATIONS OF AUDIT

The process of audit suffers from certain inbuilt limitations due to which an auditor cannot obtain an absolute assurance that financial statements are free from misstatement due to fraud or error. These fundamental limitations arise due to the following factors: -

(1) Nature of financial reporting

Preparation of financial statements involves making many judgments by management. These judgments may involve subjective decisions or a degree of uncertainty. Therefore, auditor may not be able to obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.

One of the premises for conducting an audit is that management acknowledges its responsibility of preparation of financial statements in accordance with applicable financial reporting framework and for devising suitable internal controls. However, such controls may not have operated to produce reliable financial information due to their own limitations.

Consider, for example, that management of a company has devised a control that all purchase bills should reflect stamp and signatures of an authorised person in "Goods Receiving Section" of the company stating the date and time of receiving goods in premises. It is an example of internal control devised by the company to ensure that only those purchase bills are produced for payment for which goods have been actually received. Now, what happens if concerned accountant and authorised person in "Goods Receiving Section" collude. It is a case of overriding of internal controls devised by the company due to collusion between two persons. Such a probable collusion is one of limitations of internal controls itself.

(2) Nature of Audit procedures

The auditor carries out his work by obtaining audit evidence through performance of audit procedures. However, there are *practical and legal* limitations on ability of auditor to obtain audit evidence. For example, an auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of *practical limitation* on auditor's ability to obtain audit evidence.

Management may not provide complete information as requested by auditor. There is no way by which auditor can force management to provide complete information as may be requested by auditor. In case he is not provided with required information, he can only report. It is an example of *legal limitation* on auditor's ability to obtain audit evidence.

The management may consist of dishonest and unscrupulous people and may be, itself, involved in fraud. It may be engaged in concealing fraud by designing sophisticated and carefully organized schemes which may be hard to detect by the auditor. It may produce fabricated documents before auditor to lead him to believe that audit evidence is valid. However, in reality, such documents could be fake or non-genuine.

We have already discussed under section on scope of audit that an auditor is not an expert in authentication of documents. Therefore, he may be led to accept invalid audit evidence on the basis of unauthentic documents.

It is quite possible that entity may have entered into some transactions with related parties. Such transactions may be only paper transactions and may not have actually occurred. The auditor may not be aware of such related party relationships or audit procedures may not be able to detect probable wrong doings in such transactions.

(3) Not in nature of investigation

As already discussed, audit is not an official investigation. Hence, auditor cannot obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.

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

The relevance of information decreases over time and auditor cannot verify each and every matter. Therefore, a balance has to be struck between reliability of information and cost of obtaining it.

Consider, for example, an auditor who is conducting audit of a company since last two years. During these two years, he has sought detailed information from management of company regarding various matters. During his third-year stint, he chooses to rely upon some information obtained as part of audit procedures of second year. However, it could be possible that something new has happened and that information is not relevant. So, the information being relied upon by auditor is not timely and may have lost its reliability.

(5) Future events

Future events or conditions may affect an entity adversely. Adverse events may seriously affect ability of an entity to continue its business. The business may cease to exist in future due to change in market conditions, emergence of new business models or products or due to onset of some adverse events.

Therefore, it is in view of above factors, that an auditor cannot provide a guarantee that financial statements are free from material misstatements due to frauds or errors.

Inherent Limitations of Audit (SA 200 “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”): The auditor is not expected to, and cannot, reduce audit risk to zero because there are inherent limitations of an audit. The inherent limitations of an audit arise from:

The Nature of Financial Reporting: The preparation of financial statements involves judgment by management.

The Nature of Audit Procedures: There are practical and legal limitations on the auditor’s ability to obtain audit evidence such as:

Possibility that management or others may not provide, intentionally or unintentionally, the complete information relevant for preparation and presentation of FS.

Fraud may involve sophisticated and carefully organised schemes.

Not in the nature of Investigation: An audit is not an official investigation into alleged wrongdoing.

Timeliness of financial reporting and decrease in relevance of information over time: Relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost.

Future events: Future events or conditions may affect an entity adversely. Adverse events may seriously affect ability of an entity to continue its Business.



8. WHAT IS AN ENGAGEMENT?

Engagement means an arrangement to do something. In the context of auditing, it means a formal agreement between auditor and client under which auditor agrees to provide auditing services. It takes the shape of engagement letter.

8.1 External audit engagements

The purpose of external audit engagements is to enhance the degree of confidence of intended users of financial statements. Such engagements are also reasonable assurance engagements. For example, in India, companies are required to get their annual accounts audited by an external auditor. Even non-corporate entities may choose to have their accounts audited by an external auditor because of benefits of such an audit.



9. BENEFITS OF AUDIT-WHY AUDIT IS NEEDED?

- ◆ Audited accounts provide high quality information. It gives confidence to users that information on which they are relying is qualitative and it is the outcome of an exercise carried out by following Auditing Standards recognized globally.
- ◆ In case of companies, shareholders may or may not be involved in daily affairs of the company. The financial statements are prepared by management consisting of directors. As shareholders are owners of the company, they need an independent mechanism so that financial information is qualitative and reliable. Hence, their interest is safeguarded by an audit.
- ◆ An audit acts as a moral check on employees from committing frauds for the fear of being discovered by audit.
- ◆ Audited financial statements are helpful to government authorities for determining tax liabilities.
- ◆ Audited financial statements can be relied upon by lenders, bankers for making their credit decisions *i.e.* whether to lend or not to lend to a particular entity.
- ◆ An audit may also detect fraud or error or both.
- ◆ An audit reviews existence and operations of various controls operating in any entity. Hence, it is useful at pointing out deficiencies.



10. AUDIT- MANDATORY OR VOLUNTARY?

It is not necessary that audit is always legally mandatory. There are entities like companies who are compulsorily required to get their accounts audited under law. Even non-corporate entities may be compulsorily requiring audit of their accounts under tax laws. For example, in India, every person is required to get accounts audited if turnover crosses certain threshold limit under income tax law.

It is also possible that some entities like schools may be required to get their accounts audited for the purpose of obtaining grant or assistance from the Government.

Audit is not always mandatory. Many entities may get their accounts audited voluntarily because of benefits from the process of audit. Many such concerns have their internal rules requiring audit due to advantages flowing from an audit.



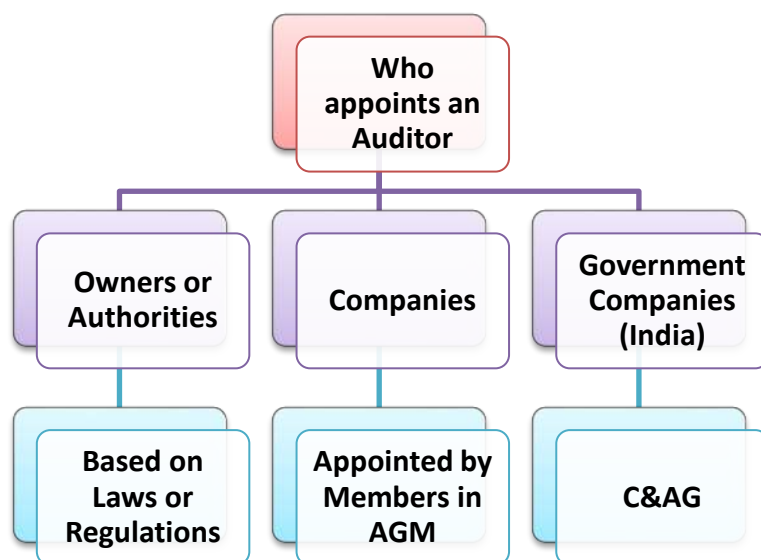
11. WHO APPOINTS AN AUDITOR?

Generally, an auditor is appointed by owners or in some cases by constitutional or government authorities in accordance with applicable laws and regulations. For example, in case of companies, auditor is appointed by members (shareholders) in Annual General Meeting (AGM). Shareholders are owners of a company and auditor is appointed by them in AGM.

However, in case of government companies in India, auditor is appointed by Comptroller and Auditor General of India (CAG), an independent constitutional authority.

Take case of a firm who engages an auditor to audit its accounts. In such a case, auditor is appointed by partners of firm.

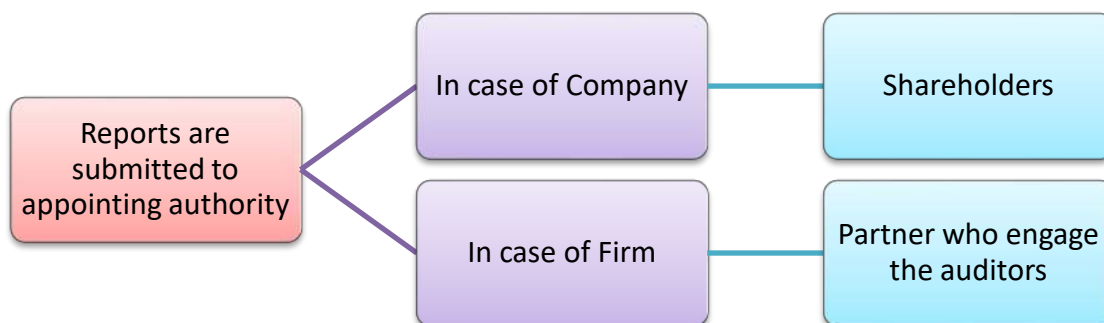
There may be a situation in which auditor may be appointed by a government authority in accordance with some law or regulation. For example, an auditor may be appointed under tax laws by a government authority.



12. TO WHOM REPORT IS SUBMITTED BY AN AUDITOR?

The outcome of an audit is written audit report in which auditor expresses an opinion. The report is submitted to person making the appointment. In case of companies, these are shareholders- in case of a firm, to partners who have engaged him.

We shall now discuss understanding reached so far from a case study involving discussion among students regarding nature, scope, limitations, benefits of auditing and other related matters.



CASE STUDY-1

Rohit, Gurpreet, Ali and Goreti are friends since their school days based in Mumbai. They have cleared CA foundation exams in the same attempt and now plan to appear for CA Intermediate exams. All of them are avid news listeners and regularly keep track of business news even on social media.

They are trying to understand new subjects including auditing. Rohit, Gurpreet and Ali have also started attending *Live Coaching Classes (LCC) being conducted by Board of studies of ICAI*. Goreti has not been able to join *Live Coaching Classes* yet as she was away on a holiday with her parents. However, she plans to catch it up with her friends very soon. Ali had also joined the classes but he had skipped some lectures.

During one informal get together, their discussions centred around new subject of auditing. They discussed many things regarding its nature, scope, benefits and other general practical issues. Goreti was regular in keeping track of audited results of companies being published in leading newspapers. Her view was that audited financial statements of companies give 100% guarantee to different stake holders. It is the main reason behind so much reliance upon auditing. But she could not understand why wrong doings in financial matters are being discovered after many years have gone by.

Ali also concurred with her view and added that when financial statements are audited, each and every transaction appearing in books of accounts is verified. However, he could not give clarity to Goreti.

Gurpreet was of the opinion that audit was conducted on the basis of sample checking. He was also of the view that audited financial statements are not a guarantee against probable wrong doings in financial matters of the companies.

Not to be left behind, Rohit also jumped in the fray. He supported Gurpreet and also added something of his own.

Based on above, answer the following questions: -

1. Gurpreet was of the view that audited financial statements are not a guarantee against probable wrong doings in financial matters of companies. What kind of assurance does audit of financial statements provide?
 - (a) It provides reasonable assurance meaning a moderate level of assurance.
 - (b) It provides reasonable assurance meaning a low level of assurance.
 - (c) It provides reasonable assurance meaning a high level of assurance.
 - (d) It provides reasonable assurance meaning an absolute level of assurance.
2. Rohit added that auditor can force an employee of the company to provide him required information and documents. Can he do so?
 - (a) Yes, he can do so. It is necessary to obtain audit evidence.
 - (b) Yes, he can do so. There are express rights given to him in this respect.
 - (c) No, he cannot do so. He can only request for providing him with necessary information and documents. But it cannot be forced by him.
 - (d) No, he cannot do so. He has no right of seeking information and documents. Therefore, question of forcing does not arise.
3. Ali had listened in one of the classes that audit covers all aspects of an entity and concluded that each and every transaction of entity is verified by auditor. Goreti also seemed to be in agreement with him but she was of the view that besides this, it also meant that audit should be so organized to cover all areas of an entity. Which of following statements is appropriate in this regard?
 - (a) Only view of Ali is correct.
 - (b) Only view of Goreti is correct.
 - (c) Views of both Ali and Goreti are correct.
 - (d) Views of both Ali and Goreti are incorrect.
4. All of them also discussed about benefits of auditing. Which of the following is not a likely benefit of auditing?

- (a) *Since auditing is connected to future events, audited information can be easily relied upon by users.*
- (b) *Errors or frauds may be discovered during audit.*
- (c) *Government authorities can make use of audited accounts for different purposes.*
- (d) *It can help in bringing out deficiencies in maintenance of financial records.*
5. *Goreti told her friends that she had read a news report about how a company had misled its auditors by producing some fabricated documents. Which of following statements seems to be appropriate in this regard?*
- (a) *It was wrong on the part of auditor to rely upon fabricated documents. He must have discovered it as the same falls within the scope of his duties.*
- (b) *Although it was wrong on the part of auditor to rely upon fabricated documents, he cannot do anything in the matter. He has to report on the basis of documents provided to him. He has no duty in this regard.*
- (c) *Auditor has to conduct audit by exercising professional skill. But he is not an expert in discovering genuineness of documents. Hence, management consisting of dishonest persons may have led him to rely upon fabricated documents deliberately.*
- (d) *Management cannot mislead auditor due to high level of knowledge and expertise possessed by him. The above is an outlier case-one of the rare odd cases.*

Answer to Questions involving Case Studies

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

Test Your Understanding 4

Zeeba Products is a partnership firm engaged in trading of designer dresses. The firm has appointed JJ & Co, Chartered accountants to audit their accounts for a year. The auditors were satisfied with control systems of firm, carried out required procedures and necessary verifications. In particular, they carried out sample checking of purchases, traced purchase bills to GST portal and also made confirmations from suppliers. They were satisfied with audit evidence obtained by them as part of audit exercise. An audit report was submitted to the firm giving an opinion that financial statements reflected true and fair view of state of affairs of the firm.

However, later on, it was discovered that purchase manager responsible for procuring dresses from one location was also booking fake purchases of small values by colluding with unethical dealers. Payments to these dealers were also made in connivance with accountant through banking channel.

The partners of firm blame auditors for futile audit exercise. Are partners of firm correct in their view point? Imagine any probable reason for such a situation.

Audit is a type of assurance engagement under which auditor gives an opinion as to whether financial statements give a true and fair view of state of affairs of the concern. However, assurance engagements are not restricted to audit alone. We shall now discuss meaning of assurance engagement and different types of assurance engagements.

13. MEANING OF ASSURANCE ENGAGEMENT

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

It means that the practitioner gives an opinion about specific information due to which users of information are able to make confident decisions knowing well that chance of information being incorrect is diminished.

13.1 Elements of an Assurance Engagement

Following elements comprise an assurance engagement: -

1 **A three party relationship involving a practitioner, a responsible party, and intended users**

An assurance engagement involves abovesaid three parties. A practitioner is a person who provides the assurance. The term practitioner is broader than auditor. Audit is related to historical information whereas practitioner may provide assurance not necessarily related to historical financial information.

A responsible party is the party responsible for preparation of subject matter.

Intended users are the persons for whom an assurance report is prepared. These persons may use the report in making decisions.

2. **An appropriate subject matter**

It refers to the information to be examined by the practitioner. For example, financial information contained in financial statements while conducting audit of financial statements.

3. **Suitable criteria**

These refer to benchmarks used to evaluate the subject matter like standards, guidance, laws, rules and regulations.

4. **Sufficient appropriate evidence**

The practitioner performs an assurance engagement to obtain sufficient appropriate evidence. It is on the basis of evidence that conclusions are arrived and an opinion is formed by auditor.

"Sufficient" relates to quantity of evidence obtained by auditor. "Appropriate" relates to quality of evidence obtained by auditor. One evidence may be providing more comfort to auditor than the other evidence. The evidence providing more comfort is qualitative and, therefore, appropriate. Evidence should be both sufficient and appropriate.

5. A written assurance report in appropriate form

A written report is provided containing conclusion that conveys the assurance about the subject matter. A written assurance report is the outcome of an assurance engagement.

Overview of Elements of assurance engagement

Checkbox	Elements of an assurance engagement
✓	Three Party relationship
✓	An appropriate subject matter
✓	Suitable Criteria
✓	Sufficient appropriate evidence
✓	Written assurance report in appropriate form

13.2 Meaning of Review; Audit Vs. Review

We have learnt that audit is a *reasonable assurance* engagement. It provides reasonable assurance. However, review is a *limited assurance* engagement. It provides lower level of assurance than audit. Further, review involves fewer procedures and gathers sufficient appropriate evidence on the basis of which limited conclusions can be drawn up. However, both "audit" and "review" are related to financial statements prepared on the basis of historical financial information.

13.3 Types of Assurance Engagements- Reasonable assurance engagement vs. Limited assurance engagement

As already discussed, assurance engagements provide assurance to users. The difference is of degree. Reasonable assurance engagement like audit provides reasonable assurance which is a high level of assurance. Limited assurance engagement like review provides lower level of assurance than audit. It is only a moderate level of assurance.

<i>Reasonable assurance engagement</i>	<i>Limited assurance engagement</i>
Reasonable assurance engagement provides high level of assurance.	Limited assurance engagement provides lower level of assurance than reasonable assurance engagement.
It performs elaborate and extensive procedures to obtain sufficient appropriate evidence.	It performs fewer procedures as compared to reasonable assurance engagement.
It draws reasonable conclusions on the basis of sufficient appropriate evidence.	It involves obtaining sufficient appropriate evidence to draw limited conclusions.
Example of reasonable assurance engagement is an audit engagement.	Example of limited assurance engagement is review engagement.

Besides reasonable assurance engagements and limited assurance engagements, there is another kind of assurance which is related to matters other than historical financial information. Such an assurance may relate to *prospective financial information and not to historical financial information*. It may relate to providing assurance on internal controls in an entity.

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

It is to be noted that in such type of assurance engagements, examination is not of historical financial information.

Here, it is important to note the difference between "Historical financial information" and "Prospective financial information." The former relates to information expressed in financial terms of an entity about economic events, conditions or circumstances occurring in past periods. The latter relates to financial information based on assumptions about occurrence of future events and possible actions by an entity.

Therefore, historical financial information is rooted in past events which have already occurred whereas prospective financial information is related to future events.

In assurance reports involving prospective financial information, the practitioner obtains sufficient appropriate evidence to the effect that management's assumptions on which the prospective financial information is based are not unreasonable, the prospective financial information is properly prepared on the basis of the assumptions and it is properly presented and all material assumptions are adequately disclosed.

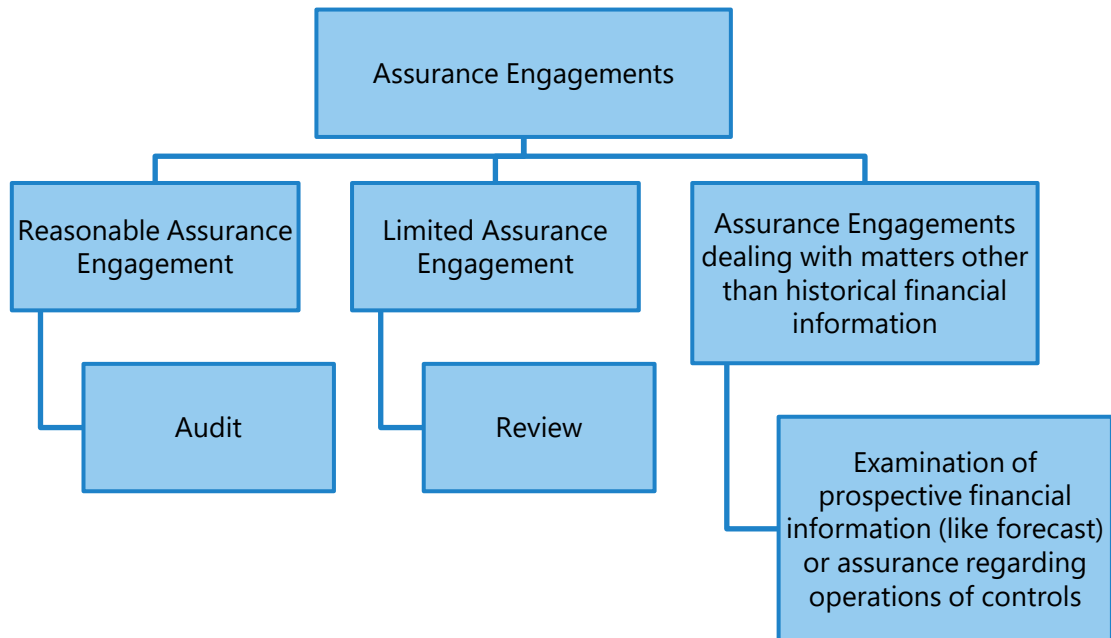
Prospective financial information relates to future events. While evidence may be available to support the assumptions on which the prospective financial information is based, such evidence is itself generally future-oriented. The auditor is, therefore, not in a position to express an opinion as to whether the results shown in the prospective financial information will be achieved.

Therefore, in such assurance engagements, practitioner provides a report assuring that nothing has come to practitioner's attention to suggest that these assumptions do not provide a reasonable basis for the projection.

Hence, such type of assurance engagement provides only a "moderate" level of assurance.

Examples of assurance engagements

Checkbox	Example of assurance engagement	Type of assurance engagement
✓	Audit of financial statements	Reasonable assurance engagement
✓	Review of financial statements	Limited assurance engagement
✓	Examination of Prospective financial information	Provides assurance regarding reasonability of assumptions forming basis of projections and related matters
✓	Report on controls operating at an organization	Provides assurance regarding design and operation of controls



Test Your Understanding 5

The management of Exotic Tours and Travels Limited requests its auditor Raja & Co. to provide an assurance report on the financial information for first quarter of a year by skipping required detailed procedures.

Can Raja & Co. provide such a report? What would be nature of such a report? Would it be necessary for them to obtain sufficient appropriate evidence in such a case?

14. QUALITIES OF AUDITOR

An auditor is concerned with the reporting on financial matters of business and other institutions. Financial matters inherently are to be set with the problems of human fallibility; errors and frauds are frequent.

Tact, caution, firmness, good temper, integrity, discretion, industry, judgement, patience, clear headedness and reliability are some of qualities which an auditor should have. In short, all those personal qualities that go to make a good businessman contribute to the making of a good auditor.

In addition, he must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence.

The auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education. He is called upon constantly to *critically* review financial statements and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert. An exhaustive knowledge of accounting in all its branches is the *sine qua non* of the practice of auditing. He must know thoroughly all accounting principles and techniques.

15. ENGAGEMENT AND QUALITY CONTROL STANDARDS: AN OVERVIEW

The following Standards issued under authority of ICAI Council are collectively known as *Engagement Standards*: -

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

The purpose of issue of these standards is to establish high quality standards and guidance in the areas of financial statement audits and in other types of assurance services.

15.1 Standards on Auditing

Standards on Auditing apply in the context of an audit of financial statements by an independent auditor. It is important to remember that Standards on Auditing apply in audit of historical information. These establish high quality benchmarks and are followed by auditors in conducting audit of financial statements.

Standards on Auditing have been issued on wide spectrum of issues in the field of auditing ranging from overall objectives of independent auditor, audit documentation, planning an audit of financial statements, identifying and assessing risk of material misstatement, audit sampling, audit evidence and forming an opinion and reporting on financial statements. These cover all significant aspects of audit of financial statements.

Some examples of Standards on Auditing are: -

- ◆ SA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing
- ◆ SA 230 Audit Documentation
- ◆ SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
- ◆ SA 500 Audit Evidence
- ◆ Revised SA 700 Forming an Opinion and Reporting on Financial Statements

15.2 Standards on Review Engagements

Standards on review engagements apply in the context of review of financial statements. We have already understood that review is a limited assurance engagement and it provides assurance which is lower than that provided by audit. It is due to the fact that review involves fewer procedures as compared to audit. Since a review also provides assurance to users, it also involves obtaining sufficient appropriate evidence. For example, when an auditor performs review of interim financial information of an entity.

Examples of Standards on Review engagements are:

- ◆ SRE 2400 (Revised) Engagements to Review Historical Financial Statements
- ◆ SRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity

It is to be noted that both Standards on auditing and Standards on review engagements apply to engagements involving historical financial information.

15.3 Standards on Assurance Engagements

There is another set of standards which apply in assurance engagements dealing

with subject matters other than historical financial information. Such assurance engagements do not include "audit" or "review" of historical financial information. These standards are known as Standards on Assurance Engagements. For example, an assurance engagement relating to examination of prospective financial information.

It is to be noted that in such type of assurance engagements, examination is not of historical financial information or engagement may relate to providing assurance regarding non-financial matters like design and operation of internal control in an entity.

Examples of Standards on Assurance Engagements are:

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

15.4 Standards on Related Services

Lastly, there are standards on related services. These standards apply in engagements to perform agreed-upon procedures regarding financial information.

For example, an engagement to perform agreed-upon procedures may require the auditor to perform certain procedures concerning individual items of financial data, say, accounts payable, accounts receivable, purchases from related parties and sales and profits of a segment of an entity, or a financial statement, say, a balance sheet or even a complete set of financial statements.

An engagement in which practitioner may be called upon to assist management with the preparation and presentation of historical financial information without obtaining assurance on that information. Such type of compilation engagements fall in the category of related services and practitioner issues a report clearly stating that it is not an assurance engagement and no opinion is being expressed.

These types of services are called related services and standards have been issued to deal with practitioner's responsibilities in this regard.

Examples of Standards on related services are:

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

It is to be clearly understood that all the above standards i.e., Standards on Auditing (SAs), Standards on Review Engagements (SREs), Standards on Assurance Engagements (SAEs) and Standards on related services (SRSs) are collectively known as the Engagement Standards.

Engagement Standards issued under the authority of Council of ICAI deal with responsibilities of auditor/practitioner.

15.5 Standards on Quality Control

Standards on Quality Control (SQC) have been issued to establish standards and provide guidance regarding a firm's responsibilities for its system of quality control for the conduct of audit and review of historical financial information and for other assurance and related service engagements.

SQC 1 has been issued in this regard. It requires auditors/practitioners to establish system of quality control so that firm and its personnel comply with professional standards and regulatory & legal requirements and reports issued are appropriate.

Its basic objective is that while rendering services, to which engagement standards apply, there should be a system of quality control with in firms to ensure complying with professional standards/legal requirements. System of quality control ensures issuing of appropriate reports in the circumstances.

Further, it is also to be remembered that Standards on Quality Control (SQC) are to be applied for all services covered by Engagement Standards.

15.6 Why are Standards needed?

- Standards ensure carrying out of audit against established benchmarks at par with global practices.
- Standards improve quality of financial reporting thereby helping users to make diligent decisions.

- Standards promote uniformity as audit of financial statements is carried out following these Standards.
- Standards equip professional accountants with professional knowledge and skill.
- Standards ensure audit quality.

15.7 Duties in relation to Engagement and Quality Control Standards

It is the duty of professional accountants to see that Standards are followed in engagements undertaken by them. Ordinarily, these are to be followed by professional accountants. However, a situation may arise when a specific procedure as required in Standards would be ineffective in a particular engagement. In such a case, he is required to document how alternative procedures performed achieve the purpose of required procedure. Also, reason for departure has also to be documented unless it is clear. Further, his report should draw attention to such departures. It is also to be noted that a mere disclosure in the report does not absolve a professional accountant from complying with applicable Standards.

Overview of Engagement and Quality Control Standards

Checkbox	Engagement and Quality Control Standards
✓	Standards on auditing (SAs) apply in audit of historical financial information.
✓	Standards on review engagements (SREs) apply in review of historical financial information.
✓	Standards on assurance engagements (SAEs) apply in engagements dealing in matters other than historical financial information.
✓	Standards on related services (SRSs) apply in engagements to perform agreed-upon procedures regarding financial information and other services like assisting management in preparation and presentation of financial statements.
✓	Standards on Quality control (SQC) apply for all services covered by engagement standards i.e. SAs, SREs, SAEs and SRSs.
✓	Duty of professional accountants to follow Standards. If not followed, reason for departure to be stated in reports.

Test Your Understanding 6

CA. P Babu is conducting audit of financial statements of Quick Buy Private Limited. He was not able to obtain external confirmations from certain debtors due to practical difficulties and peculiar circumstances. However, such a procedure is mandated under one of Standards on Auditing.

Unable to obtain external confirmations from these debtors, he relied upon sale details to these parties, e-invoices, e-way bills and also traced payments from these parties in bank accounts of the company. He was reasonably satisfied with audit evidence obtained. Is there any other reporting duty cast upon him relating to not following a mandated procedure in one of Standards on Auditing?

CASE STUDY-2

Me and You Private Limited has been newly incorporated. The plant of the company has recently started production with the help of funds provided by a bank for purchase and installation of machinery. Further, the company is also utilizing working capital credit facilities from the same bank for meeting its day to day working capital requirements like for purchase of raw materials, labour payment etc. However, just within six months of its operations, the management feels that working capital funds are inadequate and situation is creating liquidity issues in the company.

The management of the company has approached its bankers and requested for enhancement in working capital credit facilities. The bank manager is insisting upon financial statements of the company for half year along with report providing assurance in this respect duly signed by Chartered Accountant as audit is far away. It also requires projected financial statements for coming years along with a report from CA providing assurance regarding these projections to consider request of management.

The management approaches CA P, who has qualified recently and started practising. Reports providing assurance for half yearly results and projected financial statements are sought from CA P. The Management provides necessary information and records to him in this regard.

Assume, in above case, the company only provides trial balance, financial

statements in draft/preliminary form along with accompanying records for the relevant half year to CA P and requests him to provide duly signed financial statements with a report for mutually agreed professional fees.

Based on above, answer the following questions: -

1. *The management of company has engaged CA P to issue a duly signed report for half year. Which of the following standards, if any, issued by ICAI are relevant for CA P?*
 - (a) *Standards on Review Engagements*
 - (b) *Standards on Auditing*
 - (c) *Standards on Related Services*
 - (d) *There are no standards for issuing report in such situation.*
2. *Which of the following statements is MOST APPROPRIATE in given case situation?*
 - (a) *CA P can assist management in preparation of financial statements of the company. However, issue of a report in such a case is outside the scope of work.*
 - (b) *CA P can assist management in preparation of financial statements of the company and he can issue an audit report.*
 - (c) *CA P can assist management in preparation of financial statements of the company and he can issue a compilation report in this respect.*
 - (d) *The responsibility of preparation of financial statement is of company's management. CA P cannot assist management in preparation of financial statements of the company. However, he can issue a review report.*
3. *In the above said scenario for issuance of signed financial statements for half year by CA P, as discussed in last para of Case Study, identify the MOST APPROPRIATE statement: -*
 - (a) *Standard on Quality control (SQC 1) is not applicable as CA P cannot issue audit report.*
 - (b) *Standard on Quality Control (SQC 1) is not applicable as CA P cannot issue review report.*

- (c) *Standard on Quality Control (SQC 1) is applicable in such type of engagement.*
- (d) *Standard on Quality Control (SQC 1) is not applicable as CA P is barred from issuing any report in such type of engagement.*
4. *The banker of company has also requested for projected financial statements for coming years along with a report from CA P regarding these projections to consider request of management. Which of the following standards issued by ICAI are relevant for CA P in such a situation, if any?*
- (a) *Standards on Review Engagements*
- (b) *There are no standards for issuing such type of reports.*
- (c) *Standards on Related Services*
- (d) *Standards on Assurance Engagements*
5. *Suppose CA P also accepts work of issuing projected financial statements with a report to be signed by him. The management has projected turnover of ₹ 100 crore for the next year, ₹ 150 crore & ₹ 200 crore for following years respectively as compared to present turnover of ₹ 25 crore in current half year. Identify the MOST APPROPRIATE statement in this situation: -*
- (a) *CA P has to satisfy himself regarding arithmetical accuracy of projected data.*
- (b) *CA P has to satisfy himself regarding reasonableness of assumptions underlying projected turnover and its consistency with actuals.*
- (c) *CA P has to satisfy himself regarding arithmetical accuracy of data along with its proper presentation to banker.*
- (d) *CA P has to satisfy himself regarding reasonableness of assumptions underlying projected turnover, its consistency with actuals, disclosure and presentation.*

Answer to Questions involving Case Study 2

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

SUMMARY

- ◆ An audit is an independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.
- ◆ An audit provides assurance. It provides confidence to users of financial statements.
- ◆ Assurance is provided by audit by means of written audit report.
- ◆ The basic purpose of an audit of financial statements is to express an opinion on the financial statements.
- ◆ The independent audit of financial statements provides reasonable assurance. It is to be distinguished from absolute or complete assurance. However, reasonable assurance is a high level of assurance.
- ◆ An auditor is not expected to perform duties falling outside scope of his competence.
- ◆ There are inherent limitations in process of audit due to nature of financial reporting itself, nature of audit procedures, audit not being in nature of investigation and other factors. It is due to these reasons audit does not provide absolute assurance.
- ◆ Audit is a type of assurance engagement. It is a reasonable assurance engagement.
- ◆ Assurance engagement means an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.
- ◆ Assurance engagement consists of five elements consisting of- a three party relationship, an appropriate subject matter, suitable criteria, sufficient appropriate evidence and a written assurance report in appropriate form.
- ◆ Limited assurance engagement provides lower level of assurance than reasonable assurance engagement.
- ◆ Audit is a reasonable assurance engagement. Review is a limited assurance engagement.

- ◆ Assurance engagements consist of reasonable assurance engagements, limited assurance engagements and assurance engagements dealing with matters other than historical financial information.
- ◆ Standards on auditing, Standards on review engagements, Standards on assurance engagements and Standards on related services are collectively known as engagement standards. These deal with responsibilities of auditor/practitioner.
- ◆ Standards on quality control have been issued to establish standards and provide guidance regarding a firm's responsibilities for its system of quality control in providing services dealt by engagement standards.
- ◆ Standards are needed for carrying out audit against established benchmarks, for improving quality of financial reporting, for promoting uniformity, for equipping professional accountants with professional knowledge & skill and for ensuring audit quality.

For a concise revision of the key concepts covered in this chapter, students may refer to the Saransh Booklet for Paper 5: Auditing and Ethics, which serves as a useful last-mile revision resource for examination preparation. Saransh Booklet can be accessed at <https://resource.cdn.icai.org/85998bos-aps751-int-p5.pdf>

TEST YOUR KNOWLEDGE

MCQs based Questions

1. Which of the following is not an advantage of audit?
 - (a) It provides high quality financial information.
 - (b) It acts as a moral check on employees.
 - (c) It enhances risk of management bias.
 - (d) It helps in safeguarding interests of shareholders.

2. Which of the following is NOT TRUE about an assurance engagement?
- (a) It relates to providing assurance about historical financial information only.
 - (b) The practitioner obtains sufficient appropriate evidence.
 - (c) There is some information to be examined by practitioner.
 - (d) A written assurance report in appropriate form is issued by practitioner.
3. Which of the following is TRUE about Engagement Standards?
- (a) Engagement standards ensure proper rights to practitioners in course of performance of their duties.
 - (b) Engagement standards ensure preparation and presentation of financial statements in a standardized manner.
 - (c) Engagement standards ensure uniformity by practitioners in course of performance of their duties.
 - (d) Engagement standards ensure savings in resources of clients.
4. Consider following statements in relation to "Limited assurance engagement":-
- Statement I - It involves obtaining sufficient appropriate evidence to draw reasonable conclusions.
- Statement II - Review of interim financial information of a company is an example of limited assurance engagement.
- (a) Statement I is correct. Statement II is incorrect.
 - (b) Both Statements I and II are correct.
 - (c) Both Statements I and II are incorrect.
 - (d) Statement I is incorrect. Statement II is correct.
5. Which of the following is TRUE about Standards on auditing?
- (a) These deal mainly with voluntary responsibilities of auditors.
 - (b) These deal mainly with mandatory responsibilities of auditors.
 - (c) Their sole purpose is to help government authorities in augmenting revenues.
 - (d) These deal mainly in carrying out audit according to legal provisions.

Correct /Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

- (i) *The basic objective of audit does not change with reference to nature, size or form of an entity.*
- (ii) *The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements.*
- (iii) *The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error.*

Theoretical Questions

1. *You are auditing the financial statements of JEN Ltd., a manufacturing company. During a meeting, Mr. Jai CEO questions the auditor's ability to detect all material misstatements, including those caused by fraud. He insists that since the auditor is a professional, the audit should provide absolute assurance on the accuracy of the financial statements. Is the contention of Mr. Jai correct. Discuss the objectives of auditor in accordance with relevant SA.*
2. *Explain the circumstances under which a professional accountant may depart from specific procedures prescribed in the Standards and describe the documentation and reporting obligations arising from such departures.*
3. *RKP & Co., Chartered Accountants, were appointed as the statutory auditors of Orion Engineering Ltd., a company engaged in manufacturing heavy industrial equipment. During the course of audit, certain shareholders raised concerns before the auditors regarding the following matters:*
 - *They asked the auditor to certify whether the sophisticated imported machinery installed in the factory was in perfect physical condition and to estimate its remaining useful life.*
 - *Some shareholders also requested the auditor to confirm the genuineness of certain supplier invoices and contracts, alleging that some documents might be forged.*

- *A group of investors further demanded that the auditor conduct a detailed investigation into an alleged fraud by a senior employee, including questioning employees and recording statements under oath.*

With reference to the above situation, explain the matters which fall outside the scope of an audit. Also distinguish between audit and investigation.

4. *OPQ Ltd. is a widely held company engaged in manufacturing activities. The management of the company is responsible for preparation of financial statements. The shareholders of the company are not involved in day-to-day operations.*

Recently, during a board meeting, one of the directors questioned the necessity of conducting a statutory audit, stating that it only increases cost and does not add significant value. However, the CFO of the company argued that audit plays a crucial role in enhancing the reliability of financial information and safeguarding stakeholder interests.

In the given context, explain the benefits of audit to various stakeholders.

5. *Micky & Associates, Chartered Accountants, were appointed as the auditors of STI Ltd., a Textile manufacturing company, for the financial year 2025-26. Management of the company discussed with the newly appointed auditors that the company has been suffering losses for the last few years and also the Directors are suspecting that accounts are not properly maintained and might contain errors and frauds. So, in the given situation, management of the company requested the auditors to give complete assurance/guarantee about the financial statements of the company.*

Can the auditors give complete assurance/guarantee in the above situation? Discuss with reference to objectives of Audit.

6. *You are appointed as statutory auditor of Zebra Industries Ltd. for FY 2025–26. During the course of audit, you observe that the company's management frequently delays in providing certain documents and explanations requested by you. A portion of the accounting records related to "special procurement" is supported only by basic acknowledgements without proper vendor details. You also notice that some transactions appear to be with entities that may be related to the company, but management denies the existence of any such relationships. Further, during verification, you find that some documents*

produced as evidence appear unusually uniform and lack standard commercial markings, raising concerns about their authenticity. Since your audit is conducted on a test-check basis, you are unable to verify all such transactions individually.

Based on the above, explain the inherent limitations of an audit that restrict the auditor from obtaining absolute assurance that the financial statements of Zebra Industries Ltd. are free from material misstatement.

7. *CA students Sriranga and Manga were discussing on the assurance, which the auditing services provide to the users, in the form of opinion on financial statements, by means of a written report. Such an assurance lends credibility to financial statements. You are required to state some of the aspects examined by the auditor, to ensure that the financial statements which are audited are not misleading.*
8. *Mr. Praveen, an articled clerk, wants to know the applicable Engagement Standards in the following situations:*
 - (i) *An assignment to assist the management of Healthy Foods Ltd. with the preparation and presentation of historical financial information, without obtaining assurance on that information.*
 - (ii) *An assignment to examine the prospective financial information of Digital Future Ltd.*

Further, explain to Mr. Praveen the difference between reasonable assurance engagements and limited assurance engagements.

9. *Apex Infra Ltd. is a mid-sized infrastructure company engaged in construction of highways and bridges.*

During the statutory audit, the auditor notices frequent disputes with contractors, pressure on site managers to meet targets, heavy reliance on automated data processing, and aggressive working capital management by the finance department. The auditor realises that mere verification of accounting records is insufficient to form an opinion. With reference to the above case, explain why an auditor is expected to have working knowledge of disciplines other than auditing, specifically in relation to:

- (a) *Statistics & Mathematics*

- (b) *Financial Management*
- (c) *Data Processing*
- (d) *Behavioural Science*

10. *Mini & Associates, Chartered Accountants, were appointed as the auditor of CIN Ltd., a construction company. During the audit, CA Mini, a Partner of the firm noticed the following:*

- *The company has several ongoing projects, but only selected project revenues have been reported.*
- *Several expense vouchers are either missing or are handwritten and lack proper authorisation.*
- *The company has changed its depreciation method from the straight-line method to the written-down value method without adequate disclosure in the financial statements.*

These matters were brought to the attention of management. However, management argued that these issues fall outside the auditor's scope of responsibility. Whether contention of the management is correct?

11. *M Motors Ltd is a leading Indian automobile manufacturer with many offerings across commercial, passenger and electric vehicles. The Company is pioneering India's electric vehicle transition and enjoys considerable advantage in one of the fastest growing automotive markets.*

GR & Associates have been appointed as its statutory auditors for financial year 2025-26. J and K are newly appointed audit assistants in the firm and are part of engagement team constituted for purpose of audit of M Motors Ltd. However, they are confused about what such an audit tends to achieve. They perceive audit as a guarantee against possible errors or frauds in financial statements. Do you agree with perception of both the assistants? In this context, outline objectives of an independent audit conducted in accordance with Standards on Auditing.

12. *Standards on Auditing (SAs) apply in "audit of historical financial information" whereas Standards on Review Engagements (SREs) apply in "review of historical financial information." Explain in detail giving examples.*

13. Kriti, a CA student, has commenced her articleship with a reputed audit firm. She considers audit engagement to be an "assurance engagement". Her understanding is that audit engagement is the only kind of assurance engagement in which practitioner gives a written assurance report in appropriate form. However, her friend Somaya, does not agree with her. She is of the view that assurance engagements are not restricted to audit alone. Besides, Somaya also thinks that assurance engagements can also relate to matters other than historical financial information. Whose view appears to be correct? State with reasons.
14. RST Ltd., a retail company, has set up internal controls requiring all invoices to be stamped and signed by an authorised person in "Goods Receiving Section" of the company stating the date and time of receiving goods in premises to ensure that only those purchase bills are produced for payment for which goods have been actually received.

During the audit, the auditor finds that two employees – a purchasing manager and an accounts clerk – have worked together to bypass this control, submitting fake invoices that resulted in payments for goods that were never received. You are required to state the objectives of an audit, as per SA 200, when it comes to ensuring the reliability of financial statements? Also explain, why auditor can provide only reasonable, rather than absolute, assurance that the financial statements are free from material misstatement due to fraud or error in the context of the given situation?

15. XYZ Ltd., a manufacturing company based in India, operates multiple plants across the country and deals in complex machinery, which requires specialized maintenance and valuation expertise. XYZ Ltd. appointed CA Dhruv as Statutory auditor. During the audit, he observed that the management consistently applied the same method for valuation of inventory over the past few years, but this year, without proper disclosure, they switched to a different valuation method, which resulted in higher reported profits. Does such a matter fall within scope of audit?
16. The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit. Explain.

17. *"Assurance engagement" means an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. In this context, give three examples of assurance engagements highlighting difference in nature of assurance provided by such engagements.*
18. *The management of Cool Drinks Limited suspects that some employees of the company may be involved in making fraudulent payments to dummy workers at its various plants in the country. Therefore, they are considering appointment of a firm of auditors to conduct audit involving detailed examination of accounts. However, one senior person among Board members, Mr. P, objects to use of word "audit" in proposed assignment. Comment. Also, discuss how audit is different from investigation.*
19. *Mention any three standards issued under authority of ICAI Council which are collectively known as 'Engagement Standards'. Also mention the purpose of issue of these standards.*
20. *XYZ Ltd, a manufacturing company engaged in the production of various types of yarn, is planning to expand its operations into a new geographical market and also add new products. Company has prepared prospective financial information to be presented to potential investors and financial institutions to secure funding for the expansion.*

XYZ Ltd engages a firm of auditors to conduct an assurance engagement on this prospective financial information. During the engagement, the auditors reviewed the assumptions made by XYZ Ltd.'s management and issued a report.

Explain the key differences between prospective financial information and historical financial information. How does this distinction impact the level of assurance provided in an assurance engagement on prospective financial information?

21. *PD & Co., Chartered Accountants, were appointed as the statutory auditors of MR Limited for the financial year 2025-26. MR Limited included the following clause in the appointment letter to the auditors: "The Auditor shall be responsible for detecting the frauds that may happen in the company during the financial year 2025-26."*

The auditor objected to inclusion of such a clause in the appointment letter. Discuss in the light of scope of audit.

ANSWERS/ SOLUTIONS

Answers to the MCQs based Questions

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

Answers to Correct/Incorrect

- (i) **Correct:** An audit is an independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon. It is clear that the basic objective of auditing, i.e., expression of opinion on financial statements does not change with reference to nature, size or form of an entity.
- (ii) **Correct:** As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.
- (iii) **Correct:** As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.

Answers to the Theoretical Questions

1. In conducting audit of financial statements, objectives of auditor in accordance with SA-200 "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing" are:

- (i) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
- (ii) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

Audit of financial statements is carried out by the auditor with professional competence and skills in accordance with Standards on Auditing. Audit procedures are applied in accordance with SAs, audit evidence is obtained and evaluated. On basis of that, conclusions are drawn, and opinion is formed. It leads to high level of assurance which is called as reasonable assurance, but it is not absolute assurance.

It may be noted that absolute assurance is a complete assurance or a guarantee that financial statements are free from material misstatements. However, reasonable assurance is not a complete guarantee. Although it is a high-level of assurance, but it is not complete assurance.

Misstatements in financial statements can occur due to fraud or error or both. The auditor seeks to obtain reasonable assurance whether financial statements as a whole are free from material misstatements caused by fraud or error.

In the given case, Mr. Jai, CEO of JEN Ltd., questions the auditor's ability to detect all material misstatements and insists that auditor should provide absolute assurance. As per SA 200, the auditor's objective is to obtain reasonable assurance. Therefore, contention of the CEO Mr. Jai is not correct.

2. It is the duty of professional accountants to see that Standards are followed in engagements undertaken by them. Ordinarily, these are to be followed by professional accountants. However, a situation may arise when a specific procedure as required in Standards would be ineffective in a particular engagement. In such a case, he is required to document how alternative procedures performed achieve the purpose of required procedure. Also, reason for departure has also to be documented unless it is clear. Further, his report should draw attention to such departures. It is also to be noted that a

mere disclosure in the report does not absolve a professional accountant from complying with applicable Standards.

He should have properly documented the alternative procedure and reason for departure, in addition to disclosing it in the report, to fully meet his professional duties.

- 3.** In the given case, the shareholders of Orion Engineering Ltd. have requested the auditor to perform certain activities which fall outside the normal scope of audit. The scope of audit does not include the following:
- (i) Matters outside the auditor's technical competence: An auditor is not expected to perform duties that require specialised technical expertise beyond accounting and auditing knowledge. For instance, determining the physical condition or useful life of sophisticated machinery or assessing the structural suitability of buildings requires technical skills of engineers or other experts. Therefore, the auditor cannot certify such matters.
 - (ii) Authentication of documents: An auditor is not an expert in detecting forgery or verifying the genuineness of documents. While the auditor may examine documents as audit evidence, he cannot guarantee their authenticity because he does not possess specialised expertise in forensic document verification.
 - (iii) Conducting an official investigation: An audit is not an official investigation into alleged wrongdoing. The auditor does not possess legal powers such as searching premises or recording statements of witnesses on oath, which are generally available to investigative authorities.
 - (iv) Audit is distinct from investigation: Investigation involves a critical examination of accounts with a specific purpose, such as determining whether fraud exists. Its scope is specific and narrow.

On the other hand, the objective of audit is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion. The scope of audit is general and broad, whereas the scope of investigation is specific and narrow.

Accordingly, in the given case, the auditor of Orion Engineering Ltd. is justified in clarifying that certification of technical condition of machinery, authentication of documents, and conducting a detailed fraud investigation fall outside the normal scope of audit and such matters may require involvement of experts or a separate investigation.

4. Refer benefits of audit to various stakeholders described in Para 9.

Therefore, audit is not merely a statutory requirement but an essential mechanism that enhances credibility of financial statements, protects stakeholder interests, and supports informed decision-making.

5. Refer objective of an audit described in para 5.

Thus, it can be concluded that auditors can provide reasonable assurance instead of absolute assurance.

6. The auditor carries out his work by obtaining audit evidence through performance of audit procedures. However, there are practical and legal limitations on ability of auditor to obtain audit evidence. For example, an auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence.

Management may not provide complete information as requested by auditor. There is no way by which auditor can force management to provide complete information as may be requested by auditor. In case he is not provided with required information, he can only report. It is an example of *legal limitation* on auditor's ability to obtain audit evidence.

The management may consist of dishonest and unscrupulous people and may be, itself, involved in fraud. It may be engaged in concealing fraud by designing sophisticated and carefully organised schemes which may be hard to detect by the auditor. It may produce fabricated documents before auditor to lead him to believe that audit evidence is valid. However, in reality, such documents could be fake or non-genuine.

Auditor is not an expert in authentication of documents. Therefore, he may be led to accept invalid audit evidence on the basis of unauthentic documents.

It is quite possible that entity may have entered into some transactions with related parties. Such transactions may be only paper transactions and may not have actually occurred. The auditor may not be aware of such related party relationships or audit procedures may not be able to detect probable wrong doings in such transactions.

These factors collectively demonstrate that, due to practical constraints, legal boundaries, management fraud risks, and limitations in detecting related party transactions, the auditor can obtain only reasonable assurance and not absolute assurance regarding the accuracy of the financial statements.

7. Aspects to be examined by the auditor to ensure that the financial statements which are audited are not misleading are as under:

- (i) the accounts have been drawn up with reference to entries in the books of account.
- (ii) the entries in the books of account are adequately supported by sufficient and appropriate evidence.
- (iii) none of the entries in the books of account has been omitted in the process of compilation.
- (iv) the information conveyed by the statements is clear and unambiguous.
- (v) the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and
- (vi) the statement of accounts presents a true and fair picture of the operational results and of the assets and liabilities.

8. (i) An Assignment to assist the management of Healthy Foods Ltd. With the preparation and presentation of historical financial information without obtaining assurance on that information:
Standards on Related Services / The applicable standard is SRS 4410 (Revised)

- (ii) **An Assignment to examine prospective financial information of Digital Future Ltd.:** Standards on Assurance Engagements / The applicable standard is SAE 3400

(iii) **Difference between Reasonable assurance engagement and Limited assurance engagement.**

Reasonable assurance engagement	Limited assurance engagement
Reasonable assurance engagement provides high level of assurance.	Limited assurance engagement provides lower level of assurance than reasonable assurance engagement.
It performs elaborate and extensive procedures to obtain sufficient appropriate evidence.	It performs fewer procedures as compared to reasonable assurance engagement.
It draws reasonable conclusions on the basis of sufficient appropriate evidence.	It involves obtaining sufficient appropriate evidence to draw limited conclusions.
Example of reasonable assurance engagement is an audit engagement.	Example of limited assurance engagement is review engagement.

9. In the given case of Apex Infra Ltd., the auditor observed disputes with contractors, pressure on site managers, dependence on automated systems and aggressive working capital practices. These factors indicate that mere checking of books of account is not sufficient and that the auditor is required to possess working knowledge of disciplines other than auditing.

- (a) **Auditing and Statistics & Mathematics:** Auditor is expected to have the knowledge of statistical sampling for meaningful conclusions and mathematics for verification of inventories. In the case of Apex Infra Ltd., where large-scale construction activities and inventories of construction materials are involved, statistical techniques help the auditor in selecting representative samples and drawing reliable conclusions from voluminous transactions and records.
- (b) **Auditing and Financial Management:** Auditor is also expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc. Since the finance department of the company is following aggressive working capital management practices, the auditor requires understanding of

financial management concepts to assess liquidity position, evaluate financial risks and analyse whether such practices may lead to possible misstatements in the financial statements.

- (c) **Auditing and Data Processing:** EDP auditing in itself is developing as a discipline in itself. As the company heavily relies on automated data processing systems, the auditor should understand the functioning of computerised accounting systems, internal controls in EDP environment and risks relating to processing of electronic data to ensure reliability and accuracy of financial information.
- (d) **Auditing and Behavioural Science:** Knowledge of human behaviour is essential for an auditor to effectively discharge his duties. In the given case, pressure on site managers to achieve targets and frequent disputes with contractors may create conditions conducive to manipulation, bias or fraud. Understanding behavioural aspects helps the auditor in assessing management attitude, identifying unusual conduct and evaluating the possibility of intentional misstatements.

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

(1) Coverage of all aspects of entity

Audit of financial statements should be organised adequately to cover all aspects of the entity relevant to the financial statements being audited.

(2) Reliability and sufficiency of financial information

The auditor should be reasonably satisfied that information contained in underlying accounting records and other *source* data (like bills, vouchers, documents etc.) is reliable and sufficient basis for preparation of financial statements.

The auditor makes a judgment of reliability and sufficiency of financial information by making a study and assessment of accounting systems and internal controls and by carrying out appropriate tests, enquiries and procedures.

(3) Proper disclosure of financial information

The auditor should also decide whether relevant information is properly disclosed in the financial statements. He should also keep in mind applicable statutory requirements in this regard.

It is done by ensuring that financial statements properly summarize transactions and events recorded therein and by considering the judgments made by management in preparation of financial statements.

In view of above, the management's contention is not correct. The matters identified by CA Mini such as incomplete revenue recognition, missing or unauthorised expense vouchers, and inadequate disclosure of changes in accounting policy are well within the scope of the audit of financial statements, as they impact the reliability, completeness, and proper presentation of financial information.

11. Refer objective of an audit described in para 5.

Accordingly, perception of both assistants is not proper. Auditor of financial statements does not seek to provide guarantee that financial statements are free from material misstatements caused by frauds or errors. He obtains reasonable assurance.

12. Standards on Auditing (SAs) apply in "audit of historical financial information" whereas Standards on Review Engagements (SREs) apply in "review of historical financial information". Standards on auditing apply in "audit" of historical financial information which is a reasonable assurance engagement whereas Standards on Review Engagements apply in "review" of historical financial information which is a limited assurance engagement only.

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

"Audit" and "review" are two different terms. Audit is a reasonable assurance engagement, and its objective is reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement. However, "review" is a limited assurance engagement, and its objective is a reduction

in assurance engagement risk to a level that is acceptable in the circumstances of the engagement.

Standards on Auditing have been issued on wide spectrum of issues in the field of auditing including (but not limited to) overall objectives of independent auditor, audit documentation, planning an audit of financial statements, identifying and assessing risk of material misstatement, audit evidence, audit sampling, going concern and forming an opinion and reporting on financial statements.

Some examples of Standards on Auditing are:

- (i) SA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing
- (ii) SA 230 Audit Documentation
- (iii) SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
- (iv) SA 500 Audit Evidence
- (v) Revised SA 700 Forming an Opinion and Reporting on Financial Statements

Examples of Standards on Review engagements are

- (i) SRE 2400 (Revised) Engagements to Review Historical Financial Statements
- (ii) SRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity

- 13.** Audit engagement is an assurance engagement. However, assurance engagements are not restricted to auditing alone. There are other assurance engagements too like review engagements, engagements providing assurance involving prospective financial information, engagements providing assurance on internal controls in an entity. Assurance engagements provide assurance to users. The difference is of degree. Whereas an audit provides reasonable assurance which is a high level of assurance, review provides lower level of assurance as compared to audit.

There are also assurance engagements which relate to matters other than historical financial information like providing assurance on matters involving prospective financial information and providing assurance on internal controls in an entity. In assurance reports involving prospective financial information, the practitioner obtains sufficient appropriate evidence to the effect that management's assumptions on which the prospective financial information is based are not unreasonable, the prospective financial information is properly prepared on the basis of the assumptions, and it is properly presented, and all material assumptions are adequately disclosed.

In the given case, Kriti is of the view that audit engagement is the only kind of assurance engagement in which practitioner gives a written assurance report in appropriate form whereas is of the view that assurance engagements are not restricted to audit alone. Thus, view of Somaya is correct.

- 14.** In conducting audit of financial statements, objectives of auditor in accordance with SA 200, "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing" are: -
- (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
 - (b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

The process of audit suffers from certain inbuilt limitations due to which an auditor cannot obtain an absolute assurance that financial statements are free from misstatement due to fraud or error. These fundamental limitations arise due to the factors such as nature of financial reporting, nature of audit procedures, not in the nature of investigation, timeliness of financial reporting and decrease in relevance of information over time and future events.

Preparation of financial statements involves making many judgments by management. These judgments may involve subjective decisions or a degree of uncertainty. Therefore, the auditor may not be able to obtain absolute

assurance that financial statements are free from material misstatements due to frauds or errors. One of the premises for conducting an audit is that management acknowledges its responsibility of preparation of financial statements in accordance with applicable financial reporting framework and for devising suitable internal controls. However, such controls may not have operated to produce reliable financial information due to their own limitations.

In the context of RST Ltd., the management designed a control requiring that all invoices be stamped and signed by an authorized person in the Goods Receiving Section to confirm receipt of goods. However, collusion between two employees—the purchasing manager and the accounts clerk—allowed them to bypass this control by submitting fake invoices for payment. Collusion is a significant limitation of internal controls, as it overrides controls designed to prevent such fraud.

Given these factors, the auditor cannot provide absolute assurance that the financial statements are entirely free from material misstatements due to fraud or error.

15. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. The scope of audit of financial statements includes coverage of all aspects of entity, reliability and sufficiency of financial information and proper disclosure of financial information.

In the given situation, CA. Dhruv observed that the management consistently applied the same method for valuation of inventory over the past few years, but this year, without proper disclosure, they switched to a different valuation method, which resulted in higher profits. Since proper disclosure of financial information is covered under the scope of audit, thus, the auditor should decide whether relevant information is properly disclosed in the financial statements. He should also keep in mind applicable statutory requirements in this regard.

The management responsible for preparation and presentation of financial statements makes many judgments in this process of preparing and presenting financial statements. For example, choosing appropriate accounting policies in relation to various accounting issues like choosing

method of charging depreciation on fixed assets or choosing appropriate method for valuation of inventories.

The auditor evaluates selection and consistent application of accounting policies by management; whether such a selection is proper and whether chosen policy has been applied consistently on a period-to-period basis.

Thus, it can be concluded that proper disclosure of financial information is well within scope of audit.

16. The process of audit suffers from certain inbuilt limitations due to which an auditor cannot obtain an absolute assurance that financial statements are free from misstatement due to fraud or error. These fundamental limitations arise due to the following factors: -
- (i) **The Nature of Financial Reporting:** The preparation of financial statements involves judgment by management. These judgments may involve subjective decisions or a degree of uncertainty. Therefore, auditor may not be able to obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.
 - (ii) **The Nature of Audit Procedures:** There are practical and legal limitations on the auditor's ability to obtain audit evidence such as:
 - Possibility that management or others may not provide, intentionally or unintentionally, the complete information relevant for preparation and presentation of FS.
 - Fraud may involve sophisticated and carefully organised schemes.
 - (iii) **Not in the nature of Investigation:** An audit is not an official investigation into alleged wrongdoing. Hence, auditor cannot obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.
 - (iv) **Timeliness of financial reporting and decrease in relevance of information over time:** Relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost.

- (v) **Future events:** Future events or conditions may affect an entity adversely. Adverse events may seriously affect ability of an entity to continue its business.

17. Three examples of assurance engagements are as under :-

(i) Audit of financial statements

An audit of financial statements provides reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

(ii) Review of financial statements

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

(iii) Examination of prospective financial information

In assurance reports involving prospective financial information, the practitioner obtains sufficient appropriate evidence to the effect that management's assumptions on which the prospective financial information is based are not unreasonable, the prospective financial information is properly prepared on the basis of the assumptions and it is properly presented and all material assumptions are adequately disclosed. Such type of assurance engagement provides a moderate assurance.

18. Audit is distinct from investigation. Investigation is a critical examination of the accounts with a special purpose. For example, if fraud is suspected and it is specifically called upon to check the accounts whether fraud really exists, it takes character of investigation. The objective of audit, on the other hand, is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion.

The scope of audit is general and broad whereas scope of investigation is specific and narrow.

In the given situation, management of company suspects that some of its employees may be involved in making fraudulent payments on account of dummy workers at its different plants in the country. Such an assignment is in the nature of "investigation".

Therefore, Mr. P is right in objecting the use of word "audit" in the proposed assignment.

19. Engagement and Quality Control Standards: The following Standards issued under authority of ICAI Council are collectively known as Engagement Standards:

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

The purpose of issue of these standards is to establish high quality standards and guidance in the areas of financial statement audits and in other types of assurance services.

20. Difference between "Historical financial information" and "Prospective financial information": The "Historical financial information" relates to information expressed in financial terms of an entity about economic events, conditions or circumstances occurring in past periods. The "Prospective financial information" relates to financial information based on assumptions about occurrence of future events and possible actions by an entity.

Therefore, historical financial information is rooted in past events which have already occurred whereas prospective financial information is related to future events.

In assurance reports involving prospective financial information, the practitioner obtains sufficient appropriate evidence to the effect that

management's assumptions on which the prospective financial information is based are not unreasonable, the prospective financial information is properly prepared on the basis of the assumptions and it is properly presented and all material assumptions are adequately disclosed.

Prospective financial information relates to future events. While evidence may be available to support the assumptions on which the prospective financial information is based, such evidence is itself generally future- oriented. The auditor is, therefore, not in a position to express an opinion as to whether the results shown in the prospective financial information will be achieved.

Therefore, in such assurance engagements, practitioner provides a report assuring that nothing has come to practitioner's attention to suggest that these assumptions do not provide a reasonable basis for the projection.

Hence, such type of assurance engagement provides only a "moderate" level of assurance.

- 21.** Scope of Audit in detection of Fraud: In conducting audit of financial statements objectives of auditor, in accordance with SA 200, "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing" is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion.

An audit is not an official investigation into alleged wrongdoing. The auditor does not have any specific legal powers of search or recording statements of witness on oath which may be necessary for carrying out an official investigation.

Audit is distinct from investigation. Investigation is a critical examination of the accounts with a special purpose. For example, if fraud is suspected and it is specifically called upon to check the accounts whether fraud really exists, it takes character of investigation.

The scope of audit is general and broad whereas scope of investigation is specific and narrow.

Thus, inclusion of such a clause in the engagement letter is uncalled for and outside the scope of audit.

Answers to Questions involving Test Your Understanding

1. An audit does not provide assurance to investor in shares regarding safety of his money. Share prices of securities are affected by range of factors. An audit only provides reasonable assurance that financial statements are free from material misstatement whether due to fraud or error. Hence, thinking of Lalji Bhai is not correct.
2. Proper disclosure of financial information is well within scope of audit.
3. Appointment of CA for verification of books of accounts/financial records and circumstances surrounding the loss is for a specific objective to determine genuineness of loss and any issue affecting liability of insurance company. It is an investigation and not in nature of audit report.
4. It is example of failure of internal controls of the firm. The internal control has not operated due to collusion between employees which is a limitation of internal control itself. The auditor has relied upon internal controls. It is very nature of financial reporting that management is responsible for devising suitable internal controls. This is an inherent limitation of audit.
5. Such report would be in nature of "review". However, auditors would have to obtain sufficient appropriate evidence.
6. He is required to document how alternative procedures performed achieve the purpose of required procedure. Reason for departure has to be documented unless it is clear. His report should draw attention to such departure.

AUDIT STRATEGY, AUDIT PLANNING AND AUDIT PROGRAMME



LEARNING OUTCOMES

After studying this chapter, you would be able to -

- ◆ Understand the Audit Planning and its benefits.
- ◆ Learn about Planning Process and its Elements.
- ◆ Learn about establishing overall strategy and developing audit plan in detail.
- ◆ Learn about audit programme.
- ◆ Gain the knowledge of control of quality of audit work w.r.t delegation and supervision of audit work.
- ◆ Practicality of above concepts by studying through examples and case studies.

CHAPTER OVERVIEW

**Planning an audit involves:****Establishing the overall audit strategy****Developing an audit plan**

The auditor should plan his work to enable him to conduct an **effective** audit in an **efficient** and **timely** manner.

Plans should be based on **knowledge of the client's business**.

Plans should be **further developed and revised** as necessary during the course of the audit.

By now, Sameer had grasped basic nature of auditing. It was crystal clear to him that objective of an audit of financial statements is to express an opinion on the same. He could easily visualize that a complex process like audit needs to be performed methodically. "Carrying out an audit ought to be a logical and systematic process leading from one step to another. Performing a complex process effectively, would certainly, be involving planning. Planning helps one to achieve desired objectives. Audits should be no different"- He was talking to himself.

Besides, he was pretty sure that there must be timelines in which audits were to be completed for different entities. He remembered his father had held few shares of some blue-chip companies. He was able to recall that notices of annual general meetings of these companies used to be delivered at their ancestral home in Rajkot and those also related to consideration and adoption of audited accounts. Linking that, he had reasonably concluded that audits were required to be performed in a timely manner. The whole audit process, therefore, must be properly planned to ensure its effectiveness.

He was curious to learn about how planning for an audit is undertaken. What are the basic elements of planning? What are likely matters to be included therein?

He was aware about CA students undergoing articled training. Most of the students must be going for audit work of different entities as part of their practical training. A thought came to his mind- "How do students who have freshly joined their articles carry out audit work? There must be some mechanism, some sort of detailed set of instructions for carrying out audit. What is it known as?" His inquisitive mind was constantly engaged in such kind of questions.

He was also anxious to know what would happen to audit plan if some new information comes to light of auditor during course of audit which was hitherto unknown to him at time of planning? Is audit plan flexible? Can it be changed as audit progresses? Another question raging in his mind was whether all such information was necessary to be put in writing by the auditor.



1. AUDITOR'S RESPONSIBILITY TO PLAN AN AUDIT OF FINANCIAL STATEMENTS

SA 300- ***Planning an audit of financial statements*** deals with the auditor's responsibility to plan an audit of financial statements. It states that objective of the auditor is to plan the audit so that it will be performed in an effective manner.

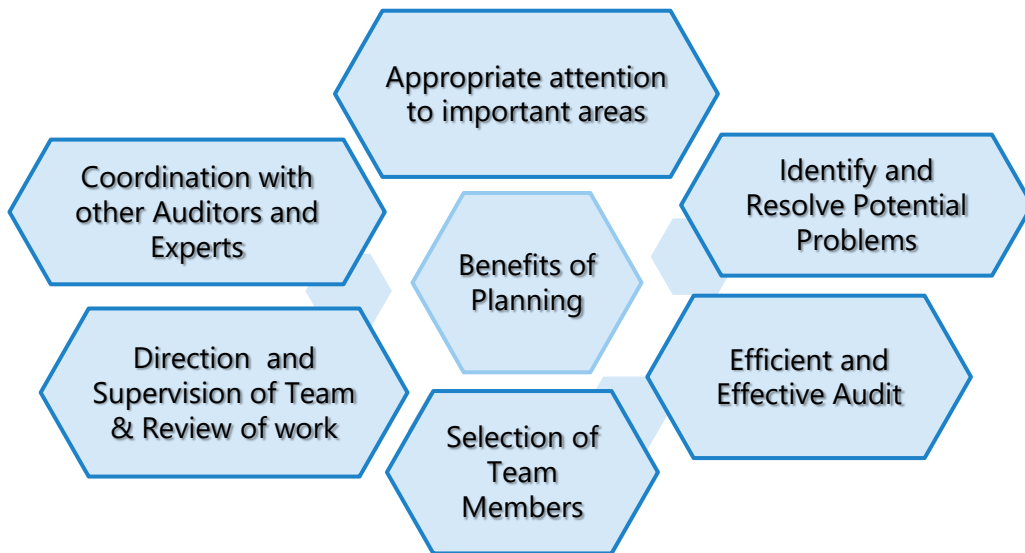
1.1 Why Planning an audit is necessary? - Its Benefits

Planning an audit is necessary to carry out it effectively in a timely manner. Besides ensuring compliance with professional standards, it helps in performing audit engagement effectively.

Adequate planning benefits the audit of financial statements in several ways, including the following: -

1. Helping the auditor to devote appropriate attention to important areas of the audit.
2. Helping the auditor identify and resolve potential problems on a timely basis.
3. Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
4. Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
5. Facilitating the direction and supervision of engagement team members and the review of their work.
6. Assisting, where applicable, in coordination of work done by others such as experts

Therefore, planning an audit ensures that audit risk is reduced to an acceptable low level. When audit work is adequately and properly planned, it reduces the risk of inappropriate opinion by the auditor.



1.2 Nature of Audit Planning- A Continuous and iterative process

Planning is not a discrete phase of an audit, but rather a continual and iterative process that 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, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as: -

1. The analytical procedures to be applied as risk assessment procedures.
2. Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
3. The determination of materiality.
4. The involvement of experts.
5. The performance of other risk assessment procedures.

Risk assessment procedures are audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error at the financial statement and assertion levels.

Therefore, planning includes consideration of matters such as obtaining knowledge about legal framework in which entity is operating. Consider for example- Telecom companies and Banks. Such entities operate in different legal and regulatory frameworks. TRAI (Telecom Regulatory Authority of India) and RBI (Reserve Bank of India) are regulators for telecom and banking industry respectively.

Planning also includes need to consider determination of material or significant matters. It also involves considering whether experts need to be involved taking into account complexity of business. Further, it also involves considering need to perform risk assessment procedures for identifying and assessing risks of material misstatement.

Planning is not a separate or distinct phase of an audit. It is to be viewed as a continual and repetitive process. It is a continuous process that begins with completion of previous audit and continues till the completion of current audit engagement.

Involvement of key engagement team members in planning audit

The engagement partner and other key members of the engagement team shall be involved in planning the audit including planning and participating in the discussion among engagement team members. The involvement of the engagement partner and other key members of the engagement team in planning the audit draws on their experience and insight, thereby enhancing the effectiveness and efficiency of the planning process.

Discussion of elements of planning with entity's management

The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement. When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit.



2. Planning Process- Elements of Planning

The elements of planning can be categorized as under: -

- (I) Preliminary engagement activities
- (II) Planning activities

(I) Preliminary engagement activities

The auditor considers whether relationship with client should be continued and whether ethical requirements including independence continue to be complied with. It includes: -

- (A) Performing procedures regarding the continuance of the client relationship
- (B) Evaluating compliance with ethical requirements, including independence
- (C) Establishing an understanding of terms of engagement

Preliminary engagement activities include the following: -

(A) Performing procedures regarding the Continuance of Client Relationships and Audit Engagements

Acceptance and Continuance of Client Relationships and Audit Engagements

It should be ensured that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed and that conclusions reached in this regard are appropriate.

The firm should obtain information considered 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.

Matters such as integrity of principal owners and key management, competence of engagement team to perform the audit engagement and implications of matters that have arisen during current and previous audit engagement may need to be considered.

Besides, in case of initial engagements, communication with predecessor auditor should be made, where there has been a change of auditors.

(B) Evaluating compliance with ethical requirements including independence

The auditor shall continuously evaluate compliance with ethical requirements including independence. "Independence" means that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him.

Throughout the audit engagement, the engagement partner shall remain alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team. If matters come to the engagement partner's attention that indicate that members of the engagement team have not complied with relevant ethical requirements, the engagement partner, in consultation with others in the firm, shall determine the appropriate action.

The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall: -

- (i) Obtain relevant information from the firm to identify and evaluate circumstances and relationships that create threats to independence
- (ii) 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
- (iii) 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.

Besides, consideration for client continuance and compliance with ethical requirements, preliminary engagements activities also include establishing an understanding of terms of engagement.

(C) Establishing an understanding of terms of engagement

It is in the interests of both the entity and the auditor that the auditor sends an audit engagement letter before the commencement of the audit to help avoid misunderstandings with respect to the audit. It ensures that there is no confusion with the client regarding terms of the engagement.

Performing preliminary engagement activities assists the auditor in identifying and evaluating events or circumstances that may affect auditor's ability to plan and perform audit engagement.

An overview of Preliminary engagement activities

Checkbox	What is included in Preliminary engagement activities?
✓	Performing procedures regarding the continuance of client relationship
✓	Evaluating Compliance with ethical requirements including independence
✓	Establishing an understanding of terms of engagement with the client to ensure there are no misunderstandings

(II) Planning activities

Planning activities involve: -

- [A] Establishing the overall audit strategy
- [B] Developing an audit plan

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

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

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

- (i) The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high-risk areas or the involvement of experts on complex matters
- (ii) 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 audit budget in hours to allocate to high risk areas
- (iii) When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates
- (iv) How such resources are 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

Factors to be taken into consideration by auditor for establishing audit strategy

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

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

It is important for auditor to identify scope of the engagement. Only a well identified scope can lead to establishment of a sound audit strategy. There are many characteristics of engagement defining its scope. Some of characteristics are as under: -

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

(b) *Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required.*

The ascertaining of reporting objectives of engagement helps the auditor to plan timing of different audit procedures and also nature of communications. Some of the instances are given under: -

- The entity's timetable for reporting
- Organization of meetings to discuss of nature, timing and extent of audit work with management
- Discussion with management regarding the expected type and timing of reports to be issued including the auditor's report
- Discussion with management regarding the expected communications on the status of audit work throughout the engagement.
- Expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.

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

The auditor needs to direct efforts of engagement team towards matters that in his professional judgment are significant. Preliminary identification of material classes of transactions, account balances and disclosures help auditor in establishing overall audit strategy. More energies need to be devoted to significant matters to obtain desired outcomes. Few examples are listed as under: -

- Volume of transactions which may determine whether it is more efficient for the auditor to rely on internal control
- Significant industry developments such as changes in industry regulations and new reporting requirements.

- Significant changes in the financial reporting framework, such as changes in accounting standards.
- Other significant relevant developments, such as changes in the legal environment affecting the entity.

(d) 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

Considering results of preliminary engagement activities and knowledge gained from similar engagements goes a long way in establishing sound audit strategy. Examples are listed as under: -

- Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified deficiencies and action taken to address them.
- The manner in which the auditor emphasizes to engagement team members the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence.

(e) Ascertain the nature, timing and extent of resources necessary to perform the engagement.

Selection of engagement team and assignment of audit work to team members is a significant factor in establishing overall audit strategy. Experienced team members may be assigned in areas where there is higher risk of material misstatement. Similarly, engagement budgeting and devotion of more time to areas of higher risk of material misstatement are to be kept in mind.

In establishing the overall audit strategy, the auditor shall:

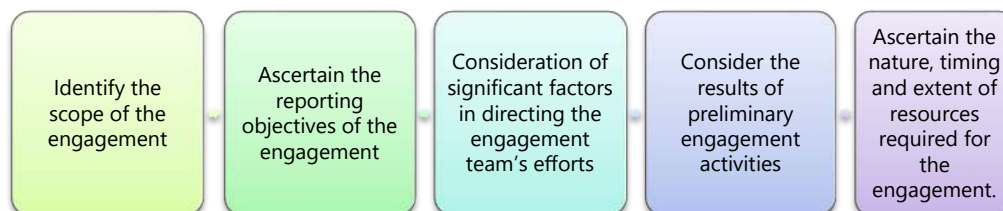


ILLUSTRATION 1

The auditor T of Hand Fab Ltd is worried as to management of key resources to be employed to conduct audit.

Required

How the audit strategy would be helpful to the auditor?

SOLUTION

Refer - **Establishing the overall audit strategy- Assistance for the auditor** for solution.

(B) Development of Audit plan

Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources.

Understanding client's business is one of the important principles in developing an audit plan. In fact, without adequate knowledge of client's business, a proper audit is not possible. Gaining knowledge of client's business is, therefore, one of the foremost requirements to develop audit plan.

SA 300 states that auditor shall develop an audit plan that shall include description of-

- (i) The **nature, timing and extent** of planned risk assessment procedures
- (ii) The **nature, timing and extent** of planned further audit procedures at assertion level
- (iii) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

The auditor plans what type of audit procedures are to be performed, their timing and how much work should be done taking into account sample size etc.

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.

For example, 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.



Test Your Understanding 1

MG & Co, a firm of auditors, having a standing of 30 years is appointed as a statutory auditor of company engaged in manufacturing of defence equipment. Due to opening of defence sector by government to private players in recent times, many new companies have entered the fray to manufacture sophisticated defence equipment. Considering technical and complex nature of operations, the auditors recognize that involvement of experts in the audit is required. Does consideration for involvement of experts by auditors fall in the domain of planning audit?

Test Your Understanding 2

CA Kartik is planning for audit of a company engaged in manufacturing of cosmetics. Considering nature of operations of the company, he had planned to include testing of controls of the company over purchases, sales and inventories. One fine day, he reaches the corporate office and asks for manuals and required documentation to ensure surprise element in testing. He had never shared with management his intention to carry out above procedures. Is approach of CA Kartik proper?

3. RELATIONSHIP BETWEEN AUDIT STRATEGY AND AUDIT PLAN

Audit strategy sets the broad overall approach to the audit whereas audit plan addresses the various matters identified in the overall audit strategy. Audit strategy determines scope, timing and direction of audit. Audit plan describes how strategy is going to be implemented. 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.

Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources.

The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.

4. OVERALL AUDIT STRATEGY AND THE AUDIT PLAN- THE AUDITOR'S RESPONSIBILITY

The overall audit strategy and the audit plan remain the auditor's responsibility. It is the auditor who is responsible for establishing overall audit strategy and developing audit plan. However, as discussed earlier, auditor may discuss elements of planning with entity's management without compromising effectiveness of audit.

ILLUSTRATION 2

W, the auditor of SKM Ltd. asks its finance and audit head to prepare audit strategy for conducting audit of SKM Ltd. W also insists him to draw detailed audit procedures. On the request of auditor W completes audit strategy as well as audit procedures as prepared by finance head of the company. Subsequently, auditor realizes that effectiveness of the audit is compromised and it was his responsibility to prepare the overall audit strategy. Comment.

SOLUTION

Refer - Overall audit strategy and the audit plan- The auditor's responsibility - Accordingly, approach of W was wrong and he should have prepared overall audit strategy and detailed audit procedures.

5. CHANGES TO PLANNING DECISIONS DURING THE COURSE OF AUDIT

The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures. For example, audit evidence obtained through on detailed checking may contradict the audit evidence obtained through testing internal controls.

6. PLANNING SUPERVISION AND REVIEW OF WORK OF ENGAGEMENT TEAM MEMBERS

The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including: -

1. The size and complexity of the entity.
2. The area of the audit.
3. The assessed risks of material misstatement
4. The capabilities and competence of the individual team members performing the audit work.

7. DOCUMENTATION

The auditor shall document: -

- (a) the overall audit strategy
- (b) the audit plan and
- (c) any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

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.

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. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

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.

Test Your Understanding 3

CA Mary, while planning audit of a company, feels that she would inquire from inhouse legal counsel of the company status of pending litigation matters against the company to identify and assess risks of material misstatements. Considering above description, are you able to identify said procedures? Where these identified procedures are included in planning in accordance with SA 300?

Test Your Understanding 4

CA Shubhendu is statutory auditor of a social media company. Due to change in information technology regulations by government, it has become mandatory for such companies to constitute "grievance redressal mechanism" for users of social media platform of the company. Failure to comply with regulations can potentially lead to civil and criminal liabilities against the company. Is above factor to be considered by auditor while framing audit strategy?

8. AUDIT PROGRAMME

It is desirable that in respect of each audit and more particularly for bigger audits, an audit programme should be drawn up. Audit programme is a list of examination and verification steps to be applied and set out in such a way that the interrelationship of one step to another is clearly shown and designed, keeping in view the assertions discernible in the statements of account produced for audit or on the basis of an appraisal of the accounting records of the client.

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

In other words, an audit programme is a detailed plan of applying the audit procedures in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives.

8.1 Evolving one audit programme- Not Practicable for All businesses

Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. On account of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable. However, it becomes a necessity to specify in detail in the audit programme the nature of work to be done so that no time will be wasted on matters not pertinent to the engagement and any special matter or any specific situation can be taken care of.

8.2 The Assistant to keep an open mind

To start with, an auditor having regard to the nature, size and composition of the business and the dependability of the internal control and the given scope of work, should frame a programme which should aim at providing for a minimum essential work which may be termed as a standard programme. As experience is gained by actually carrying out the work, the programme may be altered to take care of situations which were left out originally, but are found relevant for the particular concern. Similarly, if any work originally provided for proves beyond doubt to be unnecessary or irrelevant, it may be dropped. The assistant engaged in the job should be encouraged to keep an open mind beyond the programme given to him. He should be instructed to note and report significant matters coming to his notice, to his seniors or to the partners or proprietor of the firm engaged for doing the audit.

8.3 Periodic review of the audit programme

There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions. Unless this is done, any change in the business policy of the client may not be adequately known, and consequently, audit work may be carried on, on the basis of an obsolete programme and, for this negligence, the whole audit may be held as negligently conducted and the auditor may have to face legal consequences.

The utility of the audit programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed. However, as a basic feature, audit programme not only lists the tasks to be carried out but also contains a few relevant instructions, like the extent of checking, the sampling plan, etc. So long as the programme is not officially changed by the principal, every assistant deputed on the job should unfailingly carry out the detailed work according to the instructions governing the work. Many persons believe that this brings an element of rigidity in the audit programme. This is not true provided the periodic review is undertaken to keep the programme as up-to-date as possible and by encouraging the assistants on the job to observe all salient features of the various accounting functions of the client.

8.4 Constructing an audit programme

The audit planning ideally commences at the conclusion of the previous year's audit, and along with the related programme, it should be reconsidered for modification as the audit progresses. Such consideration is based on the auditor's review of the internal control, his preliminary evaluation thereof, and the results of his compliance and substantive procedures.

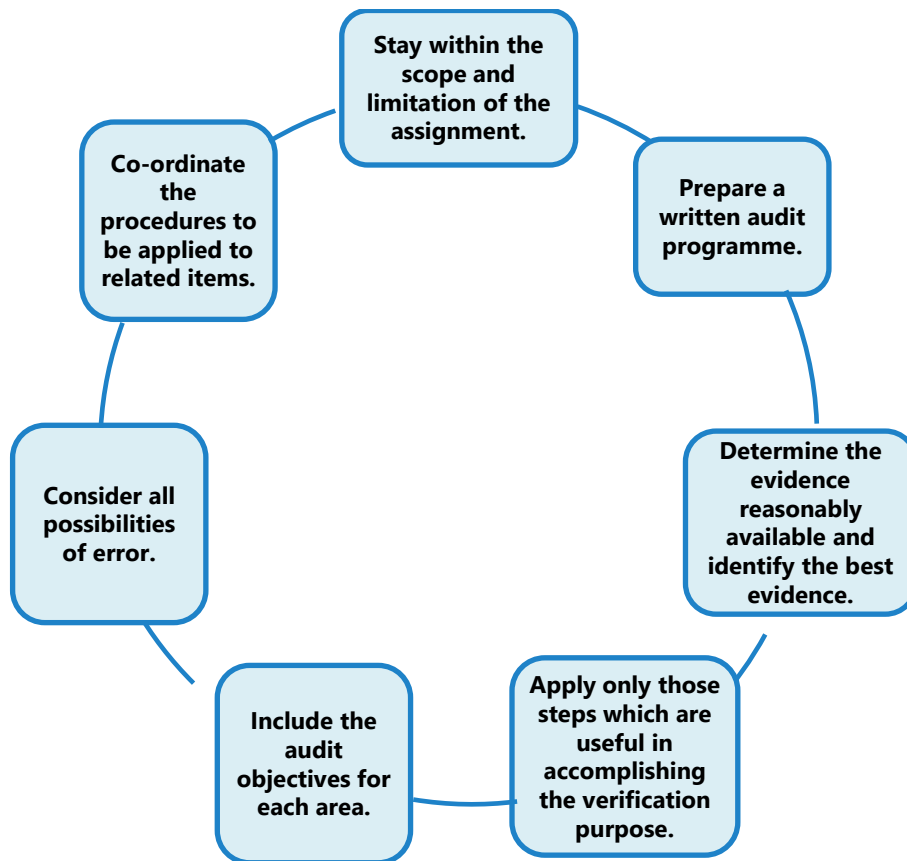
While developing an audit programme, the auditor may conclude that relying on certain internal controls is an effective and efficient way to conduct his audit. However, the auditor may decide not to rely on internal controls when there are other more efficient ways of obtaining sufficient appropriate audit evidence. The auditor should also consider the timing of the procedures, the coordination of any assistance expected from the client, the availability of assistants, and the involvement of other auditors or experts.

Further, the auditor normally has flexibility in deciding when to perform audit procedures. However, in some cases, the auditor may have no discretion as to timing, for example, when observing the taking of inventories by client personnel or verifying the securities and cash balances at the year-end.

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

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

- (2) Prepare a written audit programme setting forth the procedures that are needed to implement the audit plan.
- (3) Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.
- (4) Apply only those steps and procedures which are useful in accomplishing the verification purpose in the specific situation.
- (5) Include the audit objectives for each area and sufficient details which serve as a set of instructions for the assistants involved in audit and help in controlling the proper execution of the work.
- (6) Consider all possibilities of error.
- (7) Co-ordinate the procedures to be applied to related items.



8.5 Audit Programme- Designed to provide audit evidence

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

Evidence is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and techniques. What is best evidence for testing the accuracy of any assertion is a matter of expert knowledge and experience. This is the primary task before the auditor when he draws up the audit programme. Transactions are varied in nature and impact; procedures to be prescribed depend on prior knowledge of what evidence is reasonably available in respect of each transaction.

In most of the assertions much of the evidence be drawn and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion. In this process, an auditor would be in a position to identify the evidence that brings the highest satisfaction to him about the appropriateness or otherwise of the assertion.

An auditor picks up evidence from a variety of fields and it is generally of the following broad types:

- (a) Documentary examination
- (b) Physical examination
- (c) Statements and explanation of management, officials and employees
- (d) Statements and explanations of third parties
- (e) Arithmetical calculations by the auditor
- (f) State of internal controls and internal checks
- (g) Inter-relationship of the various accounting data
- (h) Subsidiary and memorandum records
- (i) Minutes
- (j) Subsequent action by the client and by others.

Example

1. For cash in hand, the best evidence is 'count'.
2. For investment pledged with a bank, the banker's certificate.
3. For verifying assertions about book debts, the client's ledger invoices, debit notes, credit notes, monthly accounts statement sent to the customers are all evidence: some of these are corroborative, other being complementary. In addition, balance confirmation procedure is often resorted to, to obtain greater satisfaction about the reliability of the assertion.

The auditor, however, has to place appropriate weight on each piece of evidence and accordingly should prescribe the priority of verification. It is true that in all cases one procedure may not bring the highest satisfaction and it may be dangerous for the auditor to ignore any evidence that is available. By the word "available", we do not mean that the evidence available with the client is the only available evidence. The auditor should know what normally should be available in the context of the transaction having regard to the circumstances and usage.

8.6 Advantages and disadvantages of an audit programme

The advantages of an audit programme are: -

- (a) It provides the assistant carrying out the audit with total and clear set of instructions of the work generally to be done.
- (b) It is essential, particularly for major audits, to provide a total perspective of the work to be performed.
- (c) Selection of assistants for the jobs on the basis of capability becomes easier when the work is rationally planned, defined and segregated.
- (d) Without a written and pre-determined programme, work is necessarily to be carried out on the basis of some 'mental' plan. In such a situation there is always a danger of ignoring or overlooking certain books and records. Under a properly framed programme, such danger is significantly less and the audit can proceed systematically.

- (e) The assistants, by putting their signature on programme, accept the responsibility for the work carried out by them individually and, if necessary, the work done may be traced back to the assistant.
- (f) The principal can control the progress of the various audits in hand by examination of audit programmes initiated by the assistants deputed to the jobs for completed work.
- (g) It serves as a guide for audits to be carried out in the succeeding year.
- (h) A properly drawn up audit programme serves as evidence in the event of any charge of negligence being brought against the auditor. It may be of considerable value in establishing that he exercised reasonable skill and care that was expected of professional auditor.

Some disadvantages are also there in the use of audit programmes but most of these can be removed by following some concrete steps.

The disadvantages are: -

- (a) The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.
- (b) The programme often tends to become rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on. Changes in staff or internal control may render precaution necessary at points different from those originally decided upon.
- (c) Inefficient assistants may take shelter behind the programme i.e., defend deficiencies in their work on the ground that no instruction in the matter is contained therein.
- (d) A hard and fast audit programme may kill the initiative of efficient and enterprising assistants.

All these disadvantages may be eliminated by imaginative supervision of the work carried on by the assistants; the auditor must have a receptive attitude as regards the assistants; the assistants should be encouraged to observe matters objectively and bring significant matters to the notice of supervisor/principal.

Test Your Understanding 5

Rohit, undergoing practical training, is part of an engagement team conducting audit of a company engaged in manufacturing of paints. He has been provided with audit programme pertaining to sales. It lists out various items to be checked and verified by him including invoices, rate lists, posting in debtors accounts, correlation of invoices with e-way bills on sample basis etc.

During verification, he notices that many e-way bills have been cancelled by the company within 24 hours of their generation in month of March. There is no specific instruction in audit programme in this regard. He keeps mum. Is attitude of Rohit proper?

Extract of Sample audit programme pertaining to sales of an entity

Name of concern	Fine Industries
Financial year	2025-26
Prepared by	P (with date)
Reviewed by	Q (with date)
Approved by	R (with date)

Serial number	Nature of Procedure	Extent of Check	Basis of sample	Done by
(a)	Vouch few sales invoices from copies available in record of the concern.			
(b)	Trace these invoices into the account books of the concern.			
(c)	Verify few invoices with e-way bills generated on the e- way bill portal.			
(d)	Trace few sales invoices into the stock records to ensure that sold quantities have been reduced from stocks.			
(e)	Trace also few sales invoices into accounts of buyers			

CASE STUDY

Kaur & Associates, a sole proprietor firm of Simran Kaur, is offered appointment as auditor of a company engaged in manufacturing of automobile components for the first time. She is fact checking about the integrity of promoters of the company and key managerial persons. Matters such as competence of staff to perform the engagement are also considered by her. The appointment is subsequently accepted by her.

She is also taking into account number and location of branches of the company, requirements of Schedule III of the Companies Act, 2013 and expected time by which audit has to be completed keeping in view statutory requirements. Initially, she has thought it proper to inquire key employees of the company in procurement and marketing departments and planned for the same. She has also planned to visit three plants of the company. The purpose of planned inquiry and visit is to identify and assess risk of material misstatements.

A detailed set of instructions has been prepared by her office and it has been handed over to assistants in engagement team. These set of instructions include details of extent of checking and nature of audit procedures to be performed regarding purchases, sales, items of income, items of expenditure etc. During the course of execution of above set of instructions, it has been brought to her notice that company is also producing substantial quantities of scrap generated during manufacturing process. However, no instructions have been given to engagement team in this regard.

Based on above, answer following questions:

1. Auditor is fact checking about promoters and key managerial persons. She is also considering competence of staff to perform engagement. What is she trying to do?
 - (a) She is establishing audit strategy.
 - (b) She is conducting preliminary engagement activities.
 - (c) She is designing audit plan.
 - (d) She is checking her compliance of ethical requirements.
2. Consideration of number and location of branches, requirements of financial reporting framework and expected time of completion are relevant factors primarily for which of the following -
 - (a) Developing audit plan

- (b) *Establishing overall audit strategy*
 - (c) *Designing audit programme*
 - (d) *Designing risk assessment procedures*
3. *Taking into account description of planned inquiry and visit, which of the following statements is TRUE?*
- (a) *Planned inquiry and visit fall in area of audit strategy.*
 - (b) *Planned inquiry and visit are planned risk assessment procedures and fall in field of audit plan.*
 - (c) *The said description is not related to audit planning.*
 - (d) *Planned inquiry and visit fall in scope of audit programme.*
4. *What is detailed set of instructions given to assistants in engagement team known as?*
- (a) *Audit guidelines*
 - (b) *Audit plan*
 - (c) *Audit Programme*
 - (d) *Audit Procedures*
5. *The issue of generation of scrap has been overlooked in detailed set of instructions given to engagement team. What should be proper course of action by CA Simran Kaur?*
- (a) *She should ignore this information as audit has already begun.*
 - (b) *She should modify earlier set of instructions.*
 - (c) *She should leave the matter to wisdom of engagement team.*
 - (d) *She should put the ball in court of management as she was not provided with complete information earlier.*

Answers to Questions involving case study

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

SUMMARY

- ◆ SA 300 states that objective of the auditor is to plan the audit so that it will be performed in an effective manner.
- ◆ Planning is not a discrete phase of an audit, but rather a continual and iterative process.
- ◆ Elements of planning include preliminary engagement activities and planning activities.
- ◆ Preliminary engagement activities include performing procedures regarding continuance of client relationship, evaluating compliance with ethical requirements including independence and establishing an understanding of terms of engagement with the client so that there are no misunderstandings.
- ◆ Planning activities include establishing overall audit strategy and developing audit plan.
- ◆ Audit strategy sets scope, timing and direction of audit.
- ◆ Audit plan addresses various matters identified in overall audit strategy.
- ◆ Audit plan includes nature, timing and extent of planned risk assessment procedures, planned further audit procedures and planned other audit procedures in accordance with SAs.
- ◆ The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.
- ◆ Overall audit strategy, audit plan and changes made shall be documented by auditor.
- ◆ An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given entity for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on financial statements.

For a concise revision of the key concepts covered in this chapter, students may refer to the Saransh Booklet for Paper 5: Auditing and Ethics, which serves as a useful last-mile revision resource for examination preparation. Saransh Booklet can be accessed at <https://resource.cdn.icai.org/85998bos-aps751-int-p5.pdf>

TEST YOUR KNOWLEDGE

MCQs based Questions

1. Which of the following is not considered in planning an audit generally?
 - (a) Understanding of legal and regulatory framework of an entity
 - (b) Need to consider determination of materiality
 - (c) Evaluating audit evidence
 - (d) Need to consider involvement of expert
2. Which of the following is true about audit plan?
 - (a) Once an audit plan has been finalized for an engagement, changes cannot be made to it.
 - (b) Audit plan includes scope, timing and direction of planned risk assessment procedures.
 - (c) Changes in audit plan cannot lead to change in audit strategy.
 - (d) Audit plan has to be documented by auditor.
3. Which of the following is not included in an audit programme normally?
 - (a) Extent of checking
 - (b) Date of checking
 - (c) Nature or type of procedure
 - (d) Planning of risk assessment procedures
4. Which of the following is not an advantage of an audit programme?
 - (a) It acts as a guide for audit of coming years.
 - (b) It fixes responsibility of assistants.
 - (c) It serves as a shelter for assistants.
 - (d) It serves a proof of work done by auditor.
5. Which of the following is most important principle for formulating an audit plan?
 - (a) Gaining knowledge of client's workforce
 - (b) Gaining knowledge of client's business
 - (c) Gaining knowledge of client's vendors
 - (d) Gaining knowledge of tax laws applicable to client

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

1. *The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.*
2. *Establishing an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan is prerogative of the management.*
3. *Planning is a discrete phase of an audit.*
4. *A detailed Audit Programme once prepared for a business can be used for all business under all circumstances.*
5. *The audit plan is more detailed than the overall audit strategy.*

Theoretical Questions

1. *AP & Co., Chartered Accountants, are appointed as statutory auditor of Heavy Industries Limited, a listed company engaged in manufacturing of electric vehicles, for the F.Y 2025-26. As per the recent guideline issued by the regulatory authority, every listed company is required to maintain the digital database of all those personnel who could access the books of the company to avoid Insider Trading. In case of non-compliance, hefty fines may be imposed on the company. CA P is the engagement partner from auditor firm for the audit of Heavy Industries Limited. During planning, CA P planned that he would inquire from in-house IT Head of the company about the maintenance of the digital database to identify and assess the risk of non-compliance with regulatory guidelines. In the light of above facts, explain:*
 - (i) *Whether CA P is required to consider about the maintenance of digital database while framing audit strategy?*
 - (ii) *Whether the procedures planned by CA P are in line with SA 300?*
2. *Discuss how an engagement partner ensures that firm complies with relevant ethical requirements including independence in relation to client.*

3. *"Purported disadvantages of an audit programme can be overcome". Do you agree?*
4. *An auditor of a company fails to document audit strategy and audit plan. Briefly outline consequences of such failure.*
5. *SA 300 states that auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. Discuss few factors affecting such supervision and review of work of engagement team members.*
6. *CA Krish is planning the audit of financial statements of Black and White Limited for financial year 2025-26 with the objective of conducting it in an effective manner. He also carried out the audit of the previous year and the audit report was issued in month of June 2025. He started planning the audit procedures to ensure an effective and efficient audit for the current year. He is assisted by Mr. Shiv, an articled assistant, in the audit planning process. During the planning discussions, Mr. Shiv raises a few queries regarding the audit planning stage. As a senior, help Mr. Shiv by resolving the following queries:*
 - (i) *When does the planning for an audit actually start and end?*
 - (ii) *Whether auditor can change planning decisions during the audit or not? If yes, what are those possible reasons.*
7. *Kiran Anupam & Associates, Chartered Accountants, are conducting statutory audit of ABC Ltd. for the F.Y 2025-26. During the audit, the engagement team decided to modify certain audit procedures due to introduction of new product range by the company and consequently unexpected changes in the company's internal control system. The audit manager instructed the team to update the documentation accordingly and to record the reasons for the modifications made.*

Explain key elements the auditor is required to document in relation to audit planning. State what is recorded and included in the documentation of the overall audit strategy and audit plan and their main purpose. Why is it important to document significant changes made to the audit strategy or audit plan?

8. *RST & Co., Chartered Accountants, have been the statutory auditors of Bright Vision Ltd., a company engaged in wholesale trading of electronic goods, for the last 6 years.*

During the financial year 2025–26, the company significantly changed its business model by:

- *Introducing online sales through its own e-commerce portal;*
- *Appointing multiple third-party warehouse operators across India;*
- *Implementing a new ERP system from October 2025; and*
- *Revising its credit policy by extending credit from 30 days to 90 days to boost sales.*

However, the audit team continued to follow the same audit programme that had been designed three years ago, which was primarily structured for a traditional wholesale model with centralised warehousing and manual accounting controls.

The engagement partner did not conduct any formal periodic review of the audit programme. The assistants carried out audit procedures strictly as per the existing programme without modifying the extent of checking, sampling plan, or procedures relating to inventory verification and receivables.

Subsequently, material misstatements were detected in revenue recognition and inventory records held with third-party warehouses. The management alleged that the auditor had conducted the audit negligently.

Discuss whether the auditor was justified in continuing with the old audit programme. What are the implications of not conducting periodic review of the audit programme?

9. *Mr. Nikhil is the engagement partner for Amazing Ltd., an e-commerce company, for the financial year 2025-26.*
- (i) *Mr. Nikhil plans to hold a discussion with the senior members of the audit team regarding the current assignment. However, Mr. Hardik, a newly joined article clerk, is surprised at the need for the engagement partner to discuss the audit plan with other team members. He questions why such discussions are necessary?*

- (ii) *Later, Mr. Hardik learns that Ms. Poornima, the audit manager, intends to discuss certain elements of the audit planning with the management of Amazing Ltd. He believes this is unnecessary, as sharing the audit plan with the client would remove the "surprise element" of audit procedures. Guide Mr. Hardik in relation to the above scenarios.*

10. *You are the Engagement Partner for the statutory audit of Strong Engineering Ltd. for FY 2025–26. While planning the audit, you observe the following practical issues:*

- (i) *Two newly recruited audit assistants inform you that they are unsure about the exact audit procedures expected from them for different areas of the audit.*
- (ii) *The audit this year is a major assignment involving multiple units, and your team seems unable to visualise the full scope of procedures to be performed.*
- (iii) *Because the audit work has not been formally planned, defined and segregated, you are unable to allocate tasks to assistants on the basis of their individual capabilities.*
- (iv) *Last year, in the absence of a written programme, the then audit team followed a "mental plan", as a result of which certain subsidiary records were overlooked.*
- (v) *During review, you notice that assistants have not signed off on procedures performed, making it difficult to trace work back to the responsible individual.*
- (vi) *As the principal auditor, you find it difficult to track the progress of different audit areas because no written audit programme has been initiated by assistants.*
- (vii) *Your firm wishes to use this year's audit documentation as a reference for planning next year's audit of Strong Engineering Ltd.*
- (viii) *The firm is also facing a negligence allegation on another audit, and you are concerned about having adequate evidence of exercising reasonable skill and care in this assignment.*

Based on above facts, analyse why preparing a written audit programme is advantageous for the audit of Strong Engineering Ltd.

11. *The assistant of CA K is assigned responsibility of drafting "audit programme" relating to purchases appearing in financial statements of "Broad Industries", a partnership firm. The said firm is a GST registered tax payer and is engaged in manufacturing of packing boxes from a special type of paper taxable under GST. Help him by drafting a sample audit programme for purchases.*
12. *M/s TP & Co., a firm of Chartered Accountants, has been conducting audit of KSR Ltd. since last 4 years. KSR Ltd. has diversified their business into newer areas during the last year. The senior member of the audit team handed over the standard audit programme of earlier years to the audit assistants and instructed them to follow the same. The assistants are conducting the audit accordingly. Whether the attitude of the audit assistants is justified? Guide them.*
13. *Subodh has recently joined an audit firm as an articled clerk. He was in process of assembling audit working papers in audit file of Cop Limited, as per the instructions of his senior. While assembling, he noticed following working paper in audit file: -*

Timing of Audit Activities

Activity	Expected Timing
Audit Planning	July 1, 2026 - July 5, 2026
Review by EQCR	July 6, 2026 - July 7, 2026
Audit Field Work	July 10, 2026- August 20, 2026
Review by Manager	August 21, 2026
Review by Engagement Partner	August 22, 2026 - August 25, 2026
Review by EQCR	August 26, 2026 - August 27, 2026
Response on Audit Memo	August 28, 2026
Review by Partners – internally post response on audit memo	August 29, 2026
Review by EQCR	August 30, 2026
Finalization of Audit Report and Financial Statements	September 01, 2026 - September 02, 2026
Issuance of Audit Report and Financial Statements	September 03, 2026

The above working paper lists certain factors which are considered by the auditor while establishing audit strategy. Explain how these considerations highlighted in above working paper could have helped the auditor?

14. *M/s YZW & Co., Chartered Accountants, have been appointed as the statutory auditors of First Health Private Limited for the financial year 2025-26. CA Y is the engagement partner for this assignment. First Health Private Limited operates in the business of hospitals and pharmaceuticals, with 60 hospitals and 200 pharmacy stores across the country. The company has a turnover of ` 680 crores and PAT of ` 32 crores in the current year.*

While verifying the assertions about book debts, CA Y was informed about the availability of the client's ledger invoices, debit notes, and credit notes as audit evidence. CA Y accepts these documents as audit evidence, considering them to be "available."

- (i) Is this decision correct, based on the meaning of the term "available"?*
- (ii) Also, explain how an auditor should select the most appropriate evidence when testing the accuracy of any assertion to form an opinion.*

ANSWERS/SOLUTIONS

Answers to the MCQs based Questions

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

Answers to Correct/Incorrect

1. **Correct:** Once the overall audit strategy has been established, an audit plan can be developed to achieve the audit objectives through the efficient use of the auditor's resources. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.
2. **Incorrect.** 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.

3. **Incorrect.** Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begin shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures.
4. **Incorrect.** Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. On account of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable.
5. **Correct.** 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.

Answers to the Theoretical Questions

1. As per SA 300, "Planning an Audit of Financial Statements", the auditor should 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 process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, key resources to be employed to conduct audit.

The auditor shall take following factors into consideration while establishing or framing audit strategy viz. identify the characteristics of the engagement that define its scope, consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts, etc.

In the given situation, the regulatory guideline requires Heavy Industries Ltd., a listed company, to maintain a digital database of all those personnel who could access the company's books to prevent insider trading. Further, hefty fines may be imposed in case of non-compliance with this guideline. Therefore, it is very essential that auditor while establishing overall audit

strategy evaluate whether the company maintains such a database and complies with the regulatory requirement.

Thus, in view of above, it can be concluded that CA P should incorporate the assessment of digital database maintenance into the overall audit strategy.

2. Refer to point on evaluating compliance with ethical requirements including independence.
3. Purported disadvantages of audit programme may be eliminated by imaginative supervision of the work carried on by the assistants; the auditor must have a receptive attitude as regards the assistants; the assistants should be encouraged to observe matters objectively and bring significant matters to the notice of supervisor/principal.
4. Refer to point on documentation
5. Refer to point on Planning supervision and review of work of engagement team members
6. (i) Planning is not a discrete phase of an audit, but rather a continual and iterative process that begins shortly after the completion of the previous audit and continues until the completion of the current audit engagement.

In the given situation, planning of the audit of financial statements for the year 2024-25 would have commenced right after completion of audit of preceding year in June 2024. It would have continued till completion of audit of year 2024-25.

- (ii) The auditor shall update and change the overall audit strategy and the audit plan as necessary during the audit. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures. For example, audit evidence obtained through on detailed checking may contradict the audit evidence obtained through testing internal controls.

7. 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.

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.

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. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

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.

8. There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions. Unless this is done, any change in the business policy of the client may not be adequately known, and consequently, audit work may be carried on, on the basis of an obsolete programme and, for this negligence, the whole audit may be held as negligently conducted and the auditor may have to face legal consequences.

In the given case, Bright Vision Ltd. introduced significant changes in its operations, such as online sales, third-party warehouses, implementation of a new ERP system, and extended credit terms. These changes directly

impacted revenue recognition, inventory control, receivables management, and internal controls. However, the audit firm failed to revise or review the existing audit programme and continued to apply procedures designed for a traditional wholesale model.

The utility of the audit programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed. Since no review was undertaken, the audit procedures became outdated and inadequate to address the changed risk environment.

Although assistants are required to strictly follow the audit programme as approved by the principal, the responsibility to update and revise the programme lies with the auditor. The argument that adherence to a fixed programme creates rigidity is not valid, provided periodic review is undertaken and assistants are encouraged to observe and report significant changes in the client's accounting functions.

The auditor was not justified in continuing with the obsolete audit programme without periodic review. Failure to revise the audit programme in light of significant business and control changes amounts to negligence, and the auditor may be held responsible for inadequately conducted audit and consequent legal implications.

- 9. (i)** As per SA 300 "Planning an audit of financial statements", the engagement partner and other key members of the engagement team shall be involved in planning the audit including planning and participating in the discussion among engagement team members. The involvement of the engagement partner and other key members of the engagement team in planning the audit draws on their experience and insight, thereby enhancing the effectiveness and efficiency of the planning process.

Therefore, Mr. Hardik's doubt is not justified, as SA 300 requires discussion of the audit plan with senior engagement team members to utilize their experience and professional judgment, thereby enhancing the effectiveness of audit planning.

- (ii) As per SA 300, the auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement. When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit.

Thus, Mr. Hardik's belief is incorrect, since SA 300 permits discussion of relevant elements of audit planning with management to facilitate coordination, provided care is taken not to compromise the effectiveness of audit procedures or the element of unpredictability.

- 10.** In the present case, the absence of a written audit programme has led to confusion among assistants, ineffective supervision, omission of records and lack of documentary evidence. These issues clearly establish the importance and advantages of preparing a written audit programme. The advantages in the present case may be analysed as follows:

- (i) Clear instructions to assistants: The newly recruited assistants are unsure about the audit steps. A written audit programme provides detailed, written instructions regarding the nature, timing and extent of audit procedures regarding the work to be performed.
- (ii) Providing a total perspective for a major audit: The current audit is a major, multi-unit assignment. A properly drafted programme gives the team a complete perspective of all audit procedures required.
- (iii) Easier selection of assistants based on capability: You find it difficult to allocate work because tasks are not defined. Once the work is rationally planned, defined and segregated, assistants can be assigned roles more effectively depending on their capability.
- (iv) Reduces risk of overlooking books/records: Last year some subsidiary records were overlooked due to reliance on a mental plan.

A written and predetermined programme ensures systematic and comprehensive coverage of all books and records and ensures systematic coverage.

- (v) Fixation of responsibility through sign-offs: Absence of signatures prevents linking work to individuals. A written programme allows each assistant to sign off, accepting responsibility for work done.

- (vi) Enables control and monitoring by the principal: You are unable to track progress without a written programme. When assistants initiate and follow the programme, the principal can control and monitor the audit progress effectively.
- (vii) Serves as a guide for next year's audit: The firm wants to use this year's work as reference for next year's planning.

A properly drafted programme acts as a useful guide for future audits.

- (viii) Provides evidence against negligence allegations: Since the firm faces negligence allegations elsewhere, proper documentation is critical.

A well-constructed programme provides evidence that the auditor exercised reasonable skill and care.

Considering all facts, preparing a written, structured audit programme will address each challenge directly, enhance audit efficiency, improve accountability, and provide strong defence evidence in case of negligence allegations. Therefore, adopting a comprehensive audit programme is clearly advantageous for the audit of Strong Engineering Ltd.

11. Sample audit programme pertaining to purchases

Name of Concern : Broad Industries

Financial Year : 20XX-XX

Prepared by : Name of person with date

Reviewed by : Name of person with date

Approved by : Name of person with date

S. No.	Nature of Procedure	Extent of Check	Basis of Sample	Done by
(a)	Vouch few purchase invoices of paper from purchase records of concern.			
(b)	Trace these invoices into account books of concern.			
(c)	Verify few purchase invoices of paper on GST portal.			

(d)	Trace few purchase invoices of paper in stock records to ensure that these have been added to stocks of raw material.			

12. In the given situation, the senior member of the audit team handed over the standard audit programme of earlier years to the audit assistants and instructed them to follow the same. The assistant to keep an open mind as follows:

- To start with, an auditor having regard to the nature, size and composition of the business and the dependability of the internal control and the given scope of work, should frame a programme which should aim at providing for a minimum essential work which may be termed as a standard programme.
- As experience is gained by actually carrying out the work, the programme may be altered to take care of situations which were left out originally but are found relevant for the particular concern.
- Similarly, if any work originally provided for proves beyond doubt to be unnecessary or irrelevant, it may be dropped.
- The assistant engaged in the job should be encouraged to keep an open mind beyond the programme given to him. He should be instructed to note and report significant matters coming to his notice, to his seniors or to the partners or proprietor of the firm engaged for doing the audit.

Thus, the attitude of assistants of TP & Co. is not justified. They should keep an open mind and go beyond the programme to take care of newer areas of the business of KSR Ltd. into which the Company has diversified.

13. 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. One of the factors to be taken into consideration while establishing audit strategy relates to ascertaining of reporting objectives of engagement to plan the timing of the audit and the nature of the communications required. Some of the instances are given under:

- The entity's timetable for reporting

- Organization of meetings to discuss of nature, timing and extent of audit work with management
- Discussion with management regarding the expected type and timing of reports to be issued including the auditor's report
- Discussion with management regarding the expected communications on the status of audit work throughout the engagement.
- Expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.

In the given case, working paper highlights that auditor has taken into account expected timelines to plan the audit and nature of the communications required. Since the working paper relates to the statutory audit of a company, the ascertaining of reporting objectives of engagement helps the auditor to plan timing of different audit procedures and also nature of communications.

- 14. (i)** In the given situation, M/s YZW & Co., Chartered Accountants, have been appointed as statutory auditor of First Health Private Limited which operates in business of hospitals and pharmaceuticals, with 60 hospitals and 200 pharmacy stores across the country. CA. Y, the engagement partner for this assignment, was informed about the availability of the client's ledger invoices, debit notes, credit notes as audit evidence. He accepted these documents as audit evidence, considering them to be "available". For verifying assertions about book debts, the client's ledger invoices, debit notes, credit notes, monthly accounts statement sent to the customers are all evidence: some of these are corroborative, other being complementary. In addition, balance confirmation procedure is often resorted to obtain greater satisfaction about the reliability of the assertion.

The word "available", does not mean that the evidence available with the client is the only available evidence. The auditor should know what normally should be available in the context of the transaction having regard to the circumstances and usage.

In view of the above, it can be concluded that decision of CA. Y to consider clients' ledger invoices, debit notes, credit notes as audit evidence, considering them to be available, is not correct.

- (ii) Evidence is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and techniques. What is best evidence for testing the accuracy of any assertion is a matter of expert knowledge and experience. Transactions are varied in nature and impact; procedures to be prescribed depend on prior knowledge of what evidence is reasonably available in respect of each transaction.

In most of the assertions much of the evidence be drawn and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion. In this process, an auditor would be in a position to identify the evidence that brings the highest satisfaction to him about the appropriateness or otherwise of the assertion.

An auditor picks up evidence from a variety of fields and it is generally of the following broad types:

- (i) Documentary examination
- (ii) Physical examination
- (iii) Statements and explanation of management, officials and employees
- (iv) Statements and explanations of third parties
- (v) Arithmetical calculations by the auditor
- (vi) State of internal controls and internal checks
- (vii) Inter-relationship of the various accounting data
- (viii) Subsidiary and memorandum records
- (ix) Minutes
- (x) Subsequent action by the client and by others.

Answers to Questions involving Test Your Understanding

- 1.** Consideration for involvement of experts by auditors falls within domain of planning. While planning an audit, auditor would have to consider whether involvement of experts is necessary. In the stated case, company is involved in technical and complex operations. Therefore, while planning an audit, auditors would have to consider whether involvement of expert is necessary.
- 2.** In the case, CA Kartik has reached office of the company without sharing with management his intention to test the controls. The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement without compromising effectiveness of audit. Sharing details of visit to test controls does not compromise effectiveness of audit. It is for the better facilitation and conduct of audit. Therefore, approach of CA Kartik is not proper.
- 3.** These are planned risk assessment procedures to identify and assess risk of material misstatement. The objective of planned inquiry of inhouse legal counsel is to identify and assess risk of material misstatement. Such planned risk assessment procedures are included in audit plan in accordance with SA 300.
- 4.** Changes in laws and regulations affecting the company is a factor to be considered while establishing overall audit strategy. There has been change in information technology regulations applicable to the company. Non-compliance of the same can have implications in form of civil and criminal liabilities. Such an important matter concerning changes in laws and regulations is to be considered by auditor while establishing overall audit strategy.
- 5.** Attitude of Rohit is not proper. The assistants should observe matters objectively and bring significant matters to the notice of supervisor/principal. Reasons for cancellation of many e-way bills in month of March need to be looked into. Matter should be informed to engagement partner.

RISK ASSESSMENT AND INTERNAL CONTROL

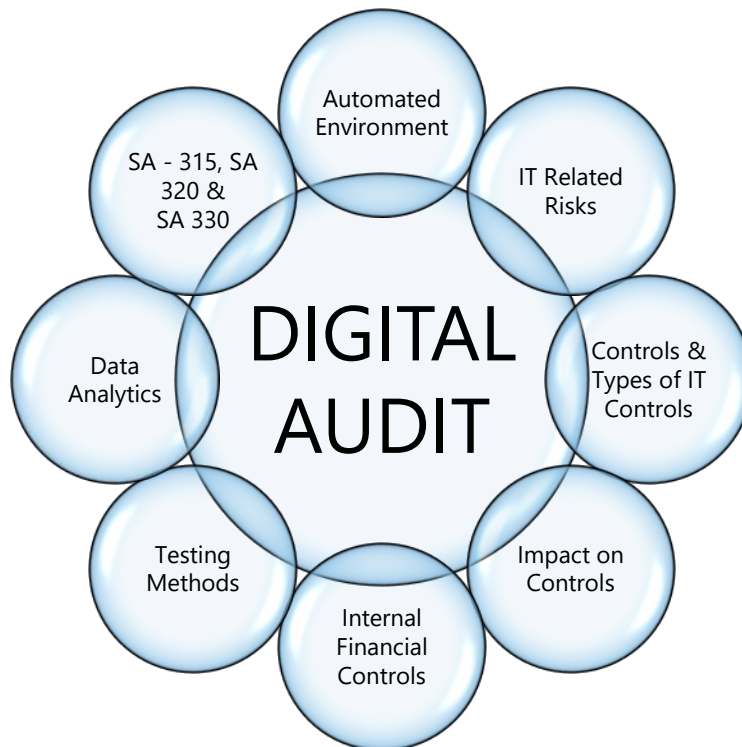
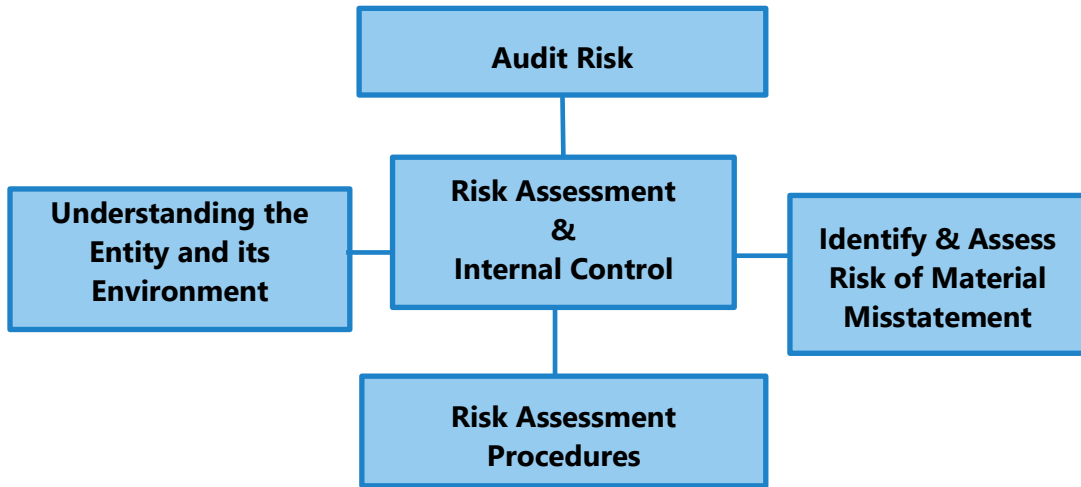


LEARNING OUTCOMES

After studying this chapter, you would be able to understand-

- ◆ Meaning of audit risk and variables affecting it.
- ◆ Risk assessment procedures.
- ◆ Concept of materiality in planning and performing an audit.
- ◆ Importance of understanding the entity and its environment.
- ◆ Meaning, objectives, benefits and limitations of internal control.
- ◆ Components of internal control.
- ◆ Whether all the controls are relevant to an audit.
- ◆ Nature and Extent of the Understanding of Relevant Controls.
- ◆ Risks that require special audit consideration.
- ◆ Evaluation of Internal control system-Benefits and methods.
- ◆ Testing of internal control.
- ◆ Automated environments-its key features.
- ◆ Risks arising from use of IT Systems.
- ◆ Types of Controls in an automated environment.
- ◆ Importance of data analytics for audit.
- ◆ Internal financial controls as per regulatory requirements.
- ◆ Auditor's responses to assessed risks.
- ◆ Practicality of above concepts by studying through examples and case studies.

CHAPTER OVERVIEW



Sameer had now subscribed to online subscription of a pink newspaper using his android phone. He was getting regular news updates pertaining to financial matters of companies. While going through such updates, he stumbled upon one report relating to audited accounts of a listed company. Scrolling the same, he gathered that SEBI had referred the matter to regulator for further action.

He was flummoxed. He had learnt that audit is carried out after proper planning and performing audit procedures. However, the news report was hinting at possibility of inappropriate opinion expressed by the auditor. Was it a single odd case? Or is there a chance of inappropriate opinion being expressed by an auditor when there are significant wrong doings in financial statements in every audit? What is this risk known as? What causes presence of this risk? Can't it be eliminated completely? How this risk can be addressed? He needed answers to such questions.

It was clear to him that a meaningful and effective audit is possible only after gaining knowledge about client's business. What are the specifics about it? It cannot be limited merely to understanding about nature of client's business. Apart from this, it must include a study and evaluation of client's systems and controls. What system has been devised and put into operation by the client to carry out its business efficiently and effectively? How the client is ensuring reliability of financial reporting? All these questions should be important to an auditor.

Whether gaining knowledge of client's systems and controls is enough? Shouldn't it be followed up with actual testing of client's controls? It is only when controls are actually tested, these can be relied upon. A thought was gaining in his mind how auditor responds to the risks. Is testing of controls enough or something more to be done?

He already knew how actively business entities are using technology to develop their systems with minimal human intervention. Shouldn't use of technology ease up the things? Can use of technology also involve risks which may be relevant to an auditor so that he doesn't give an inappropriate opinion? To satiate his mind, he turned to Chapter 3.



1. AUDIT RISK

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

It means that an auditor expresses an unmodified opinion when financial statements are materially misstated. In such a case, not only reputation of auditor would be damaged, but he could also invite regulatory action from professional body and could face probable legal action by intended users.

For Example : a company intentionally records fictitious sales of ₹20 crore at year-end to inflate its profits and show better financial performance. As a result:

- Revenue is overstated,
- Debtors are overstated, and
- Profit shown in the financial statements is materially higher than the actual profit.

During the audit, the auditor fails to detect these fake sales because:

- confirmations from customers were not properly obtained,
- supporting documents were not adequately verified, or
- audit procedures were insufficient.

Consequently, the auditor issues an unmodified audit opinion stating that the financial statements give a true and fair view.

Later, it is discovered that the sales were fictitious and the financial statements were materially misstated. In this situation, the auditor has faced **audit risk**, because an inappropriate audit opinion was expressed on materially misstated financial statements.

To avoid such unpleasant consequences, the auditor will plan and perform the audit in such a way that audit risk is reduced to an acceptably low level. SA-200 states that the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.

Thus, audit risk is the risk that the auditor expresses an unmodified opinion even though the financial statements are materially misstated.

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

1.1 Risks of material misstatement

SA 200 states that risk of material statement is the risk that the financial statements are materially misstated prior to audit. It simply means that **there is a probability of frauds or errors in financial statements before audit.**

What is meant by misstatement?

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

Few examples of misstatements could be: -

- ❑ Charging of an item of capital expenditure to revenue or vice-versa
- ❑ Difference in disclosure of a financial statement item vis-à-vis its requirement in applicable financial reporting framework
- ❑ Selection or application of inappropriate accounting policies
- ❑ Difference in accounting estimate of a financial statement item vis-à-vis its appropriateness in applicable financial reporting framework
- ❑ Intentional booking of fake expenses in statement of profit and loss
- ❑ Overstating of receivables in financial statements by not writing off irrecoverable debts
- ❑ Overstating or understating inventories

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

- (i) The overall financial statement level
- (ii) The assertion level for classes of transactions, account balances, and disclosures.

Risks of material misstatement at the overall financial statement level are those risks which affect the financial statements as a whole and are not restricted to any particular account balance, class of transaction, or disclosure. These risks are pervasive in nature because they have the potential to influence several assertions

simultaneously and may undermine the reliability of the overall financial reporting process.

Such risks generally arise due to weaknesses in the entity's control environment, adverse business conditions, management attitude, or fundamental deficiencies in the accounting system.

The auditor evaluates whether circumstances exist indicating that the financial statements as a whole may be susceptible to material misstatement. These circumstances may include weak governance structure, poor ethical culture within the organization, ineffective internal controls, dominance of management, incompetent accounting personnel, financial distress, possibility of management override of controls, rapid expansion or restructuring of business operations, or deficiencies in IT systems affecting multiple areas of accounting and reporting.

Where the auditor identifies such pervasive risks, broad overall responses are required at the engagement level. The auditor may assign more experienced staff to the engagement, increase the degree of professional skepticism, and provide greater supervision and review of audit work. Further, the auditor may perform more unpredictable audit procedures, modify the nature, timing, and extent of audit procedures, and carefully evaluate the reliability of management representations. These responses are designed to reduce the possibility that material misstatements affecting the financial statements as a whole remain undetected.

For example, XYZ Ltd. is managed entirely by a dominant promoter-director, there is no effective internal audit system, accounting staff changes frequently, and reconciliations are not performed on a timely basis. In such a case, the auditor may conclude that there exists a risk of material misstatement at the overall financial statement level because weaknesses in the control environment can affect numerous areas including revenue, expenses, assets, liabilities, and disclosures. Consequently, the reliability of the entire financial reporting process becomes doubtful. In response, the auditor may increase substantive testing, reduce reliance on internal controls, deploy senior audit personnel, and perform extensive analytical procedures and verification.

Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to

express an opinion on the financial statements at an acceptably low level of audit risk.

It relates to specific assertions concerning classes of transactions, account balances, and disclosures appearing in the financial statements. Unlike risks at the overall financial statement level, these risks are focused on particular items or assertions. The auditor assesses such risks because audit procedures are ultimately designed and performed assertion-wise. Therefore, identification of assertion-level risks helps the auditor determine where misstatements are likely to occur and what audit procedures are necessary to address them.

Assertion level risk refers to the possibility that a particular assertion relating to a specific transaction, account balance, or disclosure may be materially misstated. The auditor assesses these risks in order to determine the appropriate nature, timing, and extent of further audit procedures. Such assessment enables the auditor to obtain sufficient appropriate audit evidence and ultimately express an audit opinion at an acceptably low level of audit risk.

For example, a technology company may hold large quantities of electronic components that become obsolete very quickly due to rapid technological changes. In such a case, there is a risk that inventory may be valued at amounts higher than its net realizable value. The assertion affected here is the valuation assertion. To address this risk, the auditor may review inventory ageing analysis, compare cost with net realizable value, inspect obsolete or slow-moving items, and examine post year-end sales to verify actual realizable values.

1.2 Components of risk of material misstatement

The risk of material misstatement at assertion level comprises of two components i.e., inherent risk and control risk. Both inherent risk and control risk are the entity's risks and they exist independently of the audit of financial statements. Inherent risk and control risk are influenced by the client. These are entity's risks and are not influenced by the auditor.

1.2A Inherent risk

Inherent risk is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements before consideration of any related controls as described in SA-200.

Inherent risk refers to the possibility that an item in the financial statements may be materially misstated due to its very nature, complexity, degree of judgment involved, or surrounding business circumstances, even before considering the existence of internal controls. Certain transactions, balances, and disclosures are naturally more susceptible to error or fraud than others. **For instance**, cash is highly susceptible to theft, complex derivative instruments are prone to valuation errors, and accounting estimates involving management judgment are vulnerable to bias and manipulation. Thus, inherent risk exists because some areas of accounting are naturally more uncertain or complicated than others.

The nature of the industry significantly affects inherent risk. Certain industries inherently involve higher uncertainty and estimation. **For example**, a pharmaceutical company engaged in development of new drugs faces uncertainty relating to research expenditure, patent valuation, and regulatory approvals. Due to these uncertainties, valuation of intangible assets in such industries carries high inherent risk.

Inherent risk is also high in relation to assets that are susceptible to fraud or theft. Assets such as cash, precious metals, and easily saleable inventories are more vulnerable to misappropriation and manipulation. Therefore, these items naturally possess a greater risk of material misstatement even before considering the effectiveness of internal controls.

Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations.

Inherent risk factors are considered while designing tests of controls and substantive procedures. Category of auditor's assessment lower or higher, each category covers a range of degrees of inherent risk. Auditor may assess the inherent risk of two different assertions as lower while recognizing that one assertion has less inherent risk than the other, although both have been assessed as lower.

It is important to consider the reason for each identified inherent risk even if the risk is lower, when auditor designs tests of controls and substantive procedures.

External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete. Factors in the entity and its environment may also influence the inherent risk related to a specific assertion.

Few examples of inherent risks could include: -

- An accounting standard provides guidance on some complex issue which might not be understood by the management. Therefore, recording of this issue in financial statements carries inherent risk of being misstated.
- There are large number of business failures in an industry. Therefore, assertions in financial statements of an entity operating in such an industry carry an inherent risk of being misstated.

1.2B Control risk

In accordance with SA-200, control risk is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Control risk is a risk that internal control existing and operating in an entity would not be efficient enough to stop from happening, or find and then rectify in an appropriate time, any material misstatement relating to a transaction, balance of an account or disclosure required to be made in the financial statements of that entity. Therefore, in a way, it can be said that there exists an inverse relation between control risk and efficiency of internal control of an entity. When efficiency of internal control of an entity is high, the control risk is low and when efficiency of internal control of that entity is low, the control risk is high.

Examples of control risk could include: -

- A company has devised control that cash and cheque books should be kept in a locked safe and access is granted to authorized personnel only. There is risk that control is not being followed.
- An entity has devised a control that fire extinguishers and smoke detectors are in place and are in working condition at all times to reduce the risk of damage to inventories caused by fire. There is a risk that fire extinguishers in place are expired and are not being refilled. Similarly, there is a possibility that smoke detectors are not working.
- A company has devised a control relating to petty cash that items of expenditure of only less than ₹ 10000 should be routed through imprest system of petty cash. There is a risk that control is not being followed.

1.3 Detection risk

SA 200 defines detection risk as the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

For example, auditor of a company uses certain audit procedures for the purpose of obtaining audit evidence and reducing audit risk, but still there will remain a risk that audit procedures used by the auditor may not be able to detect a misstatement which by nature is material, then that risk is known as detection Risk.

Detection risk comprises sampling and non-sampling risk.

- ❑ **Sampling risk** is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. It simply means that the sample was not representative of the population from which it was chosen.
- ❑ **Non-sampling risk** is the risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. Like an auditor may reach an erroneous conclusion due to application to some inappropriate audit procedure.

Examples of detection risk could include: -

- ❑ Sizeable work-in-progress inventories are expected in financial statements of a company. However, auditor of the company does not devote time to attending inventory count. Instead, he chooses to rely upon alternative audit procedures.
- ❑ The auditor of a company has audited revenue of a company by taking a sample. However, there is a risk that sample of revenue is not representative of overall revenue.

The auditor can only influence detection risk. Inherent risk and control risk belong to the entity and are influenced by the entity. Therefore, auditor must reduce detection risk in order to keep audit risk at low level. **Detection risk may be reduced by increasing area of checking, testing larger samples and by including competent and experienced persons in the engagement team.**

1.4 Audit risk-What is not included?

Audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

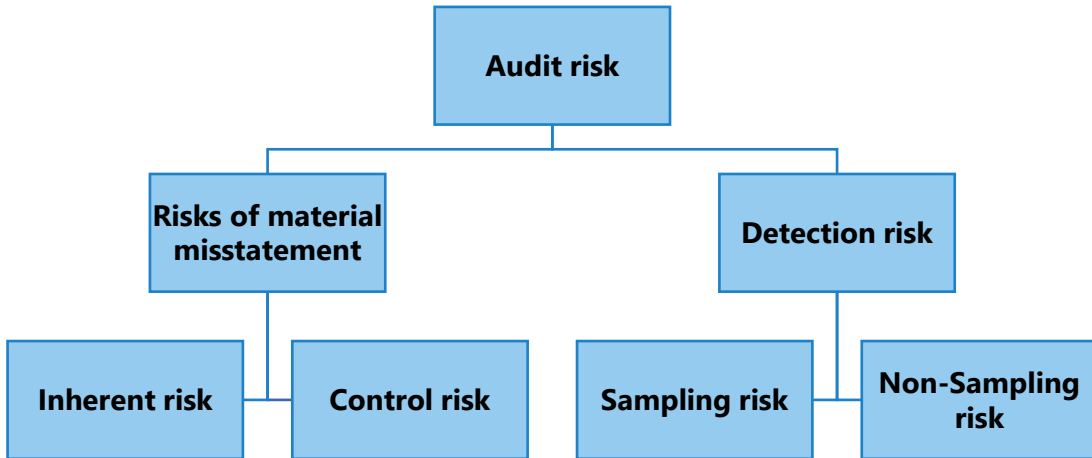
For purposes of the SAs, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant.

1.5 Assessment of risks- A matter of professional Judgment

As discussed at the outset, audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement. The distinguishing feature of the professional judgment expected of an auditor is that it is exercised by an auditor whose training, knowledge and experience have assisted in developing the necessary competencies to achieve reasonable judgments.

An Overview of Audit risk

Checkbox	Audit risk- What is included?
✓	Audit risk is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated.
✓	A function of risks of material misstatement and detection risk.
X	Auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.
X	Risk that the auditor might express an opinion that the financial statements are materially misstated when they are not.



1.5.1 Combined Assessment of the Risk of Material Misstatement

Standards on auditing do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risks of material misstatement”. However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

It can be concluded from the above that: -

$$\text{Audit risk} = \text{Risks of material misstatement} \times \text{Detection risk}$$

Since risks of material misstatement is a function of inherent risk and control risk, it can also be shown as: -

$$\text{Audit risk} = \text{Inherent risk} \times \text{Control risk} \times \text{Detection risk}$$

ILLUSTRATION 1

XYZ Ltd is engaged in the business and running several stores dealing in variety of items such as ready made garments for all seasons, shoes, gift items, watches etc. There

are security tags on each and every item. Moreover, inventory records are physically verified on monthly basis.

Discuss the types of inherent, control and detection risks as perceived by the auditor.

SOLUTION

Inherent Risk: Because items may have been misappropriated by employees, therefore, risk to the auditor is that inventory records would be inaccurate.

Control Risk: There is a security tag on each item displayed. Moreover, inventory records are physically verified on monthly basis. Despite various controls being implemented at the stores, still collusion among employees may be there and risk to auditor would again be that inventory records would be inaccurate.

Detection Risk: Auditor checks the efficiency and effectiveness of various control systems in place. He would do that by making observation, inspection, enquiry, etc. In addition to these, the auditor would also employ sampling techniques to check few sales transactions from beginning to end. However, despite all these procedures, the auditor may not detect the items which have been stolen or misappropriated.

ILLUSTRATION 2

A Partnership Firm of Chartered Accountants HT and Associates was appointed to audit the books of accounts of Wind and Ice Limited for the financial year 2025-26. There was a risk that HT and Associates would give an inappropriate audit opinion if the financial statements of Wind and Ice Limited are materially misstated. State the Risk mentioned in the question.

SOLUTION

The risk mentioned in the question is known as Audit Risk, because risk that auditor of a company will give an inappropriate audit opinion if the financial statements of that company are materially misstated is known as Audit Risk.

Test Your Understanding 1

Wear & Tear Private Limited is a “start-up” engaged in providing holistic solutions to problem of paddy stubble burning mainly catering to needs of farmers of North western India. Due to importance given by governments to this issue, companies have entered in the market in past few years. Many of these companies have not been successful and have gone bust. As an auditor of the company, can you spot the component of risks of material misstatement involved in above?

Test Your Understanding 2

A company has devised a control that its inventory of perishable goods is stored in appropriate conditions- in a controlled environment to prevent any damages to inventory. Responsibility is fixed on two persons to monitor environment using sensors and to report on deviations. Identify the component of risks of material misstatement involved as an auditor of the company.

Test Your Understanding 3

Shree Foods Private Limited is engaged in manufacturing of garlic bread. The auditors of company have planned audit procedures in respect of recognition of revenues of the company. Despite that, there is a possibility that misstatements in revenue recognition are not identified by planned audit procedures. Which risk is being alluded to?

1.6 Identifying and assessing the risk of material misstatement

As per SA 315 ***“Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment”***, the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity’s internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.

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

- (i) The auditor shall identify and assess the risks of material misstatement at:
 - (a) the financial statement level
 - (b) the assertion level for classes of transactions, account balances, and disclosuresto provide a basis for designing and performing further audit procedures
- (ii) For the purpose of identifying and assessing the risks of material misstatement, the auditor shall: -
 - (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements
 - (b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions
 - (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test and
 - (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

1.7 Risk Assessment Procedures

You have already gained a little knowledge about risk assessment procedures in Chapter 2.

The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion level are defined as risk assessment procedures.

Risk assessment procedures are a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial

statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.

The risks to be assessed include both those due to error and those due to fraud.

What is included in risk assessment procedures?

The risk assessment procedures shall include the following:

- (a) Inquiries of management and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error.
- (b) Analytical procedures.
- (c) Observation and inspection.

(a) *Inquiries of Management and Others Within the Entity:* Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority.

- Inquiries directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from those procedures.
- Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
- Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract

- Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.
- Inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
- Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system- related risks.

- (b) **Analytical Procedures:** Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, relationship between sales and square footage of selling space or volume of goods sold.

Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud. However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

- (c) **Observation and Inspection:** Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the following:

- The entity's operations.
- Documents (such as business plans and strategies), records, and internal control manuals.
- Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of director's meetings)
- The entity's premises and plant facilities.

1.8 Information obtained by performing risk assessment procedures - Used as audit evidence

Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures and related assertions and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or as tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.

For Example-While planning the audit of Beta Manufacturing Ltd., the auditor performs risk assessment procedures to understand the company's inventory process. During a walkthrough of the inventory system, the auditor observes that every issue of raw materials from the warehouse requires an electronically approved material requisition slip, and no material can be issued without system authorization.

Although the walkthrough was performed primarily to obtain an understanding of the entity and assess the risk of material misstatement, the auditor also inspects a few electronically approved requisition slips and traces them to inventory records. The evidence obtained indicates that the authorization control is operating effectively.

A walkthrough is an audit procedure in which the auditor traces a single transaction (or a few transactions) from its initiation to its final recording in the financial statements to understand how the transaction is processed and what controls operate at each stage.

At the same time, the auditor compares inventory quantities shown in the system with the physical stock available in the warehouse for a few selected items and finds no significant differences. This also provides evidence regarding the existence of inventory.

Thus, the information obtained during the risk assessment procedures not only helps the auditor assess the risks of material misstatement but also serves as audit evidence regarding:

- the operating effectiveness of the authorization control, and
- the existence assertion relating to inventory.

Since obtaining this evidence during the walkthrough is more efficient than performing separate procedures later, the auditor uses it as audit evidence while planning the overall audit approach.

Test Your Understanding 4

Jo Jo Limited is planning to list on Bombay Stock Exchange next year. As an auditor of Jo Jo Limited, identify any one reason of increased audit risk due to listing of the company next year.

Test Your Understanding 5

On perusing financial statements of Jo Jo Limited put up for audit, it is observed by the auditor that current ratio has improved from 1.20:1 (in preceding year) to 1.75:1 (in current year). Identify what kind of risk assessment procedures are being performed by auditor? Has it any relation with listing of the company next year on Bombay Stock Exchange?



2. MATERIALITY

2.1 What is meant by materiality?

SA 320 Materiality in Planning and Performing an Audit states that *misstatements*, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

The objective of an independent auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from *material* misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

Herein, lies the significance of materiality. The auditor has to obtain reasonable assurance that financial statements as a whole are free from *material* misstatement whether due to fraud or error. As a result, an audit strives to identify significant risks of material misstatement and audit procedures are geared towards it.

Materiality is not always a matter of relative size. For example, a small amount lost by fraudulent practices of certain employees can indicate a serious flaw in the enterprise's internal control system requiring immediate attention to avoid greater losses in future.

2.2 Materiality in Planning and performing an audit-Auditor's responsibility

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. SA 320 deals with auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements.

Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
- Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to above provide the auditor with such a frame of reference.

In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:

- (a) Determining the nature, timing and extent of risk assessment procedures;
- (b) Identifying and assessing the risks of material misstatement; and
- (c) Determining the nature, timing and extent of further audit procedures.

The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. Although, it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements.

The auditor has to apply his professional judgement in determining materiality, choosing appropriate benchmark and determining level of benchmark. Materiality forms the basis for determination of audit scope and the levels of testing the transactions.

While judging materiality, the significance of an item has to be viewed from different perspectives. Materiality of an item may be judged by considering the impact on the profit and loss, or on the balance sheet, or in the total of the category of expenditure or income to which it pertains, and on its comparison with the corresponding figure for the previous year.

If there is any statutory requirement of disclosure, it is to be considered material irrespective of the value of amount. Examples are given below: -

- As per Division I of schedule III of the Companies Act, 2013, any item of income or expenditure which exceeds one percent of the revenue from operations or ₹ 1,00,000, whichever is higher, needs to be disclosed separately.
- A company should disclose in notes to accounts, shares in the company held by each shareholder holding more than 5 per cent shares specifying the number of shares held as per requirements of Division I of Schedule III of the Companies Act, 2013.

2.3 Determination of materiality- a matter of professional judgment

The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:

- (a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
- (b) Understand that financial statements are prepared, presented and audited to levels of materiality;
- (c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
- (d) Make reasonable economic decisions on the basis of the information in the financial statements.

2.4 Performance Materiality

Practically, it is difficult for auditors to design tests to identify individual material misstatements. It is likely that misstatements are material in aggregate. It takes us to the concept of "performance materiality."

Performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

Performance materiality is set at a value lower than overall materiality. It lowers the risk that auditor will not be able to identify misstatements that are material when added together.

For Example - ABC Ltd. has a profit before tax of ₹50 crore. While planning the audit, the auditor determines overall materiality for the financial statements as a whole at ₹ 2 crore.

The auditor recognises that several small misstatements in different account balances may individually be immaterial but could become material when aggregated. For example:

- Inventory overstated by ₹ 60 lakh
- Trade receivables overstated by ₹ 55 lakh
- Provision for expenses understated by ₹ 50 lakh
- Depreciation understated by ₹ 45 lakh

Each misstatement is individually less than the overall materiality of ₹ 2 crore. However, together they aggregate to ₹ 2.10 crore, which exceeds the overall materiality and could influence the economic decisions of users of the financial statements.

To reduce the probability that such uncorrected and undetected misstatements, when aggregated, exceed the overall materiality, the auditor sets performance materiality at ₹ 75 lakh.

Accordingly, while designing and performing audit procedures, the auditor uses ₹ 75 lakh as the threshold for planning the nature, timing and extent of audit procedures. By adopting a performance materiality lower than the overall materiality, the auditor increases the likelihood of detecting smaller misstatements before they accumulate to a material amount.

Thus:

- Overall Materiality: ₹2 crore
- Performance Materiality: ₹75 lakh

This illustrates that performance materiality is deliberately set at an amount lower than overall materiality to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds the materiality for the financial statements as a whole.

2.5 Determining Materiality and Performance Materiality when Planning the Audit

When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.

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

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 like 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;
- ❑ The relative volatility of the benchmark.

Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value.

Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

2.6.1 Chosen Benchmark – Relevant financial data

In relation to the chosen benchmark, relevant financial data ordinarily includes: -

- ❑ Prior periods' financial results and financial positions,
- ❑ The period to-date financial results and financial position, and
- ❑ Budgets or forecasts for the current period,
- ❑ Adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates.

Consider, for example, when, as a starting point, the materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that the materiality for the financial statements as a whole is more appropriately

determined using a normalized profit before tax from continuing operations figure based on past results.

For Example-ABC Ltd. has consistently earned a Profit Before Tax of around ₹50 crore in the past several years, and its budget for the current year also projected a similar level of profitability. However, during the current year, one of its manufacturing plants was destroyed in a fire, resulting in an exceptional loss that reduced the reported Profit Before Tax to ₹8 crore. While determining materiality, the auditor does not rely solely on the current year's unusually low profit. Instead, the auditor considers relevant financial data such as the company's financial results of prior years, the current year's budget, and the fact that the reduction in profit was caused by a one-time, non-recurring event rather than normal business operations. Accordingly, the auditor concludes that using the current year's Profit Before Tax of ₹8 crore would not provide an appropriate benchmark and instead determines materiality based on a normalized Profit Before Tax of approximately ₹50 crore, which better reflects the entity's normal operating performance. This enables the auditor to determine materiality on a more reasonable and meaningful basis.

2.6.2 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.

Consider, for example, that the auditor may consider 5% of profit before tax from continuing operations to be appropriate for a profit-oriented entity in a manufacturing industry, while the auditor may consider 1% of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in different circumstances.

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

Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably

be expected to influence the economic decisions of users taken on the basis of the financial statements include the following:

1. Whether law, regulations or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items like in case of related party transactions, and the remuneration of management and those charged with governance.
2. The key disclosures in relation to the industry in which the entity operates. For example, research and development costs for a pharmaceutical company.
3. Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements like in case of newly acquired business.

2.8 Revision in Materiality level as the Audit Progresses

Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures.

If during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

2.9 Documenting the Materiality

The audit documentation shall include the following amounts and the factors considered in their determination:

- (a) Materiality for the financial statements as a whole

- (b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures
- (c) Performance materiality and
- (d) Any revision of (a)-(c) as the audit progressed

2.10 Materiality and Audit Risk

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. In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings. The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.

Materiality and Audit Risk are considered throughout the audit, in particular, when:

- (a) Identifying and assessing the risks of material misstatement;
- (b) Determining the nature, timing and extent of further audit procedures; and
- (c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

ILLUSTRATION 3

One of the team members of auditors of Highly Capable Limited was of the view that Materiality and Audit Risk are only considered at planning stage of an audit. Comment as an auditor

SOLUTION

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.

Test Your Understanding 6

CA A. Raja is auditor of Build Well Forgings Private Limited having a revenue of ₹ 25 crore. The company has been sanctioned a term loan of ₹ 50 lacs from a bank. However, as at end of the year, only ₹ 1 lac was availed due to delay in procurement of asset. The financial statements of the company do not disclose nature of security against which loan has been taken. Schedule III of the Companies Act, 2013 requires disclosure in this respect. Discuss, whether, non-disclosure of nature of security is material for auditor.

 3. UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

SA 315 Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment states that the auditor shall obtain an understanding of the following: -

(a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework

Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments.

Examples of matters the auditor may consider include market and competition, whether entity is engaged in seasonal activities, product technology relating to the entity's products. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation.

Relevant regulatory factors include the regulatory environment. The regulatory environment includes, among other matters, the applicable financial reporting framework and the legal and political environment.

Examples of matters the auditor may consider include accounting principles and industry specific practices, regulatory framework for a regulated industry, legislation and regulation that significantly affect the entity's operations, including direct supervisory activities, taxation, government policies currently affecting the conduct of the entity's business, environmental requirements affecting the industry and the entity's business.

Examples of other external factors affecting the entity that the auditor may consider include the general economic conditions, interest rates and availability of financing, and inflation etc.

(b) The nature of the entity, including: -

- (i) its operations;
- (ii) its ownership and governance structures;
- (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
- (iv) the way that the entity is structured and how it is financed; to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

An understanding of nature of entity enables the auditor to understand whether entity has a complex structure for example, whether it has subsidiaries. Complex structures often introduce issues that may give rise to risks of material misstatement. It also helps in understanding matters relating to the ownership, and relations between owners and other people or entities. This understanding assists in determining whether related party transactions have been identified and accounted for appropriately.

Examples of matters that the auditor may consider while obtaining understanding of nature of entity include: -

- ❑ Business operations such as nature of revenue sources, products or services, conduct of operations, location of production facilities, key customers and suppliers of goods and services
- ❑ Investment and investment activities such as capital investment activities and planned or recently executed acquisitions
- ❑ Financing and financing activities such as major subsidiaries, debt structure etc.
- ❑ Financial reporting such as accounting principles and revenue recognition practices

(c) The entity's selection and application of accounting policies, including the reasons for changes thereto

The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

(d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.

The entity conducts its business in the context of industry, regulatory and other internal and external factors. To respond to these factors, the entity's management define objectives, which are the overall plans for the entity. Strategies are the approaches by which management intends to achieve its objectives. The entity's objectives and strategies may change over time. Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk may arise from change or complexity.

An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, the auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement.

Examples of matters that the auditor may consider when obtaining an understanding of the entity's objectives, strategies and related business risks that may result in a risk of material misstatement of the financial statements include:-

- Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
- New products and services (a potential related business risk might be, for example, that there is increased product liability).
- Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).

(e) The measurement and review of the entity's financial performance

Management and others will measure and review those things they regard as important. Performance measures, whether external or internal, create pressures on the entity. These pressures, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Accordingly, an understanding of the entity's performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud.

Examples for measuring and reviewing financial performance which may be used by an auditor may include: -

- Key performance indicators (financial and non-financial) and key ratios, trends and operating statistics.
- Period-on-period financial performance analyses.
- Budgets, forecasts, variance analyses, and departmental or other level performance reports.
- Credit rating agency reports

3.1 Why understanding the entity and its environment is significant?

Understanding the entity and the environment in which it operates is very significant. It helps the auditor in planning the audit and in identifying areas requiring special attention. Gaining knowledge about client's business is one of the important principles in developing an overall audit plan. In fact, without adequate knowledge of client's business, a proper audit is not possible.

3.2 Understanding the entity-a continuous process

Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an "understanding of the entity"), is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

- ❑ Assessing risks of material misstatement of the financial statements
- ❑ Determining materiality in accordance with SA 320
- ❑ Considering the appropriateness of the selection and application of accounting policies
- ❑ Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions
- ❑ Developing expectations for use when performing analytical procedures
- ❑ Evaluating the sufficiency and appropriateness of audit evidence obtained such as the appropriateness of assumptions and of management's oral and written representations.

ILLUSTRATION 4

The auditor of ABC Textiles Ltd chalks out an audit plan without understanding the entity's business. Since he has carried out many audits of textile companies, there is no need to understand the nature of business of ABC Ltd. Advise the auditor how he should proceed.

SOLUTION

Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an "understanding of the entity"), is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The auditor should proceed accordingly.

ILLUSTRATION 5

While auditing the books of accounts of Heavy Material Limited for the financial year 2025-26, a team member of the auditor of Heavy Material Limited showed no inclination towards understanding the business and the business environment of the above mentioned company. Is the approach of team member of the auditor of Heavy Material Limited correct or incorrect? Also give reason for your answer.

SOLUTION

The approach of team member of the auditor of Heavy Material Limited is incorrect because understanding the business and the business environment of company whose audit is to be conducted is very important, as it helps in planning the audit and identifying areas requiring special attention during the course of audit of that company.

ILLUSTRATION 6

Prince Blankets is engaged in business of blankets. Its major portion of sales is taking place through internet. Advise the auditor how he would proceed in this regard as to understanding the entity and its environment.

SOLUTION

While understanding entity and its environment, internet sales is being perceived as risky area by the auditor and thereby would be spending substantial time and extensive audit procedures on this particular area.

 4. INTERNAL CONTROL**4.1 Meaning of Internal Control**

As per **SA-315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment"**, the internal control

may be defined 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. The term “controls” refers to any aspects of one or more of the components of internal control.”

4.2 As derived from above definition, the purpose of Internal Control is as under

Internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity’s objectives that concern:

- ☐ The reliability of the entity’s financial reporting;
- ☐ The effectiveness and efficiency of its operations;
- ☐ Its compliance with applicable laws and regulations; and
- ☐ Safeguarding of assets.

The way in which internal control is designed, implemented and maintained varies with an entity’s size and complexity.

4.3 Benefits of Understanding of Internal Control

An understanding of internal control assists the auditor in: -

- (i) Identifying types of potential misstatements;
- (ii) Identifying factors that affect the risks of material misstatement, and
- (iii) Designing the nature, timing, and extent of further audit procedures.

4.4 Limitations of Internal Control

(i) Internal control can provide only reasonable assurance

Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity’s financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control.

(ii) Human judgment in decision-making

Realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error. For example, there may be an error in the design of, or in the change to, a control.

(iii) Lack of understanding the purpose

Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

(iv) Collusion among People

Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

(v) Judgements by Management

Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

(vi) Limitations in case of Small Entities

Smaller entities often have fewer employees due to which segregation of duties is not practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties. On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

ILLUSTRATION 7

Auditor GR and Associates, appointed for audit of PNG Ltd, a manufacturing company engaged in manufacturing of various food items. While planning an audit, the auditor does not think that it would be necessary to understand internal controls. Advise the auditor in this regard.

SOLUTION

The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

ILLUSTRATION 8

The team member of the auditor of Simple and Easy Limited was of the view that understanding the internal control of the company would not help them in any manner in relation to audit procedures to be applied while conducting the audit.

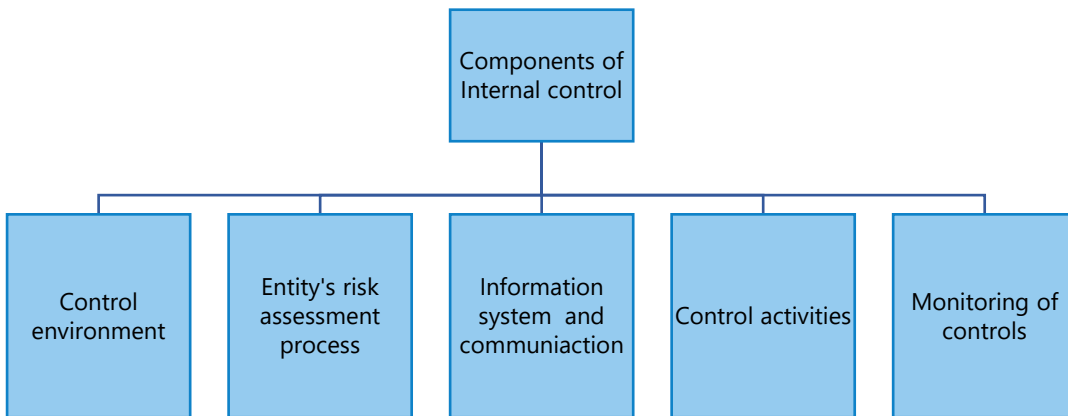
SOLUTION

The view of the team member of the auditor is incorrect because understanding the internal control of the company would help the auditor and his team members in designing the nature, timing and extent of audit procedures to be applied while conducting the audit of the company.

4.5 Components of Internal Control

The division of internal control into the following five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit: -

- (A) The control environment
- (B) The entity's risk assessment process
- (C) The information system, including the related business processes, relevant to financial reporting, and communication
- (D) Control activities
- (E) Monitoring of controls



4.5(A) Control Environment

The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

- (i) Management has created and maintained a culture of honesty and ethical behaviour and
- (ii) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

What is included in Control Environment?

The control environment includes:

- (i) the governance and management functions and
- (ii) the attitudes, awareness, and actions of those charged with governance and management.
- (iii) the control environment sets the tone of an organization, influencing the control consciousness of its people.

Elements of the Control Environment

Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

(a) Communication and enforcement of integrity and ethical values

The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and

ethical behaviour are the product of the entity's ethical and behavioural 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 behavioural standards to personnel through policy statements and codes of conduct and by example.

(b) Commitment to competence

Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

(c) Participation by those charged with governance

It includes attributes of those charged with governance such as their independence from management, their experience and stature, the extent of their involvement and the information they receive and the scrutiny of activities.

(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 towards financial reporting- what approach is taken by management in selecting accounting policies, approach in developing accounting estimates etc. Matters such as approach of management to taking and managing business risks, management's attitude towards information processing and accounting function and personnel reflects upon management's philosophy and operating style.

(e) Organisational structure

The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed. Establishing a relevant organisational 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

Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.

(g) Human resource policies and practices

Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions. 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.

Existence of a satisfactory control environment-not an absolute deterrent to fraud

The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed.

The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

4.5(B) The Entity's Risk Assessment Process

The auditor shall obtain an understanding of whether the entity has a process for:

- (a) Identifying business risks relevant to financial reporting objectives
- (b) Estimating the significance of the risks
- (c) Assessing the likelihood of their occurrence
- (d) Deciding about actions to address those risks

The entity's risk assessment process forms the basis for the risks to be managed. If that process is appropriate, it would assist the auditor in identifying risks of material misstatement. Risks can arise or change due to factor such as new technology, new business models, products or activities, changes in operating environment etc. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

4.5(C) The information system, including the related business processes, relevant to financial reporting and communication

The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas: -

- (a) The classes of transactions in the entity's operations that are significant to the financial statements
- (b) The procedures by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements
- (c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions
- (d) How the information system captures events and conditions that are significant to the financial statements
- (e) The financial reporting process used to prepare the entity's financial statements

(f) Controls surrounding journal entries.

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). Information system should provide qualitative financial information. 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.

The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities. It 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(D) Control Activities

The auditor shall obtain an understanding of control activities relevant to the audit, which the auditor considers necessary to assess the risks of material misstatement. An audit requires an understanding of only those control activities related to significant class of transactions, account balance, and disclosure in the financial statements and the assertions which the auditor finds relevant in his risk assessment process. Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels.

Control activities relevant to audit generally include policies and procedures relating to performance reviews (reviews of actual performance with budgets), information processing (for example controls over checking arithmetical accuracy of records, program change controls etc), physical controls(like controls over physical security of assets) and segregation of duties (controls over ensuring that different people are assigned the responsibilities of authorising transactions, recording transactions and maintaining custody of assets)

4.5(E) Monitoring of Controls

The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting.

Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It helps in assessing the effectiveness of controls on a timely basis. It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. It includes considering whether controls are operating as intended and that they are modified as appropriate for change in conditions.

Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

Test Your Understanding 7

CA Smriti is auditor of a company. As part of audit, she is going through company policies and practices regarding employee recruitment, training, orientation and related matters. She seems to be very much interested in finding out whether company hires best candidates from applicant pool. Identify what she is trying to do? How gaining knowledge about this aspect is useful to her as an auditor?

Test Your Understanding 8

During the audit of same company, CA Smriti is keen to find out whether there exists a proper system of segregation of duties in the company. She wants to be sure that a person responsible for recording a transaction is different from the person authorising it. Discuss what she is trying to do and how its understanding is significant to her as an auditor.

4.6 Are all Controls Relevant to the audit?

There is a direct relationship between an entity's objectives and the control it implements to provide reasonable assurance about their achievement. The entity's objectives, and therefore controls, relate to financial reporting, operations and compliance; however, not all of these objectives and controls are relevant to the auditor's risk assessment.

Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

- ❑ Materiality.
- ❑ The significance of the related risk.
- ❑ The size of the entity.
- ❑ The nature of the entity's business, including its organisation and ownership characteristics.
- ❑ The diversity and complexity of the entity's operations.
- ❑ Applicable legal and regulatory requirements.
- ❑ The circumstances and the applicable component of internal control.
- ❑ The nature and complexity of the systems that are part of the entity's internal control, including the use of service organisations.
- ❑ Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

4.7 Controls over the completeness and accuracy of information

Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures. For example, in auditing revenue by applying standard prices to records of sales volume, the auditor considers the accuracy of the price information and the completeness and accuracy of the sales volume data. Controls relating to operations and compliance objectives may also be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures.

4.8 Internal control over safeguarding of assets

Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally

limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

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

An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit. Further, although internal control applies to the entire entity or to any of its operating units or business processes, an understanding of internal control relating to each of the entity's operating units and business processes may not be relevant to the audit.

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

4.10 Nature and Extent of the Understanding of Relevant Controls

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 significant deficiency in internal control. Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include-

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

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

Obtaining an understanding of an entity's controls is not sufficient to test their operating effectiveness, unless there is some automation that provides for the consistent operation of the controls. For example, obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, because of the inherent consistency of IT processing, performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on the auditor's assessment and testing of controls such as those over program changes.

5. RISKS THAT REQUIRE SPECIAL AUDIT CONSIDERATION

As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:

- (a) Whether the risk is a risk of fraud
- (b) Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention
- (c) The complexity of transactions
- (d) Whether the risk involves significant transactions with related parties
- (e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty and

- (f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

5.1 Identifying Significant Risks

Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty. Significant risks are inherent risks with both a higher likelihood of occurrence and a higher magnitude of potential misstatement. The auditor assesses assertions affected by a significant risk as higher inherent risk. The following are always significant risks:

- ☐ Risks of material misstatement due to fraud
- ☐ Significant transactions with related parties that are outside the normal course of business for the entity

5.2 Risks of Material Misstatement – Greater for Significant Non-Routine Transactions

Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

- ☐ Greater management intervention to specify the accounting treatment.
- ☐ Greater manual intervention for data collection and processing.
- ☐ Complex calculations or accounting principles.
- ☐ The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

5.3 Risks of material misstatement– Greater for Significant Judgmental Matters

Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:

- Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
- Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

6. EVALUATION OF INTERNAL CONTROL SYSTEM

So far as the auditor is concerned, the examination and evaluation of the internal control system is an indispensable part of the overall audit programme. The auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal control normally contributes to such assurance.

6.1 Benefits of Evaluation of Internal Control to the Auditor

The review of internal controls will enable the auditor to know:

- (i) whether errors and frauds are likely to be located in the ordinary course of operations of the business
- (ii) whether an adequate internal control system is in use and operating as planned by the management
- (iii) whether an effective internal auditing department is operating
- (iv) whether any administrative control has a bearing on his work (for example, if the control over worker recruitment and enrolment is weak, there is a likelihood of dummy names being included in the wages sheet and this is relevant for the auditor)
- (v) whether the controls adequately safeguard the assets
- (vi) how far and how adequately the management is discharging its function in so far as correct recording of transactions is concerned

- (vii) how reliable the reports, records and the certificates to the management can be
- (viii) the extent and the depth of the examination that he needs to carry out in the different areas of accounting
- (ix) what would be appropriate audit technique and the audit procedure in the given circumstances
- (x) what are the areas where control is weak and where it is excessive and
- (xi) whether some worthwhile suggestions can be given to improve the control system.

ILLUSTRATION 9

Mr. Y, one of the team member of the auditors of What and Where Limited was very keen in knowing whether the internal control of the company would safeguard the company's assets. Advise Mr. Y.

SOLUTION

The review of internal controls will enable the auditors to know whether the controls adequately safeguard the assets.

ILLUSTRATION 10

Mr. H, a team member of the auditor of There and Here Limited was of the view that evaluation of internal control of the company would help in identifying the areas where internal control is weak. Advise

SOLUTION

The review of internal controls will enable the auditor to know what are the areas where control is weak and where it is excessive.

Formulate Audit Program after understanding Internal Control

The auditor can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operation. If he does not care to study this aspect, it is very likely that his audit programme may become unwieldy and unnecessarily heavy and the object of the audit may be altogether lost in the mass of entries and vouchers. It is also important for him to know whether the system is actually in operation. Often, after installation of a system, no proper follow up is there by the management to ensure compliance.

The auditor, in such circumstances, may be led to believe that a system is in operation which in reality may not be altogether in operation or may at best operate only partially. This state of affairs is probably the worst that an auditor may come across and he would be in the midst of confusion, if he does not take care.

It would be better if the auditor can undertake the review of the internal control system of client. This will give him enough time to assimilate the controls and implications and will enable him to be more objective in the framing of the audit programme. He will also be in a position to bring to the notice of the management the weaknesses of the system and to suggest measures for improvement. At a further interim date or in the course of the audit, he may ascertain how far the weaknesses have been removed.

From the foregoing, it can be concluded that the extent and the nature of the audit programme is substantially influenced by the internal control system in operation. In deciding upon a plan of test checking, the existence and operation of internal control system is of great significance. A proper understanding of the internal control system in its content and working also enables an auditor to decide upon the appropriate audit procedure to be applied in different areas to be covered in the audit programme.

In a situation where the internal controls are considered weak in some areas, the auditor might choose an auditing procedure or test that otherwise might not be required; he might extend certain tests to cover a large number of transactions or other items than he otherwise would examine and at times he may perform additional tests to bring him the necessary satisfaction.

For example, normally the distribution of wages is not observed by the auditor. But if the internal control over wages is so weak that there exists a possibility of dummy workers being paid, the auditor might include observation of wages distribution in his programme in order to find out the workers who do not turn up for receipt of wages.

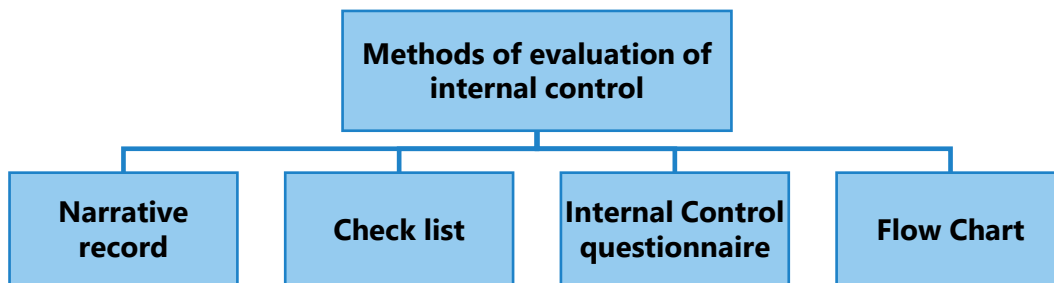
On the other hand, if he is satisfied with the internal control on sales and trade receivables, the auditor can get trade receivables' balances confirmed at almost any time reasonably close to the balance sheet date. But if the control is weak, he may feel that he should get the confirmation exactly on the date of the year closing so that he may eliminate the risk of errors and frauds occurring between the intervening period. Also, he may in that situation, decide to have a large coverage of trade receivables by the confirmation procedure.

6.2 Evaluation of Internal Control– Methods

A review of the internal control can be done by a process of study, examination and evaluation of the control system installed by the management. The first step involves determination of the control and procedures laid down by the management. By reading company manuals, studying organisation charts and flow charts and by making suitable enquiries from the officers and employees, the auditor may ascertain the character, scope and efficacy of the control system.

The auditor must ask the right people the right questions if he is to get the information he wants. It would be better if he makes written notes of the relevant information and procedures contained in the manual or ascertained on enquiry. To facilitate the accumulation of the information necessary for the proper review and evaluation of internal controls, the auditor can use one of the following to help him to know and assimilate the system and evaluate the same:

- (A) Narrative record
- (B) Check List
- (C) Internal Control questionnaire and
- (D) Flow chart



6.2(A) The Narrative Record

This is a complete and exhaustive description of the system as found in operation by the auditor. Actual testing and observation are necessary before such a record can be developed. It may be recommended in cases where no formal control system is in operation and would be more suited to small business.

The basic disadvantages of narrative records are:

- (i) To comprehend the system in operation is quite difficult.
- (ii) To identify weaknesses or gaps in the system.
- (iii) To incorporate changes arising on account of reshuffling of manpower, etc.

6.2(B) Check List

This is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer. When he completes instruction, he initials the space against the instruction. Answers to the check list instructions are usually Yes, No or Not Applicable. This is again an on-the-job requirement and instructions are framed having regard to the desirable elements of control.

Example

A few examples of check list instructions are given hereunder:

1. Are tenders called before placing orders?
2. Are the purchases made on the basis of a written order?
3. Is the purchase order form standardised?
4. Are purchase order forms pre-numbered?
5. Are the inventory control accounts maintained by persons who have nothing to do with custody of work, receipt of inventory, inspection of inventory and purchase of inventory?

The complete check list is studied by the Principal/Manager/Senior to ascertain existence of internal control and evaluate its implementation and efficiency.

6.2(C) Internal Control Questionnaire

This is a comprehensive series of questions concerning internal control. This is the most widely used form for collecting information about the existence, operation and efficiency of internal control in an organisation. An important advantage of the questionnaire approach is that oversight or omission of significant internal control review procedures is less likely to occur with this method. With a proper questionnaire, all internal control evaluation can be completed at one time or in sections. The review can more easily be made on an interim basis. The questionnaire form also provides an orderly means of disclosing control defects. It is the general

practice to review the internal control system annually and record the review in detail. In the questionnaire, generally questions are so framed that a 'Yes' answer denotes satisfactory position and a 'No' answer suggests weakness. Provision is made for an explanation or further details of 'No' answers. In respect of questions not relevant to the business, 'Not Applicable' reply is given. The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees. If on a perusal of the answers, inconsistencies or apparent incongruities are noticed, the matter is further discussed by auditor's staff with the client's employees for a clear picture. The concerned auditor then prepares a report of deficiencies and recommendations for improvement.

Few illustrative examples of Internal Control Questionnaire in different areas of an entity are given as under:

Examples of Extracts of Internal Control Questionnaire in respect of purchases, creditors, inventories and fixed assets

A. Purchases

- (1) Are purchases centralised in the Purchase Department?
- (2)
 - (a) Are purchases made only from approved suppliers?
 - (b) Is a list of approved suppliers maintained for this purpose?
 - (c) Does the master list contain more than one source of supply for all important materials?
- (3) Are the purchase orders based on valid purchase requisitions duly signed by authorised persons in this behalf?
- (4) Are purchases based on competitive quotations from two or more suppliers?
- (5) Are purchase orders pre-numbered?
- (6) Are purchase orders signed only by employees authorized in this behalf?
- (7) Are all materials received only in the Receiving Department?
- (8) Are persons connected with receipt of materials and the keeping of receiving records denied authority to issue purchase orders or to approve invoices?
- (9) Are materials inspected and counted, weighed or measured in the Receiving Department?

- (10) Are receipt of materials evidenced by pre-numbered Goods Received Note?

B. Creditors

- (1) (a) Are suppliers' invoices routed direct to the Accounts Department?
(b) Are they entered in a Bill register before submitting them to other departments for check and/or approval?
(c) Are advance and partial payments entered on the invoices before they are submitted to other departments?
- (2) Does the system ensure that all invoices are duly processed?
- (3) In respect of raw material and supplies, are reconciliations made of quantities and/or values received as shown by purchase invoices with receipt into stock records?
- (4) Does the Accounts Department match the invoices of supplies with Goods Received Notes and purchase orders?
- (5) Do all invoices bear evidence of being checked for prices, freight, terms etc.?
- (6) Are all advance payments duly authorized by persons competent to authorize such payments?
- (7) Are duplicate invoices marked immediately on receipt to avoid payment against them?
- (8) Are all supplier's statements compared with ledger accounts?
- (9) Is there any follow-up action to investigate difference, if any, between the suppliers' statements and the ledger accounts?
- (10) Is a list of unpaid creditors prepared and reconciled periodically?

C. Inventories

- (1) Are stocks stored in assigned areas?
- (2) Are stocks insured comprehensively against different risks? If some risk is not insured, whether it is due to specific decision taken by a senior official?
- (3) Is a record maintained for the insurance policies?
- (4) Is the record reviewed periodically?
- (5) Is there an official who decides on the value for which stocks are to be insured?

- (6) Is the adequacy of insurance cover reviewed periodically?
- (7) Are perpetual stock records kept for raw materials, work-in-progress, finished goods and stores?
- (8) Are stock records periodically reconciled with accounting records?
- (9) Where there is a system of perpetual inventory count:
 - (a) Is there a periodical report of shortages/excess?
 - (b) If so, are these differences investigated?
 - (c) Are these differences adjusted in the stock records and in the financial accounts?
 - (d) Is written approval obtained from a responsible official to adjust these differences?
- (10) Are there norms for stock levels to be held?

D. Fixed Assets

- (1) Are budgets for capital expenditure approved?
- (2) Is the authority to incur capital expenditure restricted to specified officials?
- (3) Are purchases of capital expenditure subject to same controls as applicable to purchases of raw materials, stores etc.?
- (4) Is there proper check to see that amounts expended do not exceed the amount authorized?
- (5) Are fixed assets verified periodically?
- (6) Is there a written procedure for such verification?
- (7) Are reports prepared on such verification?
- (8) Do such reports indicate damaged/obsolete items of fixed assets?
- (9) Are discrepancies disclosed by such reports investigated?
- (10) Are the records and financial accounts corrected with appropriate authority?

Note: The Internal Control questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees by giving replies as Yes/No/Not applicable along with explanatory notes, if any.

6.2(D) Flow Chart

It is a graphic presentation of each part of the company's system of internal control. A flow chart is considered to be the most concise way of recording the auditor's review of the system. It minimises the amount of narrative explanation and thereby achieves a consideration or presentation not possible in any other form.

It gives bird's eye view of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested. It is also necessary for the auditor to study the significant features of the business carried on by the concern, the nature of its activities and various channels of goods and materials as well as cash, both inward and outward and also a comprehensive study of the entire process of manufacturing, trading and administration. This will help him to understand and evaluate the internal controls in the correct perspective.

ILLUSTRATION 11

In order to evaluate the Internal Control of Your and My Limited, a team member of the auditors used a method according to which, number of questions relating to internal control of the company were required to be answered by the employees of the company. After obtaining the answers there was a discussion relating to those answers between team member of the auditor and employees of the company for a clear picture. State the method of evaluation of internal control as discussed above.

SOLUTION

The method of evaluation of internal control used in the above question is known as Internal Control Questionnaire because in questionnaire method, a number of questions relating to internal control of a company are required to be answered by employees of that company and when answers to the questions are obtained, there is a discussion relating to those answers between team members of the auditors and employees of that company for a clear picture.

ILLUSTRATION 12

Healthy and Useful Limited is into small manufacturing as well as trading business. For the purpose of evaluating the internal control of Healthy and Useful Limited, a team member of the auditors of the company used a method according to which the whole description of internal control that was operating in the said company was to be recorded. Identify the method of evaluation of internal control as mentioned above.

SOLUTION

The method of evaluation of internal control referred above is known as Narrative Record because in Narrative Record method, a whole description of internal control operating in an entity is recorded. Narrative Record method is also appropriate for small manufacturing as well as trading business as is mentioned in the question above case.

 7. TESTING OF INTERNAL CONTROL

After assimilating the internal control system, the auditor needs to examine whether and how far the same is actually in operation. For this, he resorts to actual testing of the system in operation. This he does on a selective basis: he can plan this testing in such a manner that all the important areas are covered in a period of, say, three years.

Test of controls are performed to obtain audit evidence about the effectiveness of the:-

- (i) Design of the accounting and internal control system
- (ii) Operation of the internal control throughout the period

Test of controls include tests of elements of the control environment where strengths in the control environment are used by auditors to reduce control risk. Some of the procedures performed to obtain the understanding of the accounting and internal control systems may not have been specifically planned as tests of control but may provide audit evidence about the effectiveness of the design and operation of internal controls relevant to certain assertions and, consequently, serve as tests of control. For example, in obtaining the understanding of the accounting and internal control systems pertaining to cash, the auditor may have obtained audit evidence about the effectiveness of the bank reconciliation process through inquiry and observation. When the auditor concludes that procedures performed to obtain the understanding of the accounting and internal control systems also provide audit evidence about the suitability of design and operating effectiveness of policies and procedures relevant to a particular financial statement assertion, the auditor may use that audit evidence, provided it is sufficient to support a control risk assessment at less than a high level.

Test of controls may include:

- ❑ Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised.
- ❑ Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.
- ❑ Re-performance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.
- ❑ Testing of internal control operating on specific computerised applications or over the overall information technology function, for example, access or program change controls.

While 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 error. 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.

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.

8. THE AUDITOR'S 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, "Identifying and Assessing Risks of Material Misstatement Through Understanding the Entity and Its Environment" in a financial statement audit.

The objective of the auditor 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: -

- (a) The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level.
- (b) The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.

In designing the further audit procedures to be performed, the auditor shall:

- (a) Consider the reasons for the assessment given to the risk of material misstatement 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.

A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular, where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

8.1 Nature and Extent of Test of Controls

In designing and performing test of controls, the auditor shall:

- (a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:
 - (i) How the controls were applied at relevant times during the period under audit.
 - (ii) The consistency with which they were applied.
 - (iii) By whom or by what means they were applied.

- (b) Determine whether the controls to be tested depend upon other controls (indirect controls), and if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls.

Inquiry alone is not sufficient to test the operating effectiveness of controls. Accordingly, other audit procedures are performed in combination with inquiry. In this regard, inquiry combined with inspection or reperformance may provide more assurance than inquiry and observation, since an observation is pertinent only at the point in time at which it is made.

The nature of the particular control influences the type of procedure required to obtain audit evidence about whether the control was operating effectively.

For example, if operating effectiveness is evidenced by documentation, the auditor may decide to inspect it to obtain audit evidence about operating effectiveness.

When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls.

Matters the auditor may consider in determining the extent of test of controls include the following:

- ☐ The frequency of the performance of the control by the entity during the period.
- ☐ The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- ☐ The expected rate of deviation from a control.
- ☐ The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.
- ☐ The extent to which audit evidence is obtained from tests of other controls related to the assertion.

8.2 Timing of Test of Controls

The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls in order to provide an appropriate basis for the auditor's intended reliance. Audit evidence pertaining

only to a point in time may be sufficient for the auditor's purpose, for example, when testing controls over the entity's physical inventory counting at the period end. If, on the other hand, the auditor intends to rely on a control over a period, tests that are capable of providing audit evidence that the control operated effectively at relevant times during that period are appropriate. Such tests may include tests of the entity's monitoring of controls.

8.3 Using Audit Evidence Obtained in Previous Audits

In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:

- (a) The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process
- (b) The risks arising from the characteristics of the control, including whether it is manual or automated
- (c) The effectiveness of general IT-controls
- (d) The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control
- (e) Whether the lack of a change in a particular control poses a risk due to changing circumstances and
- (f) The risks of material misstatement and the extent of reliance on the control

If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit.

8.4 Evaluating the Operating Effectiveness of Controls

When evaluating the operating effectiveness of relevant controls, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of

misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective. A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control.

For Example - ABC Ltd. has established an internal control whereby every sales invoice exceeding ₹ 10 lakh must be approved electronically by the Sales Manager before it is recorded in the books of account. Based on this control, the auditor initially plans to rely on its operating effectiveness.

During substantive testing of sales transactions, the auditor examines a sample of high-value sales invoices and discovers that several invoices exceeding ₹ 10 lakh were recorded without the required electronic approval. In addition, one such invoice amounting to ₹ 2.50 crore had been recorded incorrectly, resulting in a material overstatement of revenue.

The auditor concludes that the misstatements detected through substantive procedures indicate that the approval control was not operating effectively during the year. Accordingly, the auditor revises the assessment of control risk, performs additional substantive procedures, and evaluates whether the failure of the approval control represents a significant deficiency in internal control.

Conversely, suppose the auditor had performed substantive testing and did not detect any misstatements in the sample of sales transactions. The auditor cannot conclude solely on this basis that the approval control operated effectively throughout the year. The absence of detected misstatements provides evidence only about the transactions tested and does not constitute audit evidence regarding the operating effectiveness of the control. To conclude that the control operated effectively, the auditor must perform appropriate tests of controls, such as inspecting evidence of electronic approvals, reviewing system logs, and testing the operation of the approval process.

This example demonstrates that:

- Misstatements detected through substantive procedures may indicate that controls are not operating effectively.
- The absence of misstatements does not, by itself, establish that controls are operating effectively.
- A material misstatement detected during the audit is a strong indicator of the existence of a significant deficiency in internal control.

8.5 Specific inquiries by auditor when deviations from controls are detected

When deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether:

- (a) The test of controls that have been performed provide an appropriate basis for reliance on the controls
- (b) Additional test of controls are necessary or
- (c) The potential risks of misstatement need to be addressed using substantive procedures.

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.

This requirement reflects the facts that:

- (i) the auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement and
- (ii) there are inherent limitations to internal control, including management override.

Substantive procedures are audit procedures designed to detect material misstatements at the assertion level. Substantive procedures comprise: (i) Tests of details (of classes of transactions, account balances, and disclosures), and (ii) Substantive analytical procedures.

8.6 Tests of Details

Tests of details are further classified into tests of transactions i.e., vouching and tests of balances i.e., verification.

For example, a purchase transaction may be verified by examining the related purchase invoice, goods received note, inward gate entry register. Such tests of transactions help in establishing the authenticity of transactions recorded in books of accounts.

Tests of balances consist of verification of assets as well as liabilities. Verification of an item of fixed asset, for example, would help in establishing existence of that asset as on date of balance sheet. This may be obtained by reviewing entity's plan for performing physical verification of fixed assets and obtaining evidence for performance of physical verification of fixed assets by management.

8.7 Substantive analytical procedures

Substantive analytical procedures refer to analytical procedures used as substantive procedures by auditor. The term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

The use of widely recognised ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

Analytical procedures involving, for example, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details.

Substantive analytical procedures are generally more applicable to ss that tend to be predictable over time.

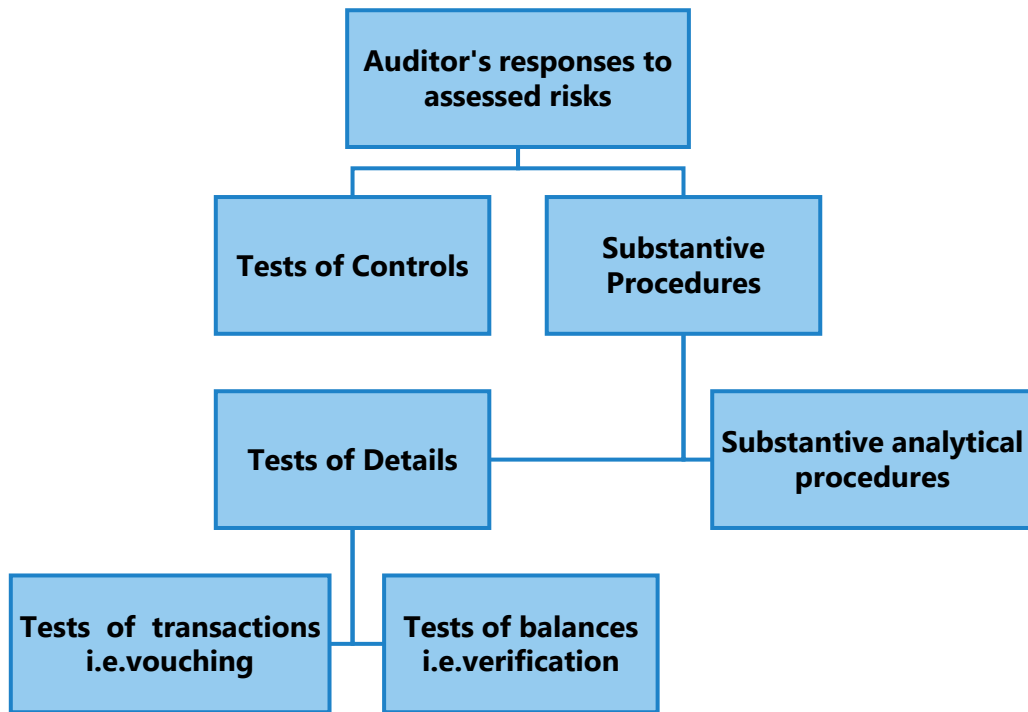
8.7.1 Nature and extent of Substantive procedures

Depending on the circumstances, the auditor may determine that:

- Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.
- Only tests of details are appropriate.
- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

Because the assessment of the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from test of controls are unsatisfactory.

In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing.



Test Your Understanding 9

Zomba Products Private limited is a small company. The control systems in the company are rudimentary. How, you as an auditor of the company, would proceed to evaluate internal control of the company?

Test Your Understanding 10

A Chartered accountant during course of audit of a company finds that cash is not deposited into bank frequently although concerned staff of company was required to do so. Further, the official responsible for ensuring performance of above function, has also not paid any attention to it. Discuss what does it represent from auditor's perspective.



9. INTERNAL FINANCIAL CONTROLS AS PER REGULATORY REQUIREMENTS

The term Internal Financial Controls (IFC) basically refers to the policies and procedures put in place by companies for ensuring:

- ☐ Reliability of financial reporting
- ☐ Effectiveness and efficiency of operations
- ☐ Compliance with applicable laws and regulations
- ☐ Safeguarding of assets
- ☐ Prevention and detection of frauds

The Companies Act, 2013 has placed a greater emphasis on the effective implementation and reporting on the internal controls for a company. The term “internal financial controls” is used at some places in the Companies Act, 2013 casting responsibilities as under: -

Relevant provision of the Companies Act, 2013	Nature of Responsibility
Section 134 (5)(e)	In case of listed Companies, the Directors' responsibility statement shall state that the Directors had laid down Internal financial controls to be followed by the company and that such Internal financial controls are adequate and were operating effectively.
Section 143(3)(i) of the Act	The auditor's report shall state whether the company has adequate Internal financial controls system in place and also on the operating effectiveness of such controls. This requirement shall not apply to a private company which – (i) is One Person Company or a small company; or (ii) has turnover less than ₹ 50 crore as per latest audited Financial Statements; and which has aggregate borrowings from banks or financial

	institutions or any body corporate at any point of time during the financial Year for less than ₹ 25 crore.
Section 177(4)(vii) of the Act	Every audit Committee shall act in accordance with the terms of reference specified in writing by the Board which shall, inter alia, include - evaluation of internal financial controls and risk management systems.
As per Section 149(8) of the Act	The company and independent directors shall abide by the provisions specified in Schedule IV which lays down the Code for independent Directors. As per this code, the role and functions of independent directors include that they shall satisfy themselves on the integrity of financial information and that financial controls and the systems of risk management are robust and defensible.

The directors and management have primary responsibility of implementing and maintaining an effective internal controls framework and auditors are expected to evaluate, validate and report on the design and operating effectiveness of internal financial controls.

10. DOCUMENTING THE RISKS

The auditor shall document:

- The discussion among the engagement team and the significant decisions reached
- Key elements of the understanding obtained regarding each of the aspects of the entity and its environment and of each of the internal control components, the sources of information from which the understanding was obtained; and the risk assessment procedures performed
- The identified and assessed risks of material misstatement at the financial statement level and at the assertion level and
- The risks identified, and related controls about which the auditor has obtained an understanding.



11. WHAT IS AN AUTOMATED ENVIRONMENT?

An automated environment basically refers to a business environment where the processes, operations, accounting and even decisions are carried out by using computer systems – also known as Information Systems (IS) or Information Technology (IT) systems. Nowadays, it is very common to see computer systems being used in almost every type of business.

11.1 Key features of an automated environment

The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex. Key features of an automated environment are as under: -

- Enables faster business operation
- Accuracy in data processing and computation
- Ability to process large volume of transactions
- Integration amongst business operations
- Better security and controls
- Less prone to human errors
- Provides latest information
- Connectivity and networking capability

If a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered more complex to audit. On the other hand, if a company is using an off-the-shelf accounting software, then it is likely to be less automated and hence less complex environment.

11.2 Understanding and documenting automated environment

In an audit of financial statements, an auditor is required to understand the entity and its business, including IT. Understanding the entity and its automated environment involves understanding how IT department is organised, IT activities,

the IT dependencies, relevant risks and controls. Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment:

- ☐ Information systems being used (one or more application systems and what they are)
- ☐ Their purpose (financial and non-financial)
- ☐ Location of IT systems - local vs global
- ☐ Architecture (desktop based, client-server, web application, cloud based)
- ☐ Version (functions and risks could vary in different versions of same application).
- ☐ Interfaces within systems (in case multiple systems exist).
- ☐ In-house vs Packaged.
- ☐ Outsourced activities (IT maintenance and support).
- ☐ Key persons (CIO, CISO, Administrators).

The understanding of a company's IT environment that is obtained should be documented.

11.3 Risks arising from use of IT Systems

Having obtained an understanding of the IT systems and the automated environment of a company, the auditor should now understand the risks that arise from the use of IT systems. Given below are some such risks that should be considered:

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

11.4 Impact of IT related risks

The above risks have to be mitigated. If not mitigated, such risks, could have an impact on audit in different ways discussed as under: -

Impact on substantive checking

Inability to address above discussed risks may lead to non-reliance of data obtained from systems. In such a case, all information, data, and reports would have to be tested thoroughly for their completeness and accuracy. It could lead to increased substantive checking i.e., detailed checking.

Impact on controls

It can lead to non-reliance on automated controls, system calculations and accounting procedures built into applications. It may result in additional audit work.

Impact on reporting

Due to regulatory requirements in respect of internal financial controls (discussed in subsequent paras) in case of companies, it may lead to modification of auditor's report in some instances.

11.5 Types of Controls in an automated environment

Controls in an automated environment can be categorized as under: -

- (A) General IT controls
- (B) Application controls
- (C) IT-dependent controls

11.5(A) General IT controls

General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. General IT-controls that maintain the integrity of information and security of data commonly include controls over the following:

- ☐ Data centre and network operations
- ☐ Program change
- ☐ Access security
- ☐ Application system acquisition, development, and maintenance (Business Applications)

These are IT controls generally implemented to mitigate the IT specific risks and applied commonly across multiple IT systems, applications and business processes. Hence, General IT controls are known as “pervasive” controls or “indirect” controls.

(a) Controls over Data centre and network operations

The objective of controls over Data centre and network operations is to ensure that production systems are processed to meet financial reporting objectives. These include activities such as overall management of computer operation activities, preparing, scheduling and executing of batch jobs, monitoring, storage and retention of backups. Such controls also help in performance monitoring of operating system, database and networks. Matters such as BCP (Business continuity plan) and DRP (Disaster recovery plan) which deal with recovery from failures are also taken care of by such type of controls.

(b) Program Change

The objective of program change controls is to ensure that modified systems continue to meet financial reporting objectives. It includes activities such as change management process, recording, managing and tracking change requests, making and testing changes etc.

(c) Access Security

The objective of controls over access security is to ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives. It includes activities such as security organization & management, security policies & procedures, application security, data security, operating system security, network security, physical security etc.

(d) Application system acquisition, development, and maintenance

The objective of such controls is to ensure that systems are developed, configured and implemented to meet financial reporting objectives. It includes overall management of development activities, project initiation, analysis & design, construction, testing & quality assurance etc.

11.5(B) Application Controls

Application controls include both automated or manual controls that operate at a business process level. Automated Application controls are embedded into IT applications viz., ERPs and help in ensuring the completeness, accuracy and

integrity of data in those systems. Examples of automated applications include edit checks and validation of input data, sequence number checks, user limit checks, reasonableness checks, mandatory data fields.

11.5(C) IT dependent Controls

IT dependent controls are basically manual controls that make use of some form of data or information or report produced from IT systems and applications. In this case, even though the control is performed manually, the design and effectiveness of such controls depends on the reliability of source data. Due to the inherent dependency on IT, the effectiveness and reliability of automated application controls and IT dependent controls require the General IT controls to be effective.

11.6 General IT Controls vs. Application Controls

- These two categories of control over IT systems are interrelated.
- The relationship between the application controls and the General IT Controls is such that General IT Controls are needed to support the functioning of application controls, and both are needed to ensure complete and accurate information processing through IT systems.

11.7 Testing methods in an automated environment

Having learnt about the various IT risks and controls, let us understand the different ways testing is performed in an automated environment. There are basically four types of audit tests that should be used. These are inquiry, observation, inspection and reperformance.

Inquiry is the most efficient audit test but it also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient. Reperformance is most effective as an audit test and gives the best audit evidence. However, testing by reperformance could be very time consuming and least efficient most of the time.

Generally, applying inquiry in combination with inspection gives the most effective and efficient audit evidence. However, which audit test to use, when and in what combination is a matter of professional judgement and will vary depending on several factors including risk assessment, control environment, desired level of evidence required, history of errors/misstatements, complexity of business,

assertions being addressed etc. The auditor should document the nature of test (or combination of tests) applied along with the judgements in the audit file.

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

- ◆ Obtain an understanding of how an automated transaction is processed by doing a walkthrough of one end-to-end transaction using a combination of inquiry, observation and inspection.
- ◆ Observe how a user processes transactions under different scenarios.
- ◆ Inspect the configuration defined in an application.

Where the general IT controls are not existing or existing but ineffective, the auditor should assess the impact of IT risks and complexity of the automated environment in which the business operations take place and plan alternative audit procedures in order to rely on the system-based information.

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

An entity's system of internal control contains manual elements and often contains automated elements. The characteristics of manual or automated elements are relevant to the auditor's risk assessment and further audit procedures based thereon. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported:

- (a) Controls in a manual system may include such procedures as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace paper documents.
- (b) Controls in IT systems consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls.

Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions.

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

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.

Manual elements in internal control may be less reliable than automated elements because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed. Manual control elements may be less suitable for the following circumstances:

- ❑ High volume or recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented, or detected and corrected, by control parameters that are automated.
- ❑ Control activities where the specific ways to perform the control can be adequately designed and automated.

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.



13. AUDIT APPROACH IN AN AUTOMATED ENVIRONMENT

Risk Assessment	Understand and Evaluate	Test for Operating Effectiveness	Reporting
- Identify significant accounts and disclosures - Qualitative and Quantitative considerations - Relevant Financial Statement Assertions (FSA) - Identify likely sources of misstatement - Consider risk arising from use of IT systems	- Document understanding of business processes using Flowcharts/ Narratives - Prepare Risk and Control Matrices (RCM) - Understand design of controls by performing walkthroughs of end-to-end process - Process wide considerations for Entity Level Controls, Segregation of Duties - IT General Controls, Application Controls	- Assess Nature, Timing and Extent (NTE) of controls testing - Assess reliability of source data; completeness of population - Testing of key reports and spreadsheets - Sample testing - Consider competence and independence of staff/team performing controls testing.	- Evaluate Control Deficiencies - Significant deficiencies, Material Weaknesses - Remediation of control weaknesses - Internal Controls Memo (ICM) or Management Letter - Auditor's report



14. DATA ANALYTICS FOR AUDIT

In today's digital age when companies rely on more and more on IT systems and networks to operate business, the amount of data and information that exists in these systems is enormous. The combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is called data analytics. While it is true that companies can benefit immensely from the use of data analytics in terms of increased profitability, better customer service, gaining competitive advantage, more efficient operations, etc., even auditors can make use of similar tools and techniques in the audit process and obtain good results.

The tools and techniques that auditors use in applying the principles of data analytics are known as Computer Assisted Auditing Techniques or CAATs in short. Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the following:

- ❑ Check completeness of data and population that is used in either test of controls or substantive audit tests.
- ❑ Selection of audit samples – random sampling, systematic sampling.
- ❑ Re-computation of balances – reconstruction of trial balance from transaction data.
- ❑ Reperformance of mathematical calculations – depreciation, bank interest calculation.
- ❑ Analysis of journal entries
- ❑ Fraud investigation.
- ❑ Evaluating impact of control deficiencies.

15. DIGITAL AUDIT

Entities are embracing digitization as part of their operations to keep pace with changing times. New technologies are helping companies revamp their operations and rethink the way business is conducted. Companies are restructuring their business models driven by technology. Automation is key to digitization.

In such a business environment, use of digital technology is being made by auditors right from planning to expression of final opinion. Auditors are making use of artificial intelligence, data analytics and other latest technologies to help understand business processes in a better way. By using such tools, auditors can conduct audit in a better way and devote more attention to areas requiring greater focus. Digital audit is helping auditors to better identify risks making use of technology.

16. ASSESS AND REPORT AUDIT FINDINGS

At the conclusion of each audit, it is possible that there will be certain findings or exceptions in IT environment and IT controls of the company that need to be assessed and reported to relevant stakeholders including management and those charged with governance viz., Board of directors, Audit committee.

Some points to consider are as follows:

- ❑ Are there any weaknesses in IT controls?
- ❑ What is the impact of these weaknesses on overall audit?
- ❑ Report deficiencies to management – Internal controls memo or Management letter.
- ❑ Communicate in writing any significant deficiencies to those Charged with governance.

The auditor needs to assess each finding or exception to determine impact on the audit and evaluate if the exception results in a deficiency in internal control.

A deficiency in internal control exists if 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 the control is missing. Evaluation and assessment of audit findings and control deficiencies involves applying professional judgement that include considerations for quantitative and qualitative measures. Each finding should be looked at individually and in the aggregate by combining with other findings/deficiencies.

CASE STUDY

CA Piyush is understanding internal controls as part of audit exercise of a company. It is a new client. He has studied controls in place in various operational areas of the company. After studying and gaining an understanding of such controls, he has decided to test few controls to actually see whether these are operating as intended by the management.

Till now, he has studied controls over inventories and bank. Few of such controls are listed below: -

Nature of Control	Control description
Control over inventories	Inventories of the company lying at each location should be insured.
Control over inventories	There should be inventory counts on a regular basis for each location of the company.
Control over Bank operations	Bank reconciliations are to be performed at regular intervals.

Based on above, answer the following questions: -

1. Which of the following most appropriately describes test of control regarding insurance of inventories?
 - (a) *Inspect insurance policies to verify that inventories at each location are insured for fire and burglary. The sum insured and period of validity of policy are not relevant.*
 - (b) *Inspect insurance policies to verify that inventories at each location are comprehensively insured. Ensure adequacy of sum insured by comparing it with value of inventories. Also ensure policy period has not expired.*
 - (c) *Inspect insurance policies to verify that inventories at each location are comprehensively insured. Ensure policy period has not expired.*
 - (d) *Inspect insurance policies to verify that inventories at each location are insured for fire and burglary. Ensure policy period has not expired.*
2. Which of the following most appropriately describes test of control regarding inventory counts?
 - (a) *Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure.*
 - (b) *Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure. Attend inventory count.*
 - (c) *Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure. Attend inventory count and perform test count.*
 - (d) *Attend inventory count and perform test count.*
3. While testing control over bank reconciliations, it has been noticed that bank reconciliations are not being performed at regular intervals. Identify the most appropriate description of "control deficiency" in this regard: -
 - (a) *Bank reconciliations are not being performed regularly as concerned staff is overburdened.*
 - (b) *Bank reconciliations are not being performed regularly as concerned staff is overburdened. It could result in errors.*

- (c) Bank reconciliations are not being performed regularly as concerned staff is overburdened. It could result in errors. It may result in misstatement of cash and bank balance in financial statements.
- (d) Bank reconciliations are not being performed regularly as concerned staff is overburdened. These should be performed monthly and reviewed by senior accountant.
4. Since the company is a new client, which of the following statements is most appropriate?
- (a) There is reduced detection risk.
- (b) There is increased detection risk.
- (c) There is no effect on detection risk.
- (d) Detection risk should be increased to lower audit risk.
5. Which of the following statements is most appropriate regarding auditor's response to assessed risk of a new client?
- (a) More substantive procedures would require to be performed.
- (b) Less substantive procedures would require to be performed.
- (c) There is no effect on substantive procedures.
- (d) There is no effect on substantive procedures as audit risk is low.

Answers to Questions involving case study

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

SUMMARY

- ◆ Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.
- ◆ Risks of material misstatements consists of two components i.e., inherent risk and control risk.
- ◆ There is always a risk that before considering any existence of internal control in an entity, a particular transaction, balance of an account or a disclosure required to be made in the financial statements of an entity have a chance of

being misstated and such misstatement can be material. This risk is known as inherent risk.

- ◆ Control risk is a risk that internal control existing and operating in an entity would not be efficient enough to stop from happening, or find and then rectify in an appropriate time, any material misstatement relating to a transaction, balance of an account or disclosure required to be made in the financial statements of that entity.
- ◆ Detection risk is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements. It comprises of sampling and non-sampling risk.
- ◆ The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.
- ◆ Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.
- ◆ Performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.
- ◆ Obtaining an understanding of the entity and its environment, including the entity's internal control is a continuous, dynamic process of gathering, updating and analysing information throughout the audit.
- ◆ 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.
- ◆ Significant risks often relate to significant nonroutine transactions or judgmental matters.
- ◆ A proper understanding of the internal control system in its content and working also enables an auditor to decide upon the appropriate audit

procedure to be applied in different areas to be covered in the audit programme.

- ◆ Methods of evaluating internal control include narrative record, checklist, internal control questionnaire and flow chart.
- ◆ Test of controls are performed to obtain audit evidence about the effectiveness of the design of the accounting and internal control system and operation of the internal control throughout the period.
- ◆ The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex.
- ◆ Controls in an automated environment include general IT controls, application controls and IT-dependent controls.
- ◆ The combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is called data analytics.
- ◆ The objective of the auditor is to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

For a concise revision of the key concepts covered in this chapter, students may refer to the Saransh Booklet for Paper 5: Auditing and Ethics, which serves as a useful last-mile revision resource for examination preparation. Saransh Booklet can be accessed at <https://resource.cdn.icai.org/85998bos-aps751-int-p5.pdf>

TEST YOUR KNOWLEDGE

MCQs based Questions

1. Which of the following is true regarding materiality?
 - (a) It is unaffected by nature of an item.
 - (b) It is unaffected by requirements of law or regulations.
 - (c) It is not a matter of professional judgment.
 - (d) It is not always a matter of relative size.

2. *The operations of a company are automated substantially. Which of the following statements is most appropriate in this respect?*
- (a) *It results in complex business environment.*
 - (b) *It results in simple business environment and easier audit.*
 - (c) *Automation has no relationship with complexity of business environment.*
 - (d) *It results in simple business environment. However, it increases complexity of audit.*
3. *Who is responsible for maintaining effective internal financial controls?*
- (a) *Statutory auditor*
 - (b) *Audit Committee*
 - (c) *Management*
 - (d) *Shareholders*
4. *Which of the following is not a risk to a company's internal control due to its IT environment?*
- (a) *Potential loss of data*
 - (b) *Inability to access data when required*
 - (c) *Unauthorized access to data*
 - (d) *Processing of large volumes of data*
5. *Which of the following is not an example of "General IT controls"?*
- (a) *Controls pertaining to Disaster recovery plan*
 - (b) *Controls pertaining to batch preparation*
 - (c) *Controls pertaining to data security*
 - (d) *Controls pertaining to validation of input data in an application*

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

- (i) *There is direct relationship between materiality and the degree of audit risk.*

- (ii) *Control risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.*
- (iii) *Tests of control are performed to obtain audit evidence about the effectiveness of Internal Controls Systems.*
- (iv) *Maintenance of Internal Control System is the responsibility of the Statutory Auditor.*

Theoretical Questions

1. *Discuss how "analytical procedures" performed as "risk assessment procedures" can be useful to an auditor.*
2. *Is materiality required to be documented by the auditor? What factors have to be considered in this regard?*
3. *Discuss relationship between "General IT controls" and "application controls" in an automated environment.*
4. *A company functions in an automated environment. Discuss in what areas data analytics can be useful for auditor of the company.*
5. *What is understood by "non-routine" transactions? Briefly outline why risks of material misstatement is greater for such transactions.*
6. *"The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting" Explain.*
7. *"Risk of material misstatement consists of two components" Explain clearly defining risk of material misstatement.*
8. *"The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the risks of material misstatement" Explain*
9. *"The auditor shall obtain an understanding of the control environment" Explain stating what is included in control environment.*
10. *Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. Explain stating clearly the objectives of Internal Control.*

11. *Identify and briefly explain the component of risks of material misstatement involved in the following situations:*
- (i) *GHK Private Limited is a start-up engaged in providing comprehensive solutions to the issue of paddy stubble burning, mainly catering to the needs of farmers of North-western India. Due to the importance given by governments to this issue, companies have entered the market in the past few years. Many of these companies have not been successful and have gone bust.*
 - (ii) *A company has devised a control that its inventory of perishable goods is stored in appropriate conditions in a controlled environment to prevent any damage to inventory. Responsibility is fixed on two people to monitor the environment using sensors and to report on deviations.*
 - (iii) *Shree Foods Private Limited is engaged in the manufacturing of garlic bread. The auditors of the company have planned audit procedures in respect of recognition of revenues of the company. Despite that, there is a possibility that the misstatements in revenue recognition are not identified by planned audit procedures.*
12. *While it is true that companies can benefit immensely from the use of data analysis in terms of increased profitability, better customer service, etc. Analyse various functions that an auditor can perform using Data Analytics tools and techniques to obtain good results.*
13. *As part of the risk assessment procedure, an auditor is required to determine whether any of the identified risks are, in their professional judgment, significant risks. In making this determination, the auditor must consider several key factors. Explain the factors that an auditor should consider while determining whether an identified risk qualifies as a significant risk, as per the relevant standards on auditing.*
14. *CA Sakshi, the statutory auditor of ZMC Ltd., a medium-sized trading company, was reviewing the company's internal control system as part of her audit procedures. She noticed following instances where errors and lapses occurred:*
- *An employee failed to take action on an important report due to lack of understanding of its content.*
 - *The finance team made duplicate payments.*

- *Two employees colluded to override a system check related to customer credit limits.*
- *The owner approved certain transactions bypassing standard operating procedures, raising concerns about management override.*
- *Duties were not segregated properly due to limited staff strength.*

CA Sakshi discussed these findings with the management and explained that such control failures, despite the existence of internal controls, are not rare. She also highlighted that internal control systems inherently have certain limitations.

Based on the above, what is CA Sakshi trying to communicate to the management? What are the inherent limitations of internal control systems that may have led to these issues?

15. *DEF Ltd. is a profit-oriented company engaged in the FMCG sector. During the audit for the financial year ended 31st March 2026, the auditor observed that the company's profit before tax from continuing operations has been highly volatile over the past few years due to fluctuations in input costs and competitive pricing strategies. However, the company's total revenue and gross profit have remained relatively stable.*

Further, the company is financed through a mix of equity and borrowings, and its financial statements are used by both investors and lenders for decision-making purposes.

The auditor is in the process of determining materiality for the financial statements as a whole in accordance with relevant Standard on Auditing.

With reference to above, explain the factors that may affect the identification of an appropriate benchmark while determining materiality for the financial statements as a whole. Also, state examples of benchmarks that may be appropriate in such circumstances.

16. *FRN Ltd. is a technology-driven company where most transactions such as sales, purchases, and inventory movements are processed through an automated ERP system. The auditor observed that the company relies heavily on system-based processing, with minimal manual intervention.*

During the audit, it was noted that certain General IT Controls (GITCs), particularly relating to access controls and change management, are either not in place or are ineffective. The auditor is required to evaluate the effectiveness of controls and decide on appropriate audit procedures in such an automated environment.

Explain the testing methods to be used by the auditor in an automated environment and the course of action where GITCs are ineffective.

17. *ABC Limited is a medium-sized manufacturing company having multiple departments and large volume of transactions. The management claims that the company has a well-designed internal control system and an internal audit department in place.*

While planning the statutory audit, the auditor decides to evaluate the internal control system of the company before determining the nature, timing and extent of audit procedures. During the review, the auditor focuses not only on accounting controls but also on administrative controls and their impact on financial reporting. Based on the above facts, explain how evaluation of the internal control system would benefit the auditor in planning and conducting the statutory audit of ABC Limited.

18. *KR & Associates, an auditor of FDP Ltd., observed that the company has implemented various internal controls addressing financial reporting, operational efficiency, and compliances during their preliminary evaluation. CA Karan suggests that all controls should be assessed to mitigate the risk of material misstatement in the financial statements, while CA Rajat is of the view that only those controls deemed relevant to the audit should be assessed based on professional judgment.*

Comment, whether the auditor should assess all the internal controls or limit the assessment to only those considered relevant by the auditor during the audit. Also, discuss the factors influencing the auditor's judgment on the relevance of controls.

19. *CDE Private Limited, a manufacturing company, had made investment in shares of some blue-chip companies. Additionally, it had temporarily deposited some of its extra funds in fixed deposits with a scheduled bank. Dividend from shares amounting to ₹ 1.80 lakhs (net of TDS, TDS = ₹ 0.20 lakhs) and bank interest of ₹ 2.70 lakhs (net of TDS, TDS = ₹ 0.30 lakhs) were credited in bank*

account of the company. During the year 2025-26, it has also sold some shares resulting in net gain of ₹ 5 lakhs. The company has shown above incomes under head "Other income" for consolidated amount of ₹ 9.50 lakhs in the statement of Profit and Loss. No other information is furnished in the financial statements put up for audit. As the auditor of the company, discuss whether the above situation constitutes "misstatement" in the financial statements of the company. Also state, few examples of misstatements.

20. CA Tina, while inspecting financial statements of a company, notices that gross profit ratio of company has increased from 14% in year 2024-25 to 24% in year 2025-26. Considering the above, she has assessed the risk of material misstatement to be high with respect to assertions relating to revenue and various direct expenses. CA Tina wants to know few possible reasons which could have led to abnormal jump in gross profit ratio.

During the discussion among engagement team members, her junior Ms. Tisha, expressed her view that detection risk in this engagement should be kept at high level.

- (i) List out a few possible reasons which could have led to abnormal jump in gross profit ratio.
 - (ii) Do you agree with viewpoint of Tisha? Provide reasons for your answer.
21. Mention the types of control in an automated environment.

Identify the type of control in the following table in Column B against Column A which contains areas where controls are to be implemented in an automated environment.

Column A	Column B
Access security	?
Sequence number checks	?
Data centre and network operations	?
Mandatory data fields	?

22. CA Amit is the auditor of LMN Ltd. While conducting the audit, he wanted to analyze the different components of internal control of the company. Identify and explain which component of internal control he is trying to understand in the following two cases: -

- (i) *Whether controls in LMN Ltd. are operating as intended and they are modified as appropriate for change in conditions.*
- (ii) *Whether there exists proper segregation of duties in the company and the person responsible for recording a transaction is different from the person authorizing it.*

ANSWERS/SOLUTIONS

Answers to the MCQs based Questions

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

Answers to Correct/Incorrect

- (i) **Incorrect:** There is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low but the risk that it could be misstated by an extremely small amount might be very high.
- (ii) **Incorrect:** Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls. **Control risk, on the other hand is** the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.
- (iii) **Correct:** Tests of Control are performed to obtain audit evidence about the effectiveness of:
 - (a) the design of the accounting and internal control systems that is whether, they are suitably designed to prevent or detect or correct material misstatements and
 - (b) the operation of the internal controls throughout the period.

- (iv) **Incorrect:** The management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of the business. Maintenance of Internal Control System is responsibility of management because the internal control is the process designed, implemented and maintained by those charged with governance/management to provide reasonable assurance about the achievement of entity's objectives.

Answers to Theoretical Questions

1. Refer to heading on "What is included in risk assessment procedures" and gather usefulness of analytical procedures performed as risk assessment procedures.
2. Refer to heading on "documenting the materiality".
3. Refer to heading on "General IT controls vs. Application controls".
4. Refer to heading on "data analytics"
5. Refer to heading on "identifying significant risks".
6. Refer to heading on "Internal Control"
7. Refer to heading "Components of risk of material misstatement".
8. Refer to heading on "Combined Assessment of the Risk of Material Misstatement".
9. Refer to heading on "Internal Control".
10. Objectives of Internal Control

Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

Objectives of Internal Control are :

- (i) transactions are executed in accordance with managements general or specific authorization;
- (ii) all transactions are promptly recorded in the correct amount in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;
- (iii) assets are safeguarded from unauthorised access, use or disposition; and
- (iv) the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

- 11. (i)** It has been stated that many companies engaged in providing holistic solutions to problem of stubble burning have not been successful. It shows that line of activity is inherently risky. Therefore, there is a greater possibility of misstatements. The component of risks of material misstatement involved in given situation is "inherent risk."
- (ii)** The company has devised a control that its inventory of perishable goods is stored in appropriate conditions and responsibility is fixed on two persons to monitor environment using sensors and to report on deviations. There is a possibility that persons given responsibility do not perform their work and report deviations. The component of risks of material misstatement involved in given situation is "control risk".
- (iii)** There is a possibility that planned audit procedures may not achieve desired result and fail to detect misstatements in revenue recognition. The risk alluded to it is "detection risk".
- 12.** Refer para 14.
- 13.** Refer para 5.
- 14.** In the given case, CA Sakshi, the statutory auditor identified various lapses in the company's internal control system, such as employees failing to act on important reports, duplicate payments, collusion to override system checks, management override of procedures and lack of segregation of duties due to limited staff. While discussing the same with management, she explained that

such deficiencies, despite the presence of internal controls, are not rare due to the inherent limitations of internal control, which include:

Refer para 4.4

15. Refer para 2.6
16. Refer para 11.7
17. Refer para 6.1
18. Refer para 4.6
19. Misstatement refers to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.

In the given situation, there is a difference in amount to be recorded as well as in disclosure of a financial statement item from what is required in accordance with applicable financial reporting framework. The company should have recorded gross amount of dividend and interest amounting to ₹ 2.00 lakhs and ₹ 3.00 lakhs respectively in its financial statements in accordance with AS 13. Therefore, amount recorded under head "Other income" should have been for ₹ 10 lakhs (2 lakhs+3 lakhs+5 lakhs).

Further, in accordance with disclosure requirements of Schedule III of the Companies Act, 2013, other income shall be classified in the above situation as: -

- (a) Interest Income of ₹ 3 lakhs
- (b) Dividend Income of ₹ 2 lakhs
- (c) Net gain on sale of investments of ₹ 5 lakhs

Few examples of misstatements are:

- Charging of an item of capital expenditure to revenue or vice-versa.
- Difference in disclosure of a financial statement item vis-à-vis its requirement in applicable financial reporting framework.
- Selection or application of inappropriate accounting policies.

- Difference in accounting estimate of a financial statement item vis-à-vis its appropriateness in applicable financial reporting framework.
- Intentional booking of fake expenses in statement of profit and loss.
- Overstating of receivables in the financial statements by not writing off irrecoverable debts.
- Overstating or understating inventories.

20. (i) In the given case, risk of material misstatement has been assessed as high in respect of assertions relating to revenue and various direct expenses due to increase in gross profit ratio of company from 14% in year 2024-25 to 24% in year 2025-26.

Few possible reasons which could have led to abnormal jump in gross profit ratio include: -

- Overvaluation of inventories
- Overstatement of revenues
- Understatement of direct expenses

- (ii) SA 200, "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing" defines detection risk as the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Tisha is of a view that detection risk in this engagement should be kept at high level whereas in the given situation, risk of material misstatement has been assessed as high for assertions relating to revenue and direct expenses. Therefore, detection risk has to be kept at low level so that a material misstatement in these assertions does not remain undetected.

Therefore, view of Ms. Tisha is not proper.

21. **Types of Controls in an automated environment:** Controls in an automated environment can be categorised as under: -

- (i) General IT controls

- (ii) Application controls
- (iii) IT-dependent controls

Column A - Areas where Controls to be implemented	Column B - Type of Controls
Access security	General IT controls
Sequence number checks	Application controls
Data centre and network operations	General IT controls
Mandatory data fields	Application controls

22. (i) In this case, CA. Amit is trying to understand that whether controls in the LMN Ltd. are operating as intended and they are modified as appropriate for change in conditions: He is gaining the understanding of the Monitoring of controls component of internal control. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It helps in assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. It includes considering whether controls are operating as intended and that they are modified as appropriate for change in conditions.
- (ii) In the given situation, CA Amit is trying to understand that whether there exists a proper system of segregation of duties in the company and the person responsible for recording a transaction is different from the person authorising it. He is gaining an understanding of internal control of the company. In particular, he is understanding "control activities". When a person recording a transaction is different from one authorizing it, he gains confidence that there exists a system for preventing misstatements. It helps him in gaining insight into the internal control system of the company.

Answers to Questions involving Test your Understanding

1. It has been stated that many companies engaged in providing holistic solutions to problem of stubble burning have not been successful. It shows that line of activity is inherently risky. Therefore, there is a greater possibility

of misstatements. The component of risks of material misstatement involved is "inherent risk."

2. The company has devised a control that its inventory of perishable goods is stored in appropriate conditions and responsibility is fixed on two persons to monitor environment using sensors and to report on deviations. There is a possibility that persons given responsibility do not perform their work and report deviations. The component of risks of material misstatement is "control risk".
3. There is a possibility that planned audit procedures may not achieve desired result and fail to detect misstatements in revenue recognition. The risk alluded to it is "detection risk".
4. Jo Jo Limited is planning to list on Bombay Stock Exchange next year. There is a greater chance of misstatements in the financial statements due to planned listing next year. There could be a possibility of intentional manipulation of financial statements so that good response is received to proposed issue. Therefore, there is increased audit risk i.e., risk of expressing inappropriate opinion by the auditor when financial statements are materially misstated.
5. It is noticed by the auditor that current ratio has improved from 1.20:1 (in preceding year) to 1.75:1 (in current year). The auditor is using "analytical procedures" as risk assessment procedures. Current ratio has improved from previous year. There could be a possibility of misstatement in current assets and current liabilities. It is possible that improvement in current ratio is artificial due to misstatements and has been done to secure good response to the proposed issue of company next year.
6. If there is any statutory requirement of disclosure, it is to be considered material. Schedule III mandates disclosure of nature of security in relation to loan. The amount involved is irrelevant.
7. The study of company policies and practices regarding employee recruitment, training, orientation and related matters including hiring of best candidates is part of understanding HR function of the company. It, in turn, helps in understanding control environment of the company. By gaining such a knowledge, she can better understand internal control of the company.

8. She is keen to find out whether there exists a proper system of segregation of duties in the company. She is gaining an understanding of internal control of the company. In particular, she is understanding "control activities". When a person recording a transaction is different from one authorizing it, she gains confidence that there exists a system for preventing misstatements. It helps her in gaining insight into the internal control system of the company.
9. In a small company, control systems are basic and not formalized. Therefore, auditor should proceed to evaluate internal control using narrative record.
10. Cash is not deposited into bank frequently, although, concerned staff of company was required to do so. Further, the official responsible for ensuring performance of above function, has also not paid any attention to it. It means that control is not working as planned. It would not be able to prevent misstatement and very purpose of control is defeated. It represents a "control deficiency".

AUDIT EVIDENCE

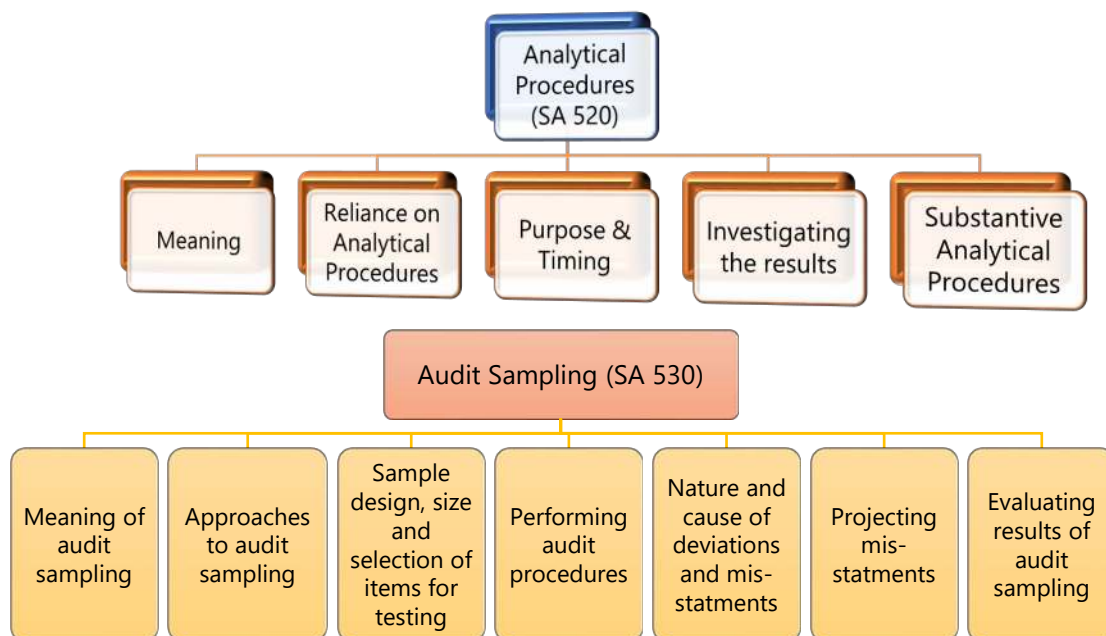
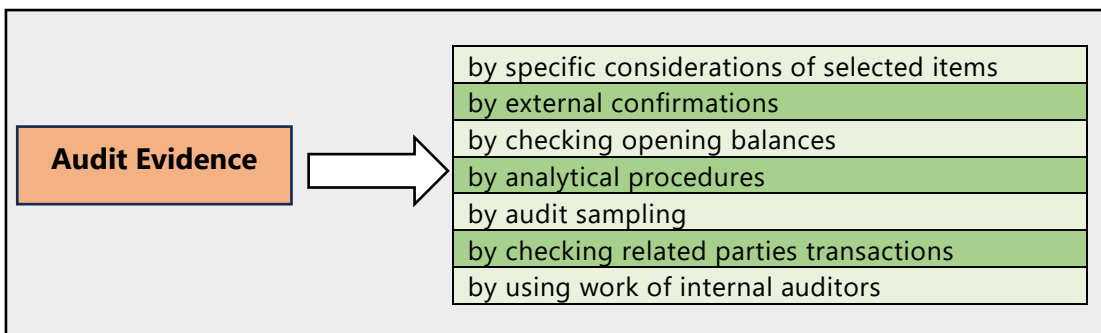


LEARNING OUTCOMES

After studying this chapter, you would be able to understand-

- ◆ Audit Evidence (SA 500)- Meaning, types, relevance and reliability, sufficiency and appropriateness and sources of audit evidence, audit procedures, nature and timing of audit procedures, Assertions, selecting items for testing, relying on the work of management expert and evaluation of audit evidence.
- ◆ Audit Evidence- Specific Considerations for Selected Items (SA 501)- inventory, litigation and claims involving the entity, and segment information.
- ◆ External Confirmations (SA 505)- meaning, definition of external, positive and negative confirmations.
- ◆ Initial Audit Engagements-Opening Balances (SA 510) - meaning and objective, sufficient appropriate audit evidence, audit procedures, and reporting regarding opening balances.
- ◆ Analytical Procedures SA (520)- meaning, scope, nature, timing, purpose, objective and forming overall conclusion based on analytical procedures.
- ◆ Audit Sampling (SA 530)- Meaning of Sample, sampling unit, sampling process, approaches and methods of sampling.
- ◆ Related Parties (SA 550)- Definition, meaning and nature of related parties relationship and transactions.
- ◆ Using the work of internal Auditors (SA 610)- Meaning, scope and objective, nature and extent of work of internal audit function, their activities, external auditor's responsibility for audit and objective having internal audit function, coordination between external auditor and internal auditor.
- ◆ Practicality of above concepts by studying through examples and case studies

CHAPTER OVERVIEW



"Audit evidence" is the very core on the basis of which conclusions are drawn and opinion is formed by an auditor. In fact, it is the foundation upon which edifice of auditing is built. On a Sunday evening, Sameer was interacting with one of his friends, Shekhar, who had joined articleship and was part of an engagement team conducting audit of a company engaged in manufacturing activities. He got to know that Shekhar was part of team attending physical count process of inventories of the company as at year end. Besides, he was also responsible for going through sales of the company, checking few sales invoices and tracing those entries in books.

After some days, both of them had a chance to meet again. Informal conversations between them drifted towards audit of that company. Sameer was visibly excited to know that his friend was helping seniors in designing and sending confirmation requests to the entities to whom this company had sold goods. "Such a process must be providing sufficient appropriate evidence for the purpose of audit"- He murmured in between.

He had an inkling that evidence should provide satisfaction to the auditor. What are the contours of it? Whether a piece of evidence coming from outside the company can only provide comfort to the auditor? What about company's internal documents and records? Aren't these also pieces of information which form part of audit evidence? His inquisitiveness was prompting him to know whether audit evidence has only to be in writing. Or can it take some other forms? Whether evidence in other forms can suffice for purpose of audit?

Besides, he was also trying to understand about nuances of inventory counting process which had cropped up in their previous discussion. Such procedures help auditor to obtain audit evidence. He precisely wanted to understand what such procedures are called as. Are there other procedures also?

He also recalled his earlier discussion where Shekhar had told him regarding his responsibility of checking "few sales invoices". How the team would have arrived at the decision to check those sample invoices? Are some methods or techniques involved in it? How does team ensure that items being selected for checking are truly representative? Recapitulating that choosing of inappropriate sampling methods can lead to increase in detection risk and consequent rise in audit risk, significance of selecting appropriate samples was not lost on him.





1. AUDIT EVIDENCE

1.1 Introduction

Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively.

Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs. An opinion founded on a rather reckless and negligent examination and evaluation may expose the auditor to legal action with consequential loss of professional standing and prestige.

He needs evidence to obtain information for arriving at his judgement.

In accordance with SA 500, the objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to draw reasonable conclusions on which to base the auditor's opinion.

1.2 Meaning of Audit Evidence as per SA 500

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

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

It includes both information contained in the accounting records underlying the financial statements and other information

ILLUSTRATION 1

The auditor of JPJ Limited explained to the audit team members about the relationship between Audit Evidence and Opinion of Auditor. Explain what relationship exists between Audit Evidence and Opinion of Auditor.

SOLUTION

There exists a very important relationship between Audit Evidence and opinion of the Auditor. While conducting an audit of a company, the auditor obtains audit evidence and with the help of that audit evidence obtained, the auditor forms an audit opinion on the financial statements of that company.

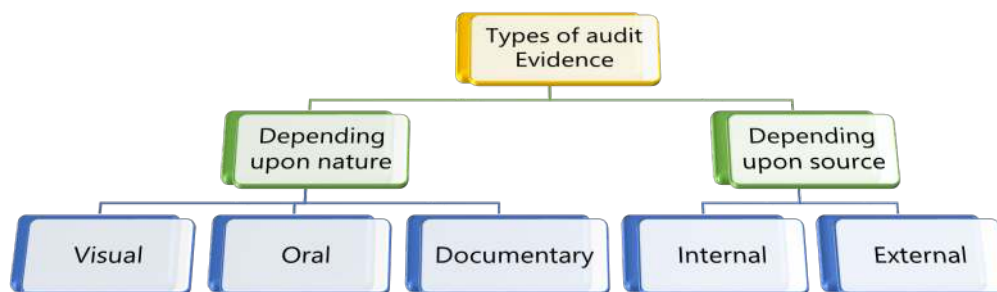
Explaining this further, audit evidence includes:-**(1) Information contained in the accounting records****Accounting records include**

- the records of initial accounting entries and supporting records, such as cheques and records of electronic fund transfers;
- invoices;
- contracts;
- the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and
- records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

(2) Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements Other information which the auditor may use as audit evidence includes, for example

- minutes of the meetings,
- written confirmations from trade receivables and trade payables,
- manuals containing details of internal control etc.

1.3 Types of Audit Evidence



(a) Depending upon nature:

1. **Visual:** For example, observing physical verification of inventory conducted by the client's staff.
2. **Oral:** For example, discussion with the management and various officers of the client.
3. **Documentary:** For example, fixed deposit certificate, loan agreement, sales bill etc.

(b) Depending upon source:

1. **Internal Evidence:** Evidence which originates within the organisation being audited is internal evidence.

Example

Sales invoice, Copies of sales challan and forwarding notes, goods received note, inspection report, copies of cash memo, debit and credit notes, etc.

2. **External evidence:** The evidence that originates outside the client's organization is external evidence.

Example

Purchase invoice, supplier's challan and forwarding note, debit notes and credit notes coming from parties, quotations, confirmations, etc.

In an audit situation, the bulk of evidence that an auditor gets is internal in nature. However, substantial external evidence is also available to the auditor. Since in the origination of internal evidence, the client and his staff have the control, the auditor should be careful in putting reliance on such evidence. It is not suggested that they are to be suspected; but an auditor has to be alive to the possibilities of manipulation and creation of false and misleading evidence to suit the client or his staff.

The external evidence is generally considered to be **more reliable as they come from third parties** who are not normally interested in manipulation of the accounting information of others. However, if the auditor has any reason to doubt the independence of any third party who has provided any material evidence **e.g. an invoice of an associated concern**, he should exercise greater vigilance in that matter.

As an ordinary rule, the auditor should try to **match internal and external evidence as far as practicable**. Where external evidence is not readily available to match, the auditor should see as to what extent the various internal evidences corroborate one another.

ILLUSTRATION 2

An audit team member of the auditors of Genuine Limited was of the view that audit evidence obtained internally from within the company under audit are more appropriate from the reliability point of view as compared to audit evidence obtained externally as evidence obtained internally are obtained from the company whose audit is being conducted.

Give your views as auditor of Genuine Limited.

SOLUTION

Audit evidence obtained externally is more appropriate from reliability point of view as compared to those which are obtained internally. The reason that audit evidence obtained externally is more appropriate from the point of view of reliability is that there is a very low risk that they can be altered or changed.

1.4 Relevance and Reliability of audit evidence

The auditor has to express opinion on the truth and fairness on the financial statements. He shall consider the relevance and reliability of the information to be used as audit evidence.

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

RELEVANCE AND RELIABILITY OF AUDIT EVIDENCE

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.

The 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.

1.4.1 Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing.

Example

If the purpose of an audit procedure is to test for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure.

On the other hand, when testing for understatement in the existence or valuation of accounts payable, testing the recorded accounts payable would not be relevant, but testing such information as subsequent disbursements, unpaid invoices, suppliers' statements, and unmatched receiving reports may be relevant.

A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others. **For example**, inspection of documents related to the collection of receivables after the period end may provide audit evidence regarding existence and valuation, but not necessarily cut-off. Similarly, obtaining audit evidence regarding a particular assertion, for example, the existence of inventory, is not a substitute for obtaining audit evidence regarding another assertion, **for example**, the valuation of that inventory. On the other hand, audit evidence from different sources or of a different nature may often be relevant to the same assertion.

Tests of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. Designing tests of controls to obtain relevant audit evidence includes identifying conditions (characteristics or attributes) that indicate performance of a control, and deviation in conditions which indicate departures from adequate performance. The presence or absence of those conditions can then be tested by the auditor.

Substantive procedures are designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures. Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.

1.4.2 Reliability

Information to be used as audit evidence should be reliable.

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.

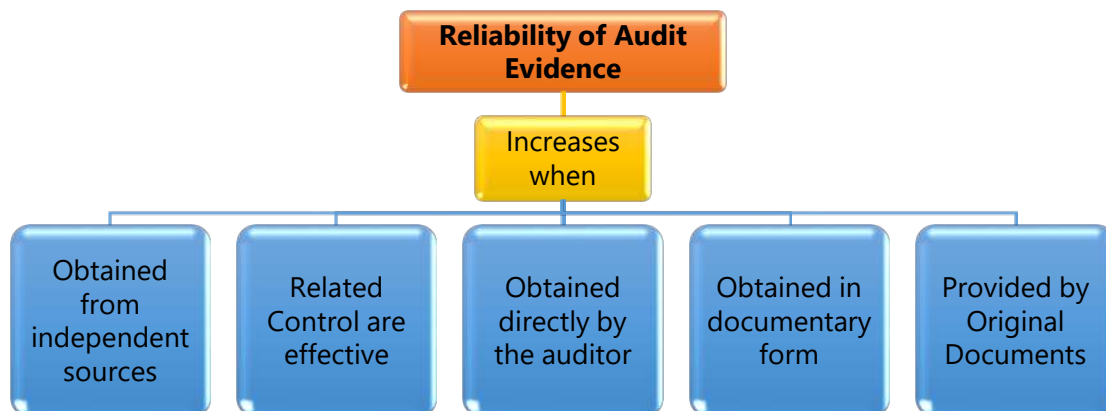
For example,

information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity.

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

- The reliability of audit evidence is **increased when it is obtained from independent sources outside the entity**.
- The reliability of audit evidence that is generated internally is **increased when the related controls**, including those over its preparation and maintenance, **imposed by the entity are effective**.

- Audit evidence obtained **directly by the auditor (for example, observation of the application of a control)** is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Audit evidence in **documentary form**, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
- Audit evidence obtained as original documents is more reliable than audit evidence obtained as photocopies or facsimiles, or documents that have been filmed, digitised or otherwise transformed into electronic form because in these cases the reliability of which may depend on the controls over their preparation and maintenance.



1.5 Sufficient appropriate audit evidence

The auditor has to obtain sufficient appropriate audit evidence to draw reasonable conclusions on financial statements.

1.5.1 Sufficiency and Appropriateness are interrelated.

The sufficiency and appropriateness of audit evidence are interrelated.

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

The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required)

Appropriateness is the measure of the **quality of audit evidence**; that is, **its relevance and its reliability** in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and nature, and is dependent on the individual circumstances under which it is obtained.



1.5.2 Obtaining Sufficient and appropriate Audit Evidence by the Auditor

The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient and appropriate audit evidence.

Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit.

It may, however, also include information obtained from other sources such as previous audits. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence.

Also, information that may be used as audit evidence may have been prepared using the work of a management's expert.

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

In addition, **in some cases the absence of information** (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, **also constitutes audit evidence**.

Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. The auditor uses various audit procedures to obtain audit evidence such as inspection, observation, confirmation, recalculation, reperformance and analytical procedures, often in some combination, in addition to inquiry.

Reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level.

SA 330 requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment.

SA 200 contains discussion of such matters as the nature of audit procedures, the timeliness of financial reporting, and the balance between benefit and cost, which are relevant factors when the auditor exercises professional judgment regarding whether sufficient appropriate audit evidence has been obtained.

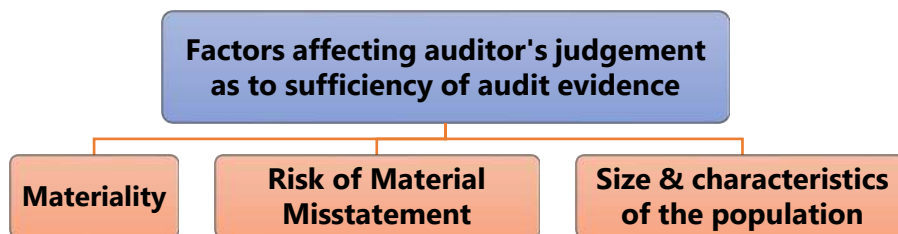
ILLUSTRATION 3

There was a Partnership Firm of Chartered Accountants VM and Associates. Mr. M, one of the partners of VM and Associates, while explaining to his audit team members about importance of audit evidence informed them about sufficiency and appropriateness of audit evidence. Mr. A, one of the members of audit team of VM and Associates was of the view that sufficiency of audit evidence means simplicity of audit evidence and appropriateness of audit evidence means ease of obtaining audit evidence. Explain whether sufficiency and appropriateness of audit evidence mean simplicity and ease of obtaining audit evidence.

SOLUTION

Sufficiency and Appropriateness of audit evidence does not mean simplicity and ease of obtaining audit evidence rather sufficiency of audit evidence is related to the quantity of audit evidence and appropriateness of audit evidence is related to quality of audit evidence.

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



- (a) **Materiality:** It may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand if assertions are more material to the users of the financial statements, more evidence would be required.
- (b) **Risk of material misstatement:** It may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components described as follows at the assertion level:
- Inherent risk—The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls.
 - Control risk—The risk that a misstatement that could occur in an assertion that could be material will not be prevented or detected and corrected on a timely basis by the entity's internal control.

Less evidence would be required in case assertions that have a lower risk of material misstatement. But on the other hand, if assertions have a higher risk of material misstatement, more evidence would be required.

- (c) **Size & characteristics of a population:** It refers to the number of items included in the population. Less evidence would be required in case of smaller, more homogeneous population but on the other hand in case of larger, more heterogeneous populations, more evidence would be required.

1.6 Source of audit evidence

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

Example

through analysis and review,
reperforming procedures followed in the financial reporting process,
and reconciling related types and applications of the same information.

Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements.

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

Example

Corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from audit evidence that is generated internally, such as evidence existing within the accounting records, minutes of meetings, or a management representation.

Information from sources independent of the entity that the auditor may use as audit evidence may include confirmations from third parties, analysts' reports, and comparable data about competitors.

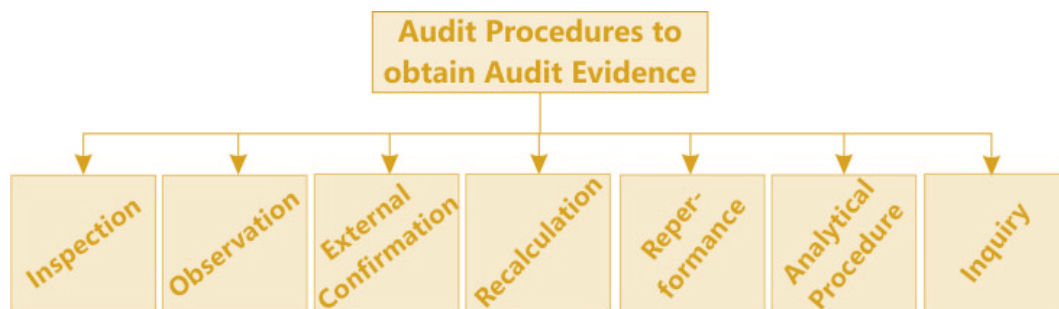
1.7 Audit procedures for obtaining audit evidence

Audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

- (a) Risk assessment procedures; and
- (b) Further audit procedures, which comprise:
 - (i) Tests of controls, when required by the SAs or when the auditor has chosen to do so; and
 - (ii) Substantive procedures, including tests of details and substantive analytical procedures.

1.7.1 Audit procedures to obtain audit evidence can include:

- (i) Inspection
- (ii) Observation
- (iii) External Confirmation
- (iv) Recalculation
- (v) Reperformance
- (vi) Analytical Procedures
- (vii) Inquiry



(i) Inspection

Inspection involves **examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset.** Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production.

An example of inspection used as a test of controls is inspection of records for evidence of authorisation.

Some documents represent **direct audit evidence of the existence of an asset, for example,** a document constituting **a financial instrument such as a stock or bond.** Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.

Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

ILLUSTRATION 4

While auditing the books of accounts of AB Limited for the financial year 2025-26, the auditor of the company used an audit procedure according to which complete documents and records of the company were checked in detail in order to obtain audit evidence. Explain the audit procedure used by the auditor of Extremely Distinct Limited.

SOLUTION

The audit procedure used by auditor of AB Limited is known as Inspection because inspection is an audit procedure in which complete documents and records of a company are checked in detail for the purpose of obtaining audit evidence.

(ii) Observation

Observation consists of looking at a process or procedure being performed by others.

For example,

the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities.

Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed.

(iii) External Confirmation

An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only.

Example

The auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are.

External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions.

Example

The absence of a "side agreement" that may influence revenue recognition.

(iv) Recalculation

Recalculation consists of **checking the mathematical accuracy of documents or records**. Recalculation may be performed manually or electronically.

(v) Reperformance

Reperformance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

Example

Re-performing the reconciliation of bank statement, re-performing the aging of accounts receivable.

(vi) Analytical Procedures

Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data.

Analytical procedures also encompass **the investigation of identified fluctuations and relationships** that are inconsistent with other relevant information or deviate significantly from predicted amounts.

(vii) Inquiry

Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures.

Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, **for example**, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries.

Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

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

The audit procedures inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry may be used as risk assessment procedures, tests of controls or substantive procedures, depending on the context in which they are applied by the auditor.

Audit evidence obtained from previous audits may, in certain circumstances, provide appropriate audit evidence where the auditor performs audit procedures to establish its continuing relevance.

Example indicating same audit procedure used for different purposes

During the audit of ABC Ltd., the auditor inspects a sample of purchase invoices at the planning stage to understand the purchase process and identify areas where material misstatements may arise. In this context, inspection is used as a risk assessment procedure.

Later, while evaluating internal controls, the auditor inspects the same purchase invoices to verify whether each invoice bears the approval of the Purchase Manager as required by the company's internal control policy. Here, inspection is used as a test of controls to determine whether the approval control operated effectively throughout the year.

Finally, while verifying the amount of purchases recorded in the financial statements, the auditor inspects purchase invoices, supplier invoices and goods receipt notes to confirm that the recorded purchases are genuine, correctly valued and pertain to the current year. In this case, inspection is used as a substantive procedure to detect material misstatements.

Thus, the same audit procedure—inspection—is used for different purposes depending on the context in which it is applied.

Example indicating use of audit evidence obtained in previous audits

XYZ Ltd. has been audited by the same audit firm for the past several years. During the previous year's audit, the auditor tested the operating effectiveness of the company's automated control whereby sales invoices could not be generated unless the goods dispatch was recorded in the ERP system. The control was found to be operating effectively.

During the current year's audit, before relying on the audit evidence obtained in the previous audit, the auditor performs procedures to establish its continuing relevance. The auditor reviews the system change logs, discusses the matter with the IT Manager, and confirms that there have been no significant changes in the ERP system, the automated control, or the related general IT controls since the previous audit. On the basis of these procedures, the auditor concludes that the audit evidence obtained in the previous audit continues to be relevant and appropriately relies on it while determining the extent of current-year testing.

This illustrates that audit evidence obtained in previous audits may, in appropriate circumstances, be used in the current audit, provided the auditor performs procedures to establish its continuing relevance.

1.7.3 Nature and Timing of the Audit Procedures

The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time.

For example,

source documents, such as purchase orders and invoices, may exist only in electronic form when an entity uses electronic commerce, or may be discarded after scanning when an entity uses image processing systems to facilitate storage and reference.

Certain electronic information may not be retrievable after a specified period of time.

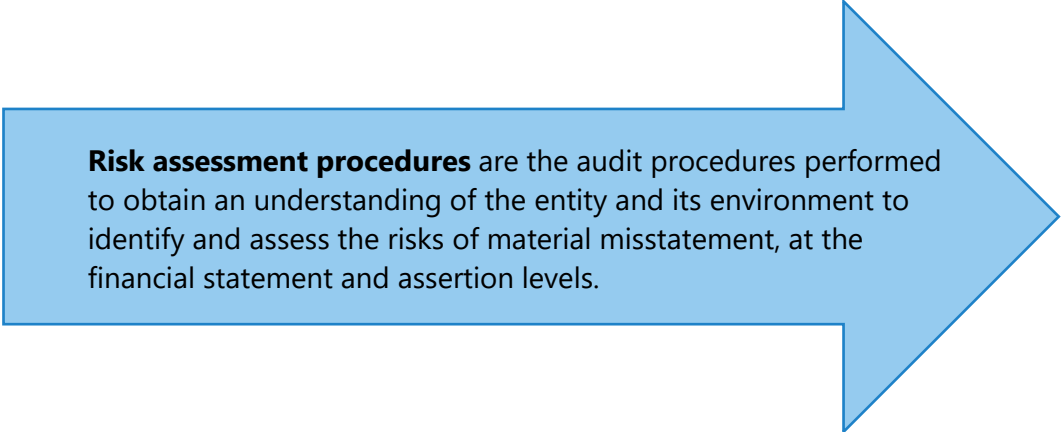
For example

if files are changed and if backup files do not exist. Accordingly, the auditor may find it necessary as a result of an entity's data retention policies to request retention of some information for the auditor's review or to perform audit procedures at a time when the information is available.

At this stage, it would be pertinent to discuss the concept of Risk assessment procedures and Further audit procedures:

1.7a Risk assessment procedures:

Risk assessment procedures refer to the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.



Risk assessment procedures are the audit procedures performed to obtain an understanding of the entity and its environment to identify and assess the risks of material misstatement, at the financial statement and assertion levels.

1.7b Further Audit Procedures

Further Audit Procedures comprise of:

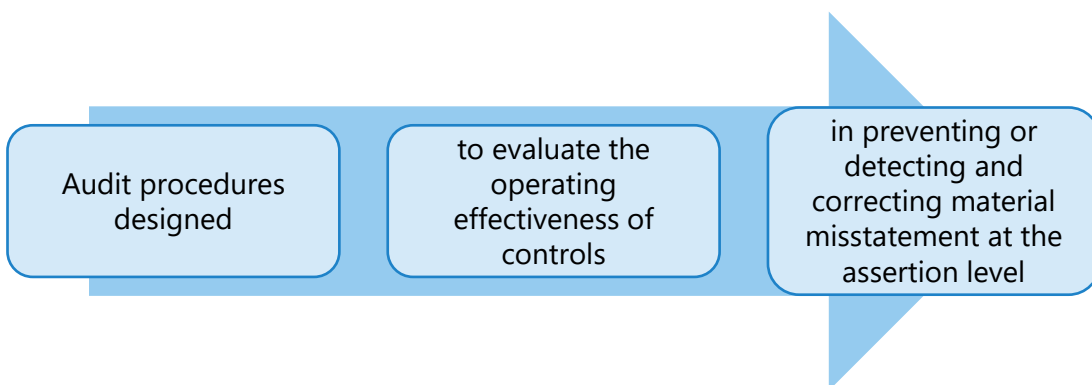
- (i) Tests of controls, when required by the SAs or when the auditor has chosen to do so; and
- (ii) Substantive procedures, including tests of details and substantive analytical procedures.

Further Audit Procedures comprise of:

- (i) Tests of Controls; and
- (ii) Substantive of procedures

(i) Tests of controls

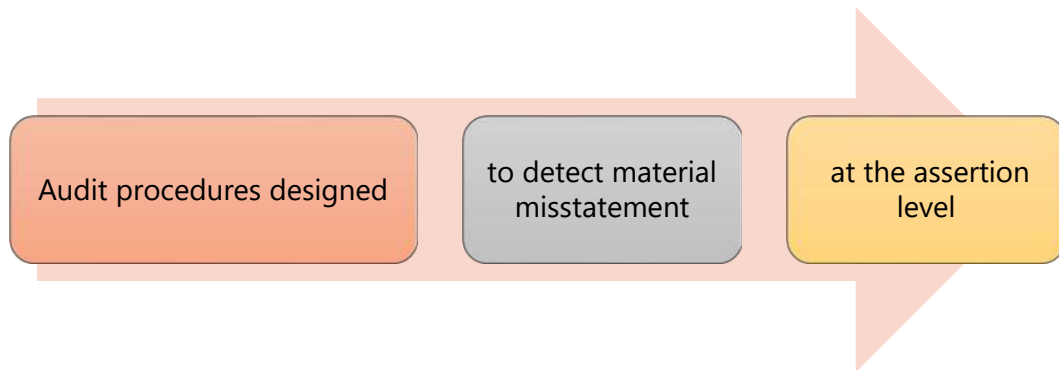
Test of controls may be defined as an audit procedure **designed to evaluate the operating effectiveness of controls** in preventing, or detecting and correcting, material misstatements at the assertion level.

**(ii) Substantive Procedures- Tests of details and Substantive analytical procedures**

Substantive procedures are designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures.

Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.

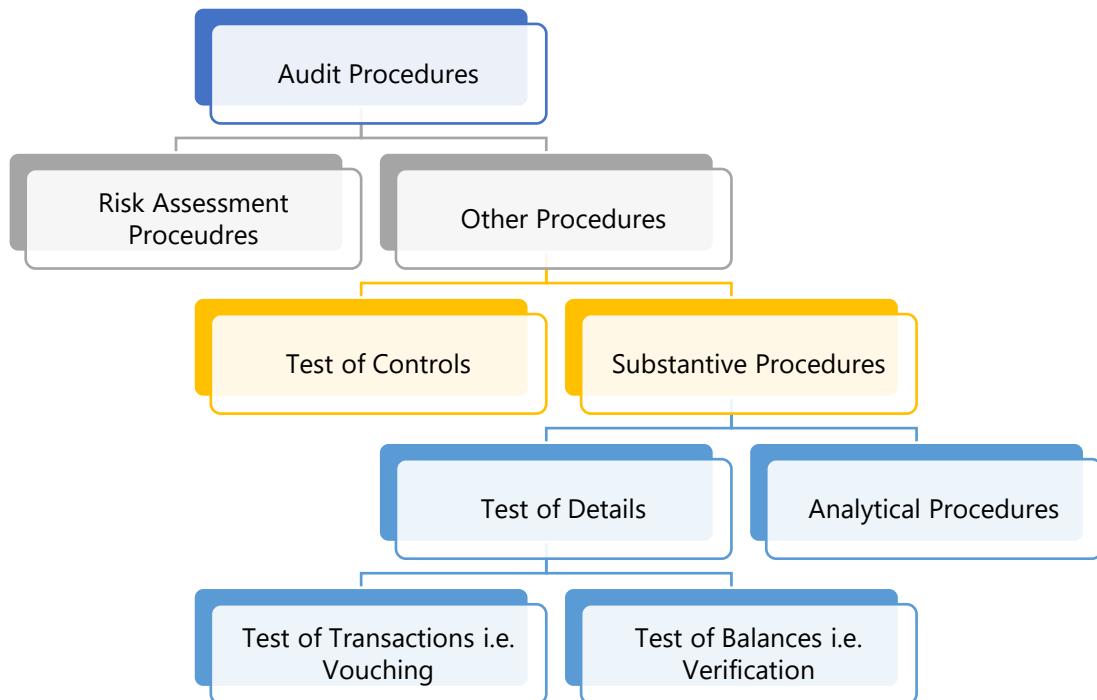
In other words, Substantive procedure may be defined as an audit procedure designed to detect material misstatements at the assertion level.



Substantive procedures comprise:

- (i) Tests of details (of classes of transactions, account balances, and disclosures), and
- (ii) Substantive analytical procedures.

The following chart illustrates different audit procedures:



Test Your Understanding 1

On perusal of financial statements of a company, auditor of company finds that notes to accounts contain ageing of trade payables in accordance with requirements of Schedule III of the Companies Act, 2013. The accountant of the company is responsible for ensuring proper ageing of trade payables included in notes to accounts. The auditor wants to verify whether the ageing of trade payables made in financial statements is proper or not. Identify what he is trying to do.

Test Your Understanding 2

CA Sooryagaythri is conducting audit of an entity. During the course of audit, she has made oral inquiries from head accountant regarding preparing of bank reconciliations every month as has been laid down by the management. Discuss, whether inquiries as stated above would provide satisfaction to her that controls in respect of preparing bank reconciliations statements have operated effectively.

Test Your Understanding 3

A company has stipulated a control that reconciliations of its records showing quantitative details of its property, plant and equipment are carried out at regular intervals with physical verification of such items. The auditor has found that such reconciliations are being carried out as stipulated. Discuss, whether above factor, increases reliability of other internally generated evidence within the company relating to existence of such items.

In obtaining audit evidence from substantive procedures, the auditor is concerned with the following assertions:

1.8 Assertions

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

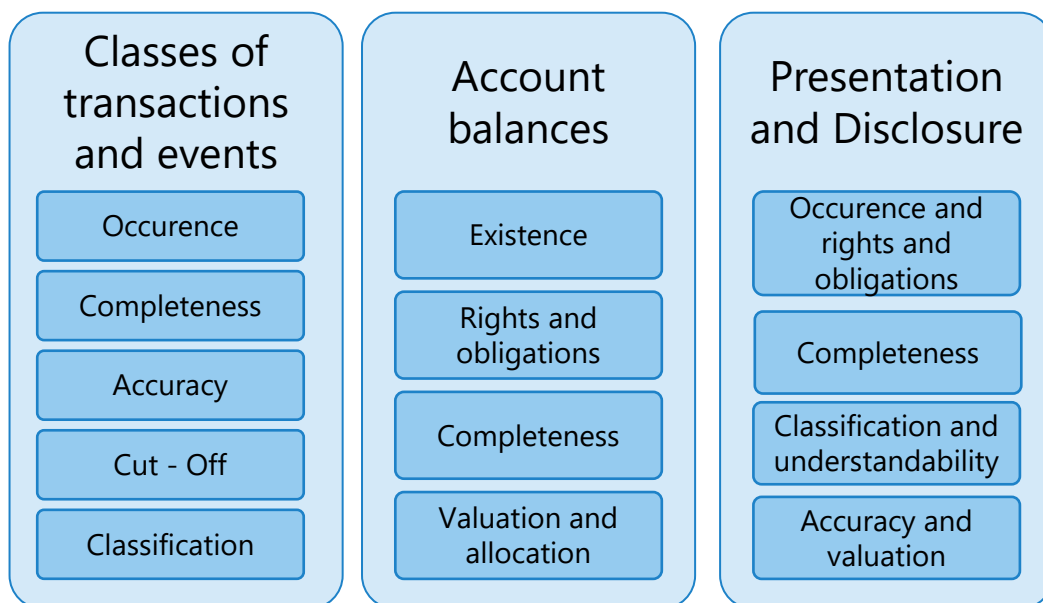
Representations by management

that are embodied in the financial statements

to consider different types of potential misstatements

1.8.1 Assertions contained in the Financial Statements.

1. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.
2. Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following three categories and may take the following forms:



(a) **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.
- (b) **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 recorded have been recorded.
 - (iv) **Valuation and allocation** – assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.
- (c) **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.
3. The auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered.

For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances.

4. When making assertions about the financial statements of certain entities, especially, **for example**, where the Government is a major stakeholder, in addition to those assertions set out in paragraph 2, management may often assert that transactions and events have been carried out in accordance with legislation or proper authority. Such assertions may fall within the scope of the financial statement audit.

Let us elaborate this with the help of two illustrations. We must clearly understand that each item contained in financial statements asserts something to the readers of the accounts to indicate the ownership, existence, quantity of various things, etc. Auditing is concerned with the testing of the authenticity of the information thus conveyed.

Example

When we find in the balance sheet, an item under current assets reading as "cash in hand - ₹ 10,000" the obvious assertions that would strike the mind are the following:

- (i) The firm concerned had ₹ 10,000 in hand in valid notes and coins on the balance sheet day;
- (ii) That the cash was free and available for expenditure to the firm; and
- (iii) That the books of account show a cash balance of identical amount at the end of the day on which the balance sheet is drawn up.

Example

Particulars		₹
Plant and Machinery (at cost)		2,00,000
Less: Depreciation till the end of previous year	70,000	
Depreciation for the year	13,000	83,000
		1,17,000

The assertions are as follows:

- (i) the firm owns the plant and machinery;
- (ii) the historical cost of plant and machinery is ₹ 2 lacs;
- (iii) the plant and machinery physically exists;

- (iv) the asset is being utilised in the business of the company productively;
- (v) total charge of depreciation on this asset is ₹ 83,000 to date on which ₹ 13,000 relates to the year in respect of which the accounts are drawn up; and
- (vi) the amount of depreciation has been calculated on recognised basis and the calculation is correct.

From the above two illustrations we know the sort of assertions that are implied in the financial statements. Incidentally, the assertions are generally implied and not specifically spelt out, though some explicit assertions are also found in the financial statements.

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

An example of the former category may be found in the following items appearing in the liability side of the balance sheet:

Secured Loans ₹ 4,00,000

The description does not give us a complete picture. We do not know:

- (i) the name of the lender, if it is relevant;
- (ii) the nature of security provided; and
- (iii) the rate at which interest is payable.

A specific mention is required about these things for a proper appreciation of the item and the financial position.

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

if it is stated that there is no contingent liability it would be an expressed negative assertion;

On the other hand, if in the balance sheet there is no item as "building", it would be an **implied negative assertion** that the entity did not own any building on the balance sheet date.

Every financial statement contains an overall representation in addition to the specific assertions so far discussed. Each financial statement purports to present something as a whole in addition to its component details. For example, an income statement purports to present "the results of operations" a balance sheet purports

to present “financial position”. The auditor’s opinion is typically directed to these overall representations. But to formulate and offer an opinion on the overall truth of these statements he has first to inquire into the truth of many specific assertions, expressed and implied, both positive, and negative, that makes up each of these statements. Out of his individual judgements of these specific assertions he arrives at a judgement on the financial statements as a whole.

1.9 Audit Trail

An audit trail is a documented flow of a transaction. It is used to investigate how a source document was translated into an account entry and from there it was inserted into financial statement of an entity. It is used as audit evidence to establish authentication and integrity of a transaction. Audit trails help in maintaining record of system and user activity. Like, in case of banks, there is an audit trail keeping track of log-on activity detailing record of log-on attempts and device used.

It is a step-by-step record by which accounting, trade details, or other financial data can be traced to their source. Audit trails are used to verify and track many types of transactions including accounting and financial transactions.

Audit trails (or audit logs) act as record-keepers that document evidence of certain events, procedures or operations, because their purpose is to reduce fraud, material errors, and unauthorized use. Audit trails help to enhance internal controls and data security. Audit trails can help in fixing responsibility, rebuilding events and in thorough analysis of problem areas. For example, audit trails can track activities of users thus fixing responsibility for users. These can also be used to rebuild events upon occurring of some problem. Audit trail analysis can specify reason of the problem. It can also help in ensuring operation of system as intended. In this way, audit trails can help entities in their regular system operations.

However, audit trails involve costs. The cost is not only in terms of system expenditure but also in terms of time involved in analysing data made available by audit trails. However, use of automated tools can be made to analyse large volume of data thrown up by audit trails.

Systems which have a feature of audit trail inspires confidence in auditors. It helps auditors in verifying whether controls devised by the management were operating effectively or not. It aids in verification whether a transaction was indeed performed by a person authorised to do it. Since audit trails also enhance data security, these can be used by auditor while performing audit procedures thus increasing reliability of audit evidence obtained.

1.10 Information to Be Used as Audit Evidence

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

- The nature and complexity of the matter to which the management's expert relates.
- The risks of material misstatement in the matter.
- The availability of alternative sources of audit evidence.
- 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.
- Whether the management's expert is subject to technical performance standards or other professional or industry requirements.
- The nature and extent of any controls within the entity over the management's expert's work.
- The auditor's knowledge and experience of the management's expert's field of expertise.
- The auditor's previous experience of the work of that expert.

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

- (a) Obtaining audit evidence about the accuracy and completeness of the information; and
- (b) Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes.

1.11 Selecting Items for Testing to Obtain Audit Evidence

When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure.

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

- (a) Selecting all items (100% examination);
- (b) Selecting specific items; and
- (c) Audit sampling.

The application of any one or combination of these means may be appropriate depending on the auditors' judgement to obtain audit evidence.

1.11(a) Selecting All Items

The auditor may decide that it will be **most appropriate to examine the entire population of items** that make up a class of transactions or account balance (or a stratum within that population).

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

100% examination may be appropriate when,

For example:

- The population constitutes a small number of large value items;
- There is a significant risk and other means do not provide sufficient appropriate audit evidence; or
- The repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective.

1.11(b) Selecting Specific Items

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

In making this decision, factors that may be relevant include the auditor's understanding of the entity, the assessed risks of material misstatement, and the characteristics of the population being tested.

The judgmental selection of specific items is subject to non-sampling risk.

Specific items selected may include:

- **High value or key items.**

The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic.

For example

items that are suspicious, unusual, particularly risk-prone or that have a history of error.

- **All items over a certain amount.**

The auditor may decide **to examine items whose recorded values exceed a certain amount** so as to verify a large proportion of the total amount of a class of transactions or account balance.

- **Items to obtain information.**

The auditor may examine items to obtain information about matters **such as the nature of the entity or the nature of transactions.**

1.11(c) Audit Sampling

Audit sampling is designed to enable conclusions to be drawn about an entire population on the basis of testing a sample drawn from it. Audit sampling is discussed in subsequent paragraphs.

1.12 Inconsistency in or Doubts over Reliability of Audit Evidence

If:

- (a) audit evidence obtained from one source is inconsistent with that obtained from another; or
- (b) the auditor has doubts over the reliability of information to be used as audit evidence,

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

For example

responses to inquiries of management, internal audit, and others are inconsistent.

SA 230 includes a specific documentation requirement if the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter.

Who is 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.

1.13 Relying on the work of a management's expert

If the entity has employed or engaged experts, the auditor may rely on the works of experts, provided he is satisfied that sufficient and appropriate audit evidence is obtained with reasonable assurance to form an opinion on the financial statements.

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;

- (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.

Example – Work of a Management’s Expert (SA 500)

ABC Ltd. engages an independent actuary to determine its gratuity liability. The actuarial valuation report is prepared for management and used in the preparation of the financial statements. Since the actuary is appointed by management (and not by the auditor), the auditor evaluates the competence, capabilities and objectivity of the actuary and assesses whether the valuation methodology and key assumptions are reasonable. If satisfied, the auditor uses the actuarial report as audit evidence in accordance with SA 500.

1.14 Evaluation of Audit Evidence

SA 500 “Audit Evidence” is applicable to all the audit evidence obtained during the course of the audit to enable the auditor to obtain **sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor’s opinion.**

Most of the auditor’s work in forming the auditor’s opinion consists of obtaining and evaluating audit evidence.

The auditor has to conclude whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor’s opinion, is a matter of professional judgment.

Example – Evaluation of Audit Evidence

XYZ Ltd. has reported Trade Receivables of ₹85 crore as at the year-end. During the audit, the auditor obtains external balance confirmations from major customers, examines subsequent collections received after the year-end, verifies supporting sales invoices and despatch documents and reviews the ageing analysis of outstanding receivables. The auditor also evaluates whether an adequate provision for doubtful debts has been made for long outstanding and doubtful receivables.

After evaluating the results of these audit procedures, the auditor concludes that the audit evidence obtained is both sufficient (in quantity) and appropriate (relevant and reliable) to support the existence, accuracy and valuation of trade receivables. Accordingly, the auditor determines that audit risk relating to this account balance has been reduced to an acceptably low level and uses this evidence as a basis for forming the audit opinion.



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

2.1 Meaning of Audit Evidence- Specific Considerations for Selected Items

The auditor has to express his opinion on financial statements of an entity. For this, he has to examine the books of accounts. He needs evidence in support of transactions recorded in books of accounts. There are some transactions for which he needs specific considerations. For example, inventory

SA 501- “Audit Evidence- Specific Considerations for Selected Items” 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.

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

The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the:

- (A) Existence and condition of inventory;
- (B) Completeness of litigation and claims involving the entity; and
- (C) Presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

2.3 Inventory

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.
- (2) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

2.4 Attendance at Physical Inventory Counting

Attendance at Physical Inventory Counting Involves:

- (a) Inspecting the inventory to ascertain its existence and evaluate its condition, and performing test counts;
- (b) Observing compliance with management's instructions and the performance of procedures for recording and controlling the results of the physical inventory count; and
- (c) Obtaining audit evidence as to the reliability of management's count procedures.

These procedures may serve as test of controls or substantive procedures depending on the auditor's risk assessment, planned approach and the specific procedures carried out.

2.5 Matters Relevant in Planning Attendance at Physical Inventory Counting

Matters relevant in planning attendance at physical inventory counting include, **for example:**

- (a) Nature of inventory.
- (b) Stages of completion of work in progress.
- (c) The risks of material misstatement related to inventory.
- (d) The nature of the internal control related to inventory.
- (e) Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
- (f) The timing of physical inventory counting.
- (g) Whether the entity maintains a perpetual inventory system.

- (h) The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate
- (i) Whether the assistance of an auditor's expert is needed to obtain sufficient appropriate audit evidence.

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

If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures required above, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date, or dates, and the final inventory records are properly recorded include:

- Whether the perpetual inventory records are properly adjusted.
- Reliability of the entity's perpetual inventory records.

Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records.

Perpetual inventory records are continuous records that are updated whenever inventory is received, issued, sold or transferred, so that the quantity (and, in many cases, the value) of each inventory item is available at any point in time.

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

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.

2.8 Attendance at Physical Inventory Counting becomes impractical

If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory.

If it is not possible to do so, the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

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, 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.

In some cases where attendance is impracticable, alternative audit procedures, for example inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

In other cases, however, 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 requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.

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

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.

Other audit procedure may include -

For Example

- Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.
- Requesting confirmation from other parties when inventory has been pledged as collateral.
- 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.

ILLUSTRATION 5

JK Exports Ltd is a manufacturer exporter having its own production capacity and also gets the job work done through various job workers. The auditor of JK Exports Ltd. Considers that inventory held with job workers is material to the financial statements.

Required

Suggest the audit procedures in the given case.

SOLUTION

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.

2.10 Litigation and Claims

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, including:

- (a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;
- (b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
- (c) Reviewing legal expense accounts.

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.

In addition to the procedures identified above **other relevant procedures include,**

For example

using information obtained through risk assessment procedures carried out as part of obtaining an understanding of the entity and its environment to assist the auditor to become aware of litigation and claims involving the entity.

Audit evidence obtained for purposes of identifying litigation and claims that may give rise to a risk of material misstatement also may provide audit evidence regarding other relevant considerations, such as valuation or measurement, regarding litigation and claims. SA 540 establishes requirements and provides guidance relevant to the auditor's consideration of litigation and claims requiring accounting estimates or related disclosures in the financial statements.

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

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct **communication with the entity's external legal counsel**.

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

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

If it is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry, for example if the professional body to which the external legal counsel belongs prohibits response to such a letter, the auditor may seek direct communication through a letter of specific inquiry. For this purpose, a letter of specific inquiry includes:

- (a) A list of litigation and claims;
- (b) Where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
- (c) 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 by the entity's external legal counsel to be incomplete or incorrect.

In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims.

This may be the case, **for example**, where:

- i) The auditor determines that the matter is a significant risk.
- ii) The matter is complex.
- iii) There is disagreement between management and the entity's external legal counsel. Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

Further if:

- (a) management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel, or the entity's external

legal counsel refuses to respond appropriately to the letter of inquiry, or is prohibited from responding; and

- (b) the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures,
- the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

ILLUSTRATION 6

Parag India Ltd is a manufacturer of various FMCG (fast moving consumable goods) range of products. The company is having several cases of litigation pending in courts. The auditor wanted to identify litigation and claims resulting to risk of material misstatements.

Required

Suggest the auditor with reference to SAs.

SOLUTION

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, including:

- (a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;
- (b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
- (c) Reviewing legal expense accounts.

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel.

Test Your Understanding 4

The audit procedures performed so far by auditor of a company indicate that there is a possibility that company has not disclosed all material litigation cases involving the company. Does such a situation warrant direct communication by auditor with external lawyer of the company?

2.12 Segment Information

Definition of segment information

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

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

The auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by:

- (a) Obtaining an understanding of the methods used by management in determining segment information, and:
 - (i) Evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework; and
 - (ii) Where appropriate, testing the application of such methods; and
- (b) Performing analytical procedures or other audit procedures appropriate in the circumstances.

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

The auditor's responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements taken as a whole. Accordingly, the auditor is not required to perform audit procedures that would be necessary to express an opinion on the segment information presented on a stand alone basis.

2.15 Understanding of the Methods Used by Management

Depending on the circumstances, 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:

1. Sales, transfers and charges between segments, and elimination of intersegment amounts.
2. Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
3. The allocation of assets and costs among segments.
4. Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.



3. EXTERNAL CONFIRMATIONS (SA 505)

3.1 Introduction

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

It also includes the following generalisations applicable to audit evidence:

- Audit evidence is more reliable when it is obtained from independent sources outside the entity.
- Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
- Audit evidence is more reliable when it exists in documentary form, whether paper, electronic or other medium.

3.2 Scope of this SA

The Standard on Auditing (SA) 505 "External Confirmations" deals with the auditor's use of external confirmation procedures **to obtain audit evidence** in accordance with the requirements of SA 500.

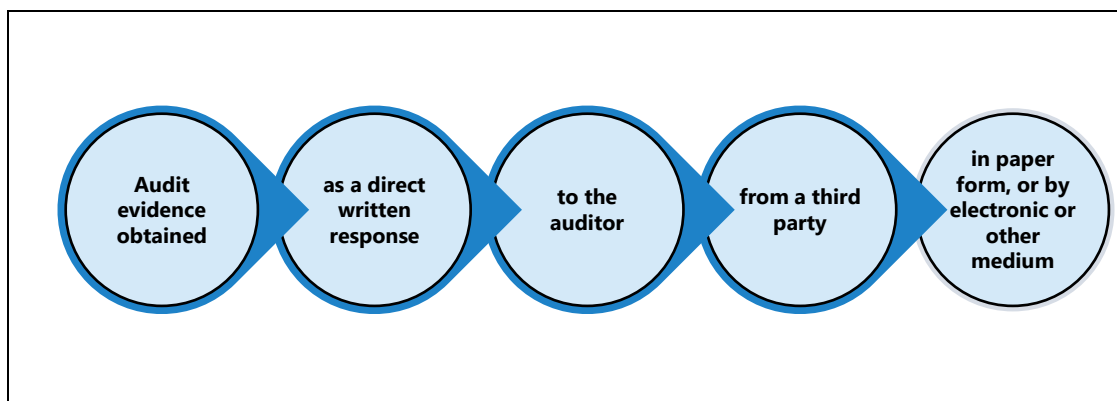
Accordingly, depending on the circumstances of the audit, audit evidence in the form of external confirmations received directly by the auditor from confirming parties may be more reliable than evidence generated internally by the entity.

SA505 is intended to assist the auditor in designing and performing external confirmations procedures to obtain relevant and reliable audit evidence.

Thus, **the objective of the auditor**, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence.

3.3 Definition of External Confirmation

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



3.4 Definitions of other terms

Positive confirmation request – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.

Negative confirmation request – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.

Non-response – A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.

Exception – A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

The exception needs to be assessed to the entire population after analyzing the reason for difference.

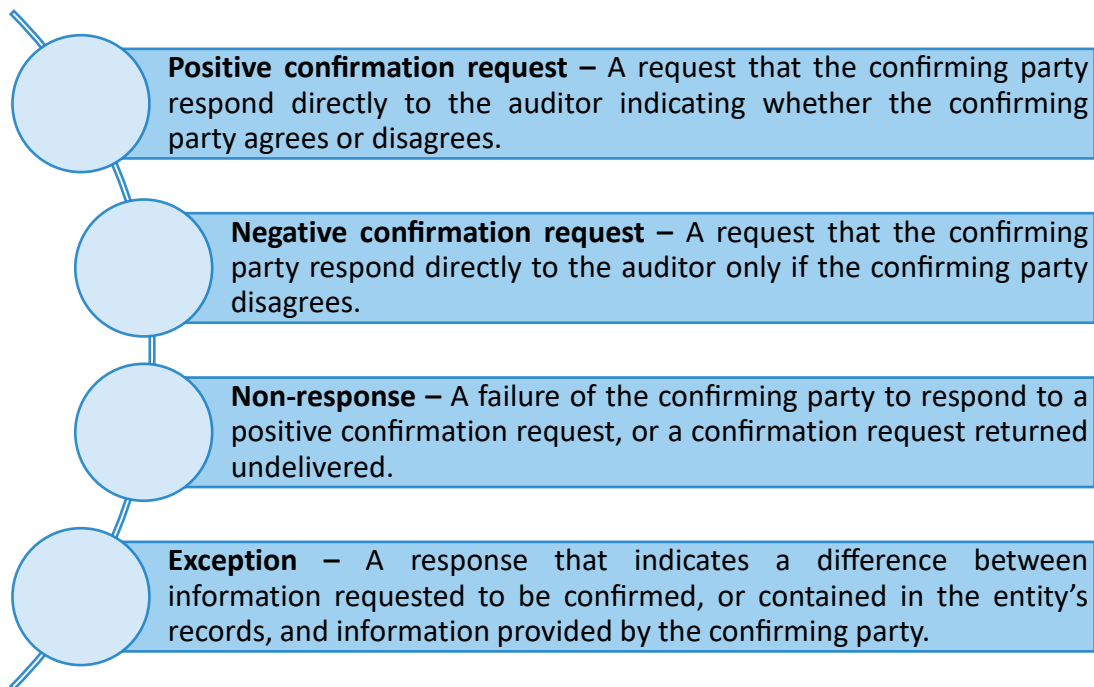


ILLUSTRATION 7

During the financial year 2025-26, the auditor of Healthy and Wealthy Limited asked a Trade Receivable to respond directly to the auditor whether or not the amount they were required to pay to Healthy and Wealthy Limited was ₹ 1,23,000. That trade receivable confirmed to the auditor of Healthy and Wealthy Limited, that they were required to pay an amount of ₹ 1,23,000 to Healthy and Wealthy Limited. State and explain the type of Confirmation Request as required by the auditor.

SOLUTION

The above-mentioned situation is an example of Positive Confirmation Request because in Positive Confirmation Request the party confirms the auditor of a company whether such party agrees or whether such party disagrees with the information for which the confirmation is required by auditor of that company.

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

When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

- (a) Determining the information to be confirmed or requested;
- (b) Selecting the appropriate confirming party;
- (c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and
- (d) Sending the requests, including follow-up requests when applicable, to the confirming party.

(a) Determining the Information to be Confirmed or Requested

External confirmation procedures frequently are performed to confirm or request information regarding account balances and their elements. They may also be used to confirm terms of agreements, contracts, or transactions between an entity and other parties, or to confirm the absence of certain conditions, such as a "side agreement".

(b) Selecting the Appropriate Confirming Party

Responses to confirmation requests provide more relevant and reliable audit evidence when confirmation requests are sent to a confirming party the auditor believes is knowledgeable about the information to be confirmed.

For example

a financial institution official who is knowledgeable about the transactions or arrangements for which confirmation is requested may be the most appropriate person at the financial institution from whom to request confirmation.

(c) Designing Confirmation Requests

1. Design of a confirmation request

The design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses.

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

Factors to consider when designing confirmation requests include:

- (i) The assertions being addressed.
- (ii) Specific identified risks of material misstatement, including fraud risks.
- (iii) The layout and presentation of the confirmation request.
- (iv) Prior experience on the audit or similar engagements.
- (v) The method of communication (for example, in paper form, or by electronic or other medium)
- (vi) Management's authorisation or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorisation.
- (vii) The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

3. Positive confirmation request

A positive external confirmation request asks the confirming party to reply to the auditor in all cases, either by indicating the confirming party's agreement with the given information, or by asking the confirming party to provide information. **A response to a positive confirmation request ordinarily is expected to provide reliable audit evidence.** There is a risk, however, that a confirming party may reply to the confirmation request without verifying that the information is correct. The auditor may reduce this risk by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, and ask the confirming party to fill in the amount or furnish other information. On the other hand, use of this type of "blank" confirmation request may result in lower response rates because additional effort is required of the confirming parties.

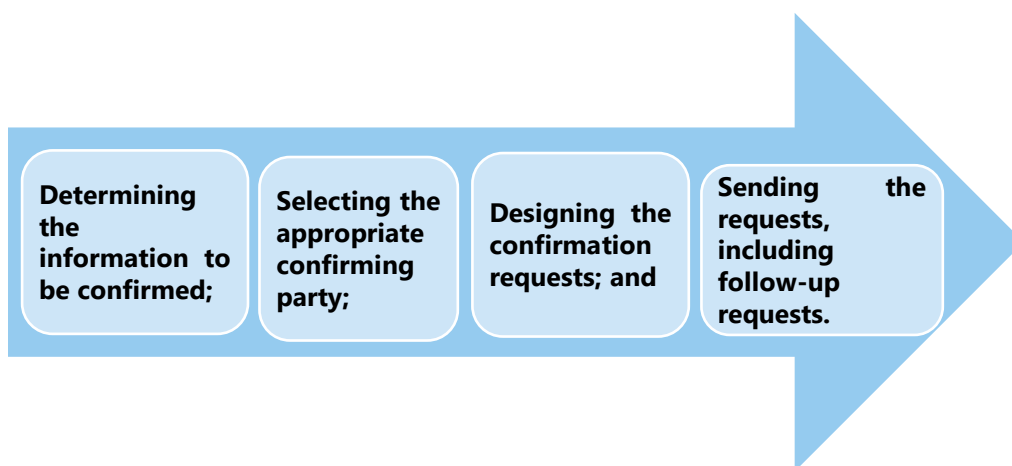
4. Determination of properly addressed requests

Determining that requests are properly addressed includes testing the validity of some or all of the addresses on confirmation requests before they are sent out.

(d) Follow-up on Confirmation Requests

The auditor may send an additional confirmation request when a reply to a previous request has not been received within a reasonable time.

For example, the auditor may, having re-verified the accuracy of the original address, send an additional or follow-up request.



3.6 Management's refusal to allow the auditor to send a confirmation request-steps taken by the Auditor

If management refuses to allow the auditor to send a confirmation request, the auditor shall:

- Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and **reasonableness**;
- Evaluate the implications of management's refusal on the auditor's assessment of the **relevant risks of material misstatement**, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
- Perform alternative audit procedures** designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is **unreasonable**, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260.

The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705.

Inquire as to management's reasons for the refusal;

Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement; and

Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

- (a) **Reasonableness of Management's Refusal:** A refusal by management to allow the auditor to send a confirmation request is a limitation on the audit evidence the auditor may wish to obtain. The auditor is therefore required to inquire as to the reasons for the limitation.

A common reason advanced is the existence of a legal dispute or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely confirmation request.

The auditor is required to seek audit evidence as to the validity and reasonableness of the reasons because of the risk that management may be attempting to deny the auditor access to audit evidence that may reveal fraud or error.

- (b) **Implications for the Assessment of Risks of Material Misstatement:** The auditor may conclude that it would be appropriate to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit procedures.

For example

if management's request to not confirm is unreasonable, this may indicate a fraud risk factor that requires evaluation in accordance with SA 240.

(c) Alternative Audit Procedures

Examples of alternative audit procedures the auditor may perform include:

- For accounts receivable balances – examining specific subsequent cash receipts, shipping documentation, and sales near the period-end.
- For accounts payable balances – examining subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes.

ILLUSTRATION 8

While conducting the audit of AB Ltd, the auditor K of KLM and Associates, Chartered Accountants observes that there are large number of Trade payables and receivables standing in the books of accounts as on 31st March. The auditor wanted to send confirmation request to few trade receivables, but the management refused the auditor to send confirmation request.

Required

How would the auditor proceed?

SOLUTION

If management refuses to allow the auditor to send a confirmation request, the auditor shall:

- (a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;
- (b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
- (c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260.

The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705.

3.7 Negative Confirmations

Negative confirmations provide less persuasive audit evidence than positive confirmations.

Accordingly, the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present:

- (a) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;
- (b) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions;
- (c) A very low exception rate is expected; and
- (d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

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.

For example

Holders of bank deposit accounts may be more likely to respond if they believe that the balance in their account is understated in the confirmation request, but may be less likely to respond when they believe the balance is overstated. Therefore, sending negative confirmation requests to holders of bank deposit accounts may be a useful procedure in considering whether such balances may be understated, but is unlikely to be effective if the auditor is seeking evidence regarding overstatement.

3.8 Evaluating the Evidence Obtained

The auditor shall evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether performing further audit procedures is necessary.

When evaluating the results of individual external confirmation requests, the auditor may categorise such results as follows:

- (a) A response by the appropriate confirming party indicating agreement with the information provided in the confirmation request, or providing requested information without exception;
- (b) A response deemed unreliable;
- (c) A non-response; or
- (d) A response indicating an exception.

The auditor's evaluation, when taken into account with other audit procedures the auditor may have performed, may assist the auditor in concluding whether sufficient appropriate audit evidence has been obtained or whether performing further audit procedures is necessary, as required by SA 330.

Test Your Understanding 5

CA Jignesh Desai is in midst of audit of a company. The company is fairly large one and has a well-functioning internal audit department. While considering sending out external confirmation requests to trade receivables outstanding as on date of financial statements, he has delegated the process of choosing trade receivables, designing requests and receiving responses from customers to internal audit department. The responses are also received on the mail id of internal audit department. Is approach of CA Jignesh Desai proper?

Test Your Understanding 6

On reviewing schedule of trade receivables of a company, CA Mary finds that in respect of one outstanding balance, the CFO of the company is not willing to allow her to send external confirmation request due to the reason that sending out such request could spoil precariously placed business relations with the customer. On further inquiry, she finds out that there is a dispute going on with the company relating to some quality issues of goods sent to the customer and matter is sub judice. Efforts are also being made by the company for out of court settlement. Reviewing correspondence with the customer, she finds that issue is near resolution and no fraud risk factors exist. Is unwillingness of CFO justifiable?



4. INITIAL AUDIT ENGAGEMENTS - OPENING BALANCES (SA 510)

4.1 Scope of this SA

The Standard on Auditing (SA) 510 “Initial Audit Engagements-Opening Balances” deals with the auditor’s responsibilities relating to opening balances when conducting an initial audit engagement. In addition to financial statement amounts, opening balances include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments. When the financial statements include comparative financial information, the requirements and guidance in SA 710 also apply.

4.2 Definitions

1. **Initial audit engagement refers** to an engagement in which either:
 - (i) The financial statements for the prior period were not audited; or
 - (ii) The financial statements for the prior period were audited by a predecessor auditor.

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

Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period.

Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

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

4.3 Objective of Auditor with respect to Opening Balances– in conducting an Initial Audit Engagement

In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

- (a) Opening balances contain misstatements that materially affect the current period's financial statements; and
- (b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

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

The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

- (a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;
- (b) Determining whether the opening balances reflect the application of appropriate accounting policies; and
- (c) Performing one or more of the following:
 - (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;
 - (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
 - (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

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

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

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

4.5.1 Nature and extent of Audit Procedures

The nature and extent of audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances **depend on such matters as:**

- The accounting policies followed by the entity.
- The nature of the account balances, classes of transactions and disclosures and the risks of material misstatement in the current period's financial statements.
- The significance of the opening balances relative to the current period's financial statements.
- Whether the prior period's financial statements were audited and, if so, whether the predecessor auditor's opinion was modified.

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

If the prior period's **financial statements were audited by a predecessor auditor**, the auditor may be able to obtain sufficient appropriate audit evidence regarding the opening balances by **perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements such as supporting schedules to the audited financial statements.**

Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

4.5.3 For current assets and liabilities

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

For example

The collection (payment) of opening accounts receivable (accounts payable) during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.

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.

4.5.4 For non-current assets and liabilities

For non-current assets and liabilities,

- (i) such as property plant and equipment, investments and long-term debt, some audit evidence may be obtained by **examining the accounting records and other information** underlying the opening balances.
- (ii) In certain cases, the auditor may be able to obtain some audit evidence regarding opening balances **through confirmation with third parties**.

For example

for long-term debt and investments audit evidence may be obtained through confirmation with third parties. In other cases, the auditor may need to carry out additional audit procedures.

4.6 Consistency of Accounting Policies relating to opening balances

The auditor shall obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, and whether changes in the accounting policies have been properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

If the auditor concludes that:

- (a) the current period's accounting **policies are not consistently applied** in relation to opening balances in accordance with the applicable financial reporting framework; or
- (b) **a change in accounting policies** is not properly accounted for or not adequately presented or disclosed in accordance with the applicable financial reporting framework,

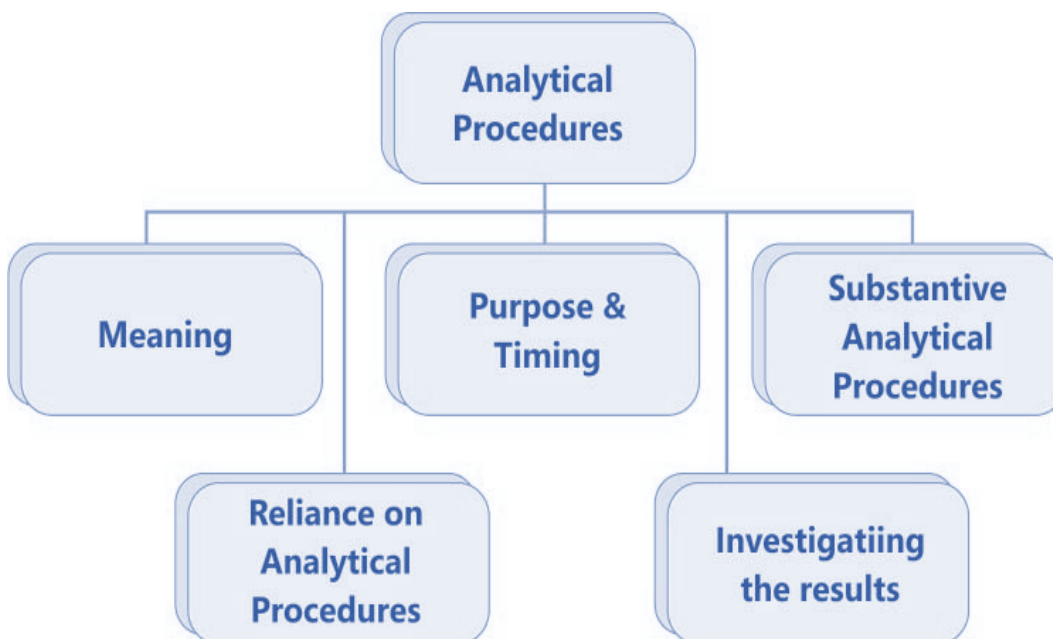
the auditor shall express a qualified opinion or an adverse opinion as appropriate in accordance with SA 705.

4.7 Reporting by the auditor with regard to opening balances

1. If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances,
the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with SA 705.
2. If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion, as appropriate, in accordance with SA 705.



5. ANALYTICAL PROCEDURES (SA 520)



5.1 Meaning of Analytical Procedures

Since routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like comparisons, trend and ratio analysis in addition to reasonable tests. These collectively are known as overall tests. With the passage of tests, analytical procedures have acquired lot of significance as substantive audit procedure. SA 520 on Analytical Procedures discusses the application of analytical procedures during an audit. Let us try to understand the concept discussed above with the help of the following illustration:



ILLUSTRATION 9

CA Aarav wants to verify the payments made by XYZ Ltd. on account of building rent during the FY 2025-26. The rent amounts to ₹50,000/- per month for the year. The monthly rent payments are consistent with the rent agreement. However, the other companies in the similar industry are paying rent of ₹ 10,000/- per month for a similar location. How will applying the analytical procedures impact the verification process of such rental payments by XYZ Ltd.?

SOLUTION

If CA Aarav checks in detail the monthly rent payments, he may find that such payments are consistent with the rent agreement i.e. XYZ Ltd. paid ₹ 50,000/- per month as rent and the same is getting reflected in the rent agreement. Here, CA Aarav may not be able to find out the inconsistency in the rent payment with respect to rent payment prevalent in the similar industry for rent of the similar location.

If CA Aarav applies analytical procedure i.e. compares the rent payment by XYZ Ltd. with the similar payments made by companies in similar industry and similar area, he will notice an inconsistency in such rent payments as the other companies are paying a very less monthly rent in similar industry for similar area.

However, if CA Aarav does not make such comparison and only checks the monthly payments and rent agreement of XYZ Ltd., he would not have found such inconsistency and as such the misstatement may remain undetected.

Meaning of Analytical Procedures. As per the Standard on Auditing (SA) 520 “Analytical Procedures”, the term “analytical procedures” means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

**ILLUSTRATION 10**

Analytical procedure involves analysis of relationship among financial and non-financial data. Explain with the help of an example as to how, the statutory auditor of ABC Ltd. will analyse such relationship with respect to the total wages paid by ABC Ltd. during the FY 2025-26.

SOLUTION

As per SA 520, Analytical Procedures means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. The following example explains the analysis of relationship between financial and non-financial data while applying analytical procedures.

The statutory auditor of ABC Ltd. has to verify the total wages paid by the company having factories in various states. He can verify the same by analyzing the relationship between wages per worker and total number of workers across all the factories.

i.e. Total wages = Wages per worker x Total number of workers.

Here wages per worker is financial data i.e. in ₹ and total number of workers is a number which is a non financial data. Thus, the statutory auditor of ABC Ltd. is evaluating financial information i.e. total wages paid (in ₹) by analyzing the relationship between wages per worker (in ₹) which is financial data and number of workers which is a non financial data.

Analytical procedures include the consideration of comparisons of the entity's financial information with as well as consideration of relationships.



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

Comparable information for prior periods.

Example:

CA Brijesh, while verifying the travelling expenses of PRT Ltd., may compare the travelling expenses of current year amounting to ₹ 2.50 lakhs with previous year travelling expense of PRT Ltd. amounting to ₹ 2 lakhs and infer that there has been an increase of 25% in the travelling expense incurred by the company. CA Brijesh may compare such percentage increase with the trend of the earlier several years.

Thus, CA Brijesh, can use comparable information for prior periods of PRT Ltd. while applying analytical procedure with respect to the expenses incurred by the company.

Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.

Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

Examples of Analytical Procedures having consideration of relationships are:

Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.

Between financial information and relevant non-financial information, such as payroll costs to number of employees.

Particulars	Client		Industry	
<i>Year</i>	<i>2024-25</i>	<i>2025-26</i>	<i>2024-25</i>	<i>2025-26</i>
<i>Inventory Turnover</i>	<i>2.8</i>	<i>2.9</i>	<i>3.1</i>	<i>2.8</i>
<i>Gross Margin</i>	<i>22.5%</i>	<i>22.7%</i>	<i>23.6%</i>	<i>22.2%</i>

Various methods may be used to perform analytical procedures.

These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques.

Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

Thus, we can say that Analytical Procedures may be segregated into the following major types:

as comparison of client and industry data,

comparison of client data with similar prior period data,

comparison of client data with client-determined expected results,

comparison of client data with auditor-determined expected results and

comparison of client data with expected results, using non financial data.

5.2 Scope of SA 520

SA 520 deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.

Objectives

The objectives of the auditor are:

- (a) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and
- (b) To 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.

5.3 Purpose and timing of Analytical Procedures

(A) Purpose of Analytical Procedures: Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable.

For instance, establishing the relationship that exists between certain balances included in the Balance Sheet and the Statement of Profit and Loss and comparing them with those that existed between the same set of balances in the previous year, reconciling the physical balances of assets with the relevant financial record; obtaining of account from the bankers, account receivables and account payables and reconciling with relevant balances in books of account; confirming amounts of outstanding income and expenses by preparing reconciliation statements, etc. These are helpful in the detection of unusual state of affairs and mistakes in accounts.

Example

In XYZ Ltd., after applying analytical procedures as comparison of the gross profit ratio with that of the previous year, it is discovered that there has been fall in the ratio. Therefore, it became necessary for the auditor to make further enquiries as it may be due to pilferage of inventories/ misappropriation of a part of the sale

proceeds/ a change in the cost of sales without a corresponding increase in the sales price.

On verifying the balances of **sundry account receivables** by obtaining the confirmation of their statements of account, it will be possible for the auditor to find out whether the discrepancy in the balance of an account receivable is due to the failure to debit his account with the cost of goods supplied to him or is the result of non-adjustment of a remittance received from him.

Also whether in the case of **account payable**, the discrepancy is due to failure to afford him credit for one or more consignments of goods supplied by him or failure to debit him with an amount of remittance.

In case of **inventories of raw materials and stores** at the end of the year any excesses or shortages therein shall be detected. The investigation of their causes might disclose that the shortages were the result of a misappropriation of inventory or that the excess were due to requisitions having been entered before the inventories were issued.

By reconciling the **amounts of interest and dividends** collected with the amounts which had accrued due and that which are outstanding for payment, the mistake, if any, in the adjustment of such an income would be detected.

The overall tests can be extended for making **inter-firm and intra-firm comparison** of trading results.

Example

If balances included in the Statement of Profit and Loss of an entity are compared with those contained in the Statement of Profit and Loss for the same period of another entity engaged in the same trade and working under similar circumstances, it would be possible to find out the cause of the variation in the rate of profitability that exists.

- ◆ Similarly, it would also be possible **to compare the balances** on the Statement of Profit and Loss with that of the previous period, it would be possible to find out the reasons for increase or decrease in the amount of profits of those years.
- ◆ By setting up certain expenses ratios on the basis of balances included in the Statement of Profit and Loss, for the year under audit, comparing them with

the same ratios for the previous year, it is possible to ascertain the extent of increase or decrease in various items of expenditure in relation to sales and that of trading profit in relation to sales.

- ♦ If differences are found to be material, the auditor would ascertain the reasons thereof and assess whether the accounts have been manipulated to inflate or suppress profits.



An abnormal fall in the cost of manufacture or that in the **administrative cost**, apart from economy in expenses, there could be no provision or less provision for expenses incurred in the year. When it is suspected, the auditor should compare the entries in the outstanding book with those in the previous year. He must also check the vouchers for one month immediately before the close of the following years.

To verify that none of the expenses in the accounts under audit have been charged to the accounts of the following years.

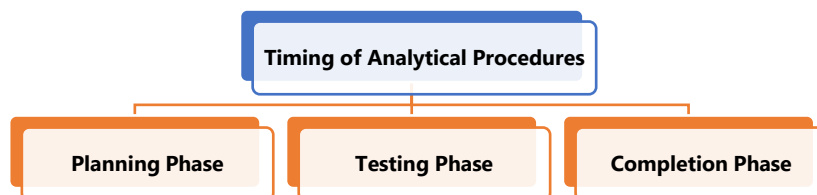
Often it is possible to independently verify the correctness of some of the items of expenses included in the Statement of Profit and Loss.

For instance, the cost of importing goods which are subjected to an ad-valorem duty at uniform rate can be verified from the amount of duty paid. Similarly, a quantity of sugar sold by sugar mill can be verified independently from the amount of GST paid.

Similarly, the amount of any income or expenses which has a direct relationship with the amount of profits or that of sales can be verified independently, *e.g.*, commission paid to a manager calculated on the basis of net profits, commission paid to a selling agent as percentage of sales, etc. Such calculation of ratios, trends and comparisons is also termed as analytical review.

Thus, it is important to note that Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

(B) Timing of Analytical Procedures: Experienced auditors use analytical procedures in all stages of the audit. Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition, these are also required during the completion phase.



(C) Analytical Procedures in Planning the Audit: In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures. Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.

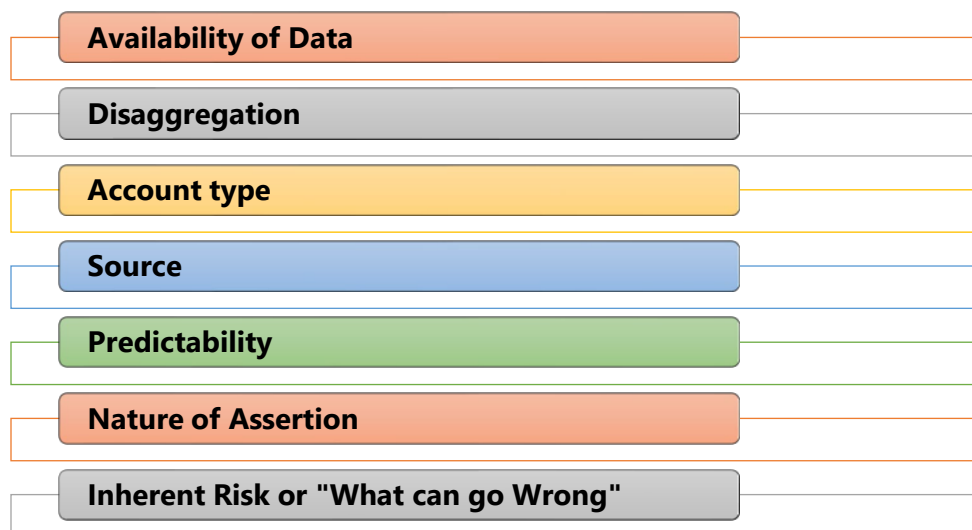
For example: Analytical procedures may help the auditor during the planning stage to determine the nature, timing and extent of audit procedures that will be used to obtain audit evidence for specific account balances or classes of transactions.

5.4 Substantive Analytical Procedures

The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and the results of any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

5.5 Factors to be considered for Substantive Audit Procedures



The auditor should consider the following factors for Substantive Audit Procedures:

- i) **Availability of Data** – The availability of reliable and relevant data will facilitate effective analytical procedures.
- ii) **Disaggregation** – The degree of disaggregation in available data can directly affect the degree of its usefulness in detecting misstatements.
- iii) **Account Type** – Substantive analytical procedures are more useful for certain types of accounts than for others. Income statement accounts tend to be more predictable because they reflect accumulated transactions over a period, whereas balance sheet accounts represent the net effect of transactions at a point in time or are subject to greater management judgment.

Example

We can analyze data to understand the relationship to another account and through this, disaggregate the transactions flowing to and from the balance sheet account (e.g., sales and cash receipts flowing through trade receivables), or to compare ratios over time as this enhances our ability to obtain audit evidence for balance sheet accounts.

- iv) **Source** – Some classes of transactions tend to be more predictable because they consist of numerous, similar transactions, (e.g., through routine processes). Whereas the transactions recorded by non-routine and estimation SCOTs (Significant Classes of Transactions) are often subject to management judgment and therefore more difficult to predict.

Example

Transactions of routine nature like transactions related to sales and purchases are predictable and repetitive in nature. Therefore, on such data analytical procedures can be efficiently applied.

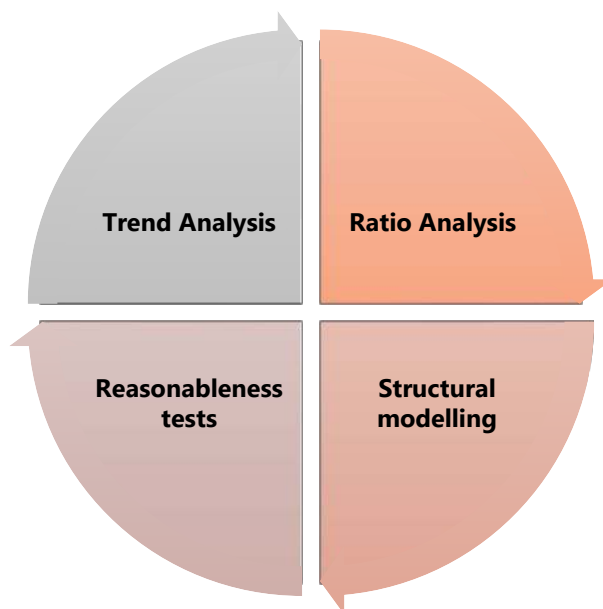
However, Significant Classes Transactions are those classes of transactions in a company's operations that are key to the financial statements and are not frequent in nature. Example: Expenditure on Research & Advertisement is not of routine nature and are subject to management judgement and therefore more difficult to predict.

- v) **Predictability** – Substantive analytical procedures are more appropriate when an account balance or relationships between items of data are predictable (e.g., between sales and cost of sales or between trade receivables and cash receipts). A predictable relationship is one that may reasonably be expected to exist and continue over time.
- vi) **Nature of Assertion** – Substantive analytical procedures may be more effective in providing evidence for some assertions (e.g., completeness or valuation) than for others (e.g., rights and obligations). Predictive analytical procedures using data analytics can be used to address completeness, valuation/measurement and occurrence.
- vii) **Inherent Risk or "What Can Go Wrong"** – When we are designing audit procedures to address an inherent risk or "what can go wrong", we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence. When inherent risk is higher, we may design tests of details to address the higher inherent risk. When significant risks have been identified, audit evidence obtained solely from substantive analytical procedures is unlikely to be sufficient.

Example

When side agreements with respect to revenue recognition have been identified as a significant or fraud risk, it is unlikely that an analysis of sales compared to cash receipts or cost of sales would be appropriate to respond to that risk.

5.6 Techniques available as Substantive Analytical Procedures



The design of a substantive analytical procedure is limited only by the availability of reliable data and the experience and creativity of the audit team. **Substantive analytical procedures generally take one of the following forms:**

- i) **Trend analysis** – Trend analysis is a commonly used technique. It is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. The auditor evaluates whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

In other words, trend analysis implies analysing account fluctuations by comparing current year to prior year information and, also, to information derived over several years.

Example

The auditor may compare the salary paid by the company during the year under audit with the salary paid by the company for several earlier years. There may be some percentage increase in the salary expense over the years. However, an unusual increase in such expense amount may indicate that fraudulent payments are being made to fake employees.

- ii) **Ratio analysis** – Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.

Example

Financial ratios may include:

- ◆ Trade receivables or inventory turnover
- ◆ Freight expense as a percentage of sales revenue

Example

The statutory auditor can review the Gross profit ratio of the company for the year under audit. The auditor can further compare such GP ratio with the GP ratio of the company in the earlier years or the GP ratio of the other companies in the same industry for the year under audit.

- iii) **Reasonableness tests** – Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts. In other words these tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts.

Example

Interest expense against interest bearing obligations

Raw Material Consumption to Production (quantity)

Wastage & Scrap % against production & raw material consumption (quantity)

Work-in-Progress based on issued of materials & Sales (quantity)

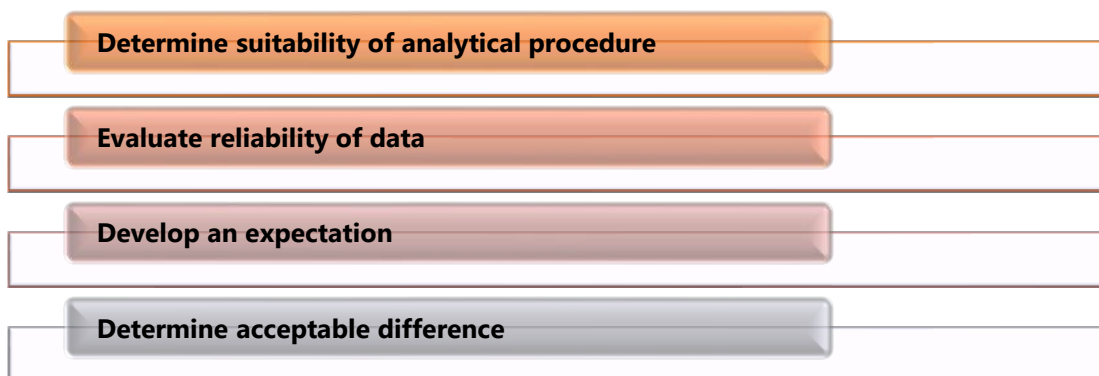
Sales discounts and commissions against sales volume

Rental revenues based on occupancy of premises

- iv) **Structural modelling** – A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).

5.7 Analytical Procedures used as Substantive Tests

When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330, the auditor shall:



- (i) 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;
- (ii) 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;

- (iii) 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
- (iv) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.

5.8 Suitability of particular analytical procedures for given assertions

1. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.
2. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary.
3. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.
4. In some cases, even an unsophisticated predictive model may be effective as an analytical procedure.

Example

If an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognized trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

Different types of analytical procedures provide different levels of assurance. Analytical procedures involving, **for example**, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details,

provided the elements are appropriately verified. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may provide less persuasive evidence, but may provide useful corroboration if used in combination with other audit procedures.

The determination of the suitability of particular substantive analytical procedure is influenced by the nature of the assertion and the auditor's assessment of the risk of material misstatement. **For example, if controls over sales order processing are weak, the auditor may place more reliance on tests of details rather than on substantive analytical procedures for assertions related to receivables.**

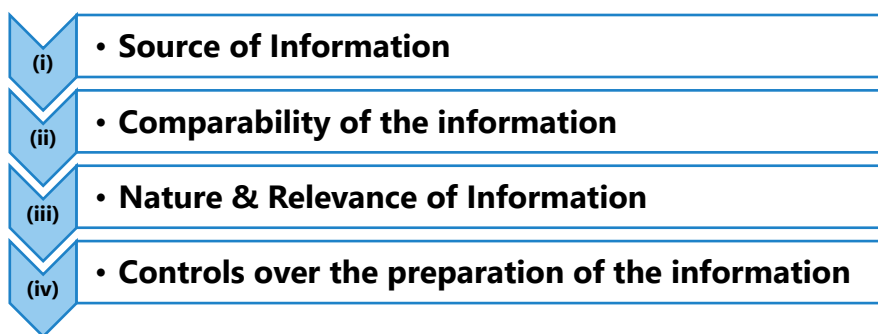
Filling the Assurance Bucket



Particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion. **For example, when obtaining audit evidence regarding the valuation assertion for accounts receivable balances, the auditor may apply analytical procedures to an aging of customers' accounts in addition to performing tests of details on subsequent cash receipts to determine the collectability of the receivables.**

5.9 The reliability of DATA

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:



- (i) Source of the information available. **For example**, information may be more reliable when it is obtained from independent sources outside the entity;
- (ii) Comparability of the information available. **For example**, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;
- (iii) Nature and relevance of the information available. **For example**, whether budgets have been established as results to be expected rather than as goals to be achieved; and
- (iv) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. **For example**, controls over the preparation, review and maintenance of budgets.

The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls.

For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. SA 500 establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures.

5.10 Evaluation of whether the expectation is sufficiently precise

Matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include:

(i) The accuracy with which the expected results of substantive analytical procedures can be predicted.

For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.

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

For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.

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

For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information.

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

The auditor's determination of the amount of difference from the expectation that can be accepted without further investigation is influenced by materiality and the consistency with the desired level of assurance, taking account of the possibility that a misstatement, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

SA 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of risk. Accordingly, as the assessed risk increases, the amount of difference considered acceptable without investigation decreases in order to achieve the desired level of persuasive evidence.

5.12 Investigating results of Analytical Procedures

If analytical procedures performed in accordance with 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:

- (i) **Inquiring of management and obtaining appropriate audit evidence relevant to management's responses:** Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.
- (ii) **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.

5.13 Analytical procedures that assist when forming an overall conclusion

The conclusions drawn from the results of analytical procedures designed and performed in accordance with, are intended to corroborate 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.

Test Your Understanding 7

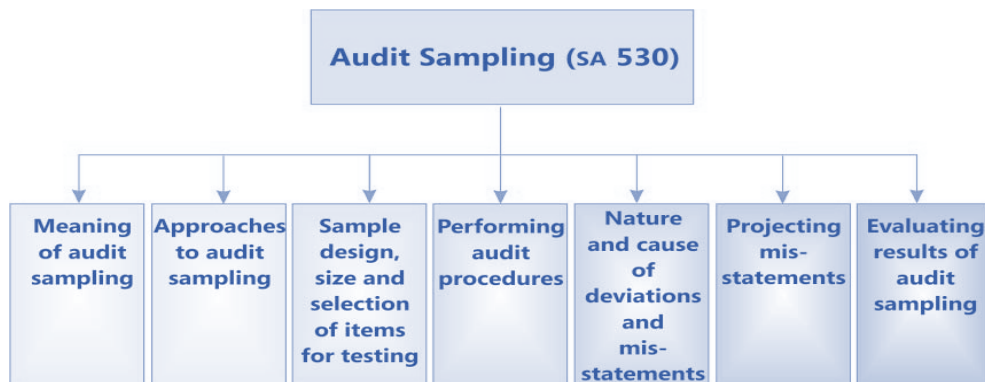
An auditor of a company intends to apply analytical procedures for verifying revenue. Discuss any two analytical procedures which may be performed by auditor relating to revenues.



6. AUDIT SAMPLING (SA 530)

6.1 Sampling: An Audit Procedure

No conscious effort in human society is divested of economic considerations and auditing is no exception. There is a growing realisation that the traditional approach to audit is economically wasteful because all the efforts are directed to check all transactions without any exception. This invariably leads to more emphasis on routine checking, which often is not necessary in view of the time and the cost involved. With the shift in favour of formal internal controls in the management of affairs of organisations, the possibilities of routine errors and frauds have greatly diminished i.e. the internal controls as designed by the management are for the very purpose of prevention, detection and correction of frauds and errors. Thus the auditors often find extensive routine checking as nothing more than a ritual because it seldom reveals anything material. Now the approach to audit and the extent of checking are undergoing a progressive change in favour of more attention towards the questions of **principles and controls** with a curtailment of non-consequential routine checking.



By routine checking we traditionally think of extensive checking and vouching of all the entries, disregarding the concept of materiality.

The extent of the checking to be undertaken is primarily a matter of judgment of the auditor, there is nothing statutorily stated anywhere which specifies what work is to be done, how it is to be done and to what extent it has to be done. It is also not obligatory that the auditor must adopt the sampling technique. What he is to do as an auditor is to express his opinion on the financial statements and become bound by that.

To ensure good and reasonable standard of work, he should adopt standards and techniques that can lead him to an informed professional opinion. On consideration of this fact, it can be said that it is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking (i.e sampling), he should adopt standards and techniques which are widely followed and which have a recognised basis.

Since statistical theory of sampling is based on a scientific law, it can be relied upon to a greater extent than any arbitrary technique which lacks in basis and acceptability. This enables the auditor to make conclusions and express fair opinion without having to check all of the items within the financial statements.

6.2 Meaning of Audit Sampling

According to SA 530 "Audit sampling", 'audit sampling' refers to the application of audit procedures to less than 100% of items within a population relevant under the audit, such that all sampling units (i.e all the items in the population) have a equal chance of selection. This is to ensure that the items selected represent the entire population which enables the auditor to draw conclusions and express his opinion based on a pre-determined objective.



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.

Scope of SA 530

SA 530 becomes applicable when the auditor has decided to use audit sampling in performing audit procedures. This standard deals with the **auditor's use of -**

- ◆ Statistical and
- ◆ Non-statistical sampling

when designing and selecting the-

- (i) audit sample,
- (ii) performing tests of controls and tests of details, and
- (iii) evaluating the results from the sample.

SA 500 “Audit Evidence”, 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 audit opinion.

SA 500 lays down the means available to the auditor for selecting the items for testing. One of those is audit sampling. Hence SA 530 complements SA 500.

6.3 Population

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

The auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected.

6.3.1 Characteristics of Population

1. Appropriateness: The auditor will need to determine that the population from which the sample is drawn is appropriate for the specific audit objective. Appropriate means population from which the samples are drawn shall be **relevant** for the specific objective under audit. This is because when the samples are drawn, the audit procedures are applied on the sample and the conclusions are projected on the population.

It is important for the auditor to ensure that the population is appropriate to the objective of the audit procedure, which will include consideration of the direction of testing.

Example

If the auditor’s objective were to test for overstatement of accounts receivable, the population could be defined as the accounts receivable listing. On the other hand, when testing for understatement of accounts payable, the population would not be the accounts payable listing, but rather subsequent disbursements, unpaid invoices, suppliers’ statements, unmatched receiving reports, or other populations that would provide audit evidence of understatement of accounts payable.

2. Completeness: The population also needs to be complete, which means that if the auditor intends to use the sample to draw conclusions about whether a control activity is operated effectively during the financial reporting period, the population needs to include all relevant items i.e all the activities that form part of that relevant internal control, throughout the entire period. If population is complete in all respects, the conclusions drawn on the population will be considered to be reasonable.

3. Reliable: When performing the audit sampling, the auditor performs audit procedures to ensure that the information upon which the audit sampling is performed is sufficiently complete and accurate. Auditor should obtain evidence about the reliability of population. If population is not reliable with respect to accuracy and source, the sample drawn will definitely not be relevant for the specific audit objective.

6.4 Sampling Unit

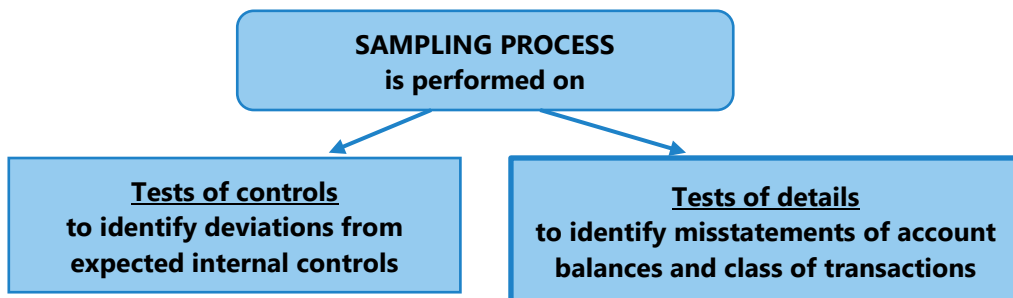
The individual items that make up the population are known as sampling units. The population can be divided into sampling units in a variety of ways. It is a selection from the population that is used as an extrapolation of the population. Audit procedures are applied on these units and the conclusions drawn from them are projected on the population.

In simple words, conclusions drawn on the sample becomes the conclusion of the population from where it is drawn.

Example: If the auditor's objective were to test the validity of accounts receivables, the sampling unit could be defined as customer balances or individual customer invoices. The auditor defines the sampling unit in order to obtain an **efficient and effective** sample to achieve the particular audit objectives. The conclusion on the population is based on the audit procedures applied on the sampling unit.

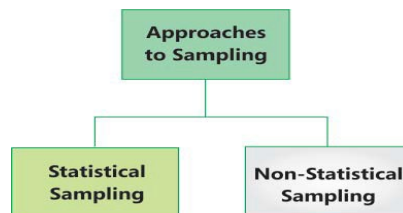
Sample must be representative

Whatever may be the approach non-statistical or 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.



6.5 Approaches to Sampling (Types of Sampling)

Audit sampling enables the auditor to obtain and evaluate audit evidence about **some characteristic of the items selected** in order to form or assist in forming a conclusion about the population, from which the sample is drawn. Audit sampling can be applied using either

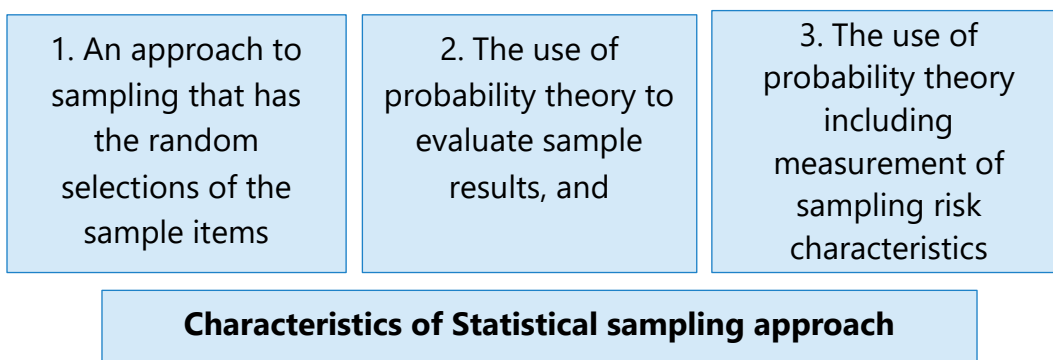


A) non-statistical or

B) statistical sampling approaches.

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

Sample is chosen by applying certain mathematical and statistical methods. A sampling approach that does not have the above features is considered as **non-statistical sampling**.



A Statistical Sampling-More Scientific

1. Audit testing done through this approach is more scientific than testing based entirely on the auditor's own judgment because it involves use of **mathematical laws of probability** in determining the appropriate sample size in varying circumstances.
2. Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.

3. There is no personal bias of the auditor in case of statistical sampling. Since it is scientific, the results of sample can be evaluated and projected on the whole population in a more reliable manner.

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

For Example: An auditor while verifying the Purchases during the year realised that the purchase transactions in that year are more than 45000 in number, then in such case, statistical sampling will be highly recommended in the audit program. Random Sampling (discussed ahead in this topic) is the method you decide to choose sample in such a situation.

B Non-Statistical Sampling

Under this approach, the sample size and its composition are determined on the basis of the **personal experience and knowledge** of the auditor.

This approach has been in common application for many years because of its simplicity in operation. Traditionally, the auditor on the basis of his personal experience will determine the size of the sample and express it in terms that number of pages or personal accounts in the purchases or sales ledger to be checked. **For example**, March, June and September may be selected in year one and different months would be selected in the next year, On basis of value of items, top 10 highest value. Etc.

An attempt would be made to avoid establishing a pattern of selection year after year, i.e. the way of selecting samples, to maintain an element of surprise as to what the auditor is going to check. It is a common practice to check large number of items towards the close of the year so that the adequacy of cut-off procedures can also be determined. Also, because year end transactions are prone to high risk of misappropriation.

The non-statistical sampling is criticized on the grounds that it is neither objective nor scientific. The expected degree of objectivity cannot be assured in non-statistical sampling because the risk of personal bias in selection of sample items cannot be eliminated.

The closeness of the qualities projected by the sample results with that of the whole population cannot be measured because the sample has not been selected in accordance with the mathematically based statistical techniques. However, it may

be stated that the auditor with his experience and knowledge of the client's business can evaluate accurately enough the sample findings to make audit decision and the mathematical proof of accuracy in some cases may be a luxury which the auditor cannot afford.

This method is simple to operate but sometimes the sample may not be a true representative of the total population because of personal bias and no scientific method of selection.

6.6 Sampling Vs Traditional method of Auditing

In most of the circumstances, the evidence available is not conclusive and the auditor always takes a calculated risk in giving his opinion. Even by undertaking hundred percent checking of the transactions, the auditor does not derive absolute satisfaction. This state of uneasiness led pragmatic auditors to adopt the statistical theory of sampling to derive the necessary satisfaction about the state of affairs by checking only a part of the total population of entries.

Auditors realised that they can derive good satisfaction by undertaking a much lesser checking by adoption of this technique in the auditing process. It is a mathematical truth that the sample, if picked purely on a random basis would reveal the features and characteristics of the population.

By adopting the sampling technique, the auditor only checks a part of the whole mass of transactions. The satisfaction he used to derive earlier, by checking all the transactions, can be derived by a sample checking provided he can put reliance on the internal controls and checks within the client's organisation because they provide the reliability of the records. Sampling is used as a part of Tests of controls. Auditor will check few internal controls and their operating effectiveness. Based on the conclusion derived, he can then design the sample size for tests of details (i.e checking of transactions and balances)

If the internal control is satisfactory in its design and implementation, a much smaller sample can give the auditor the necessary reliability of the result he obtains.

On the other hand, if in certain areas controls are slack or not properly implemented, the auditor may have to take a much larger sample for getting satisfactory result.

Another truth about the sampling technique should be noted. It can never bring complete reliability; it cannot give precisely accurate results. It is a process of estimation. It may have some error. What error is tolerable for a particular matter under examination is a matter of the individual's judgment in that particular case.

Example

Mr. X may consider that in his estimation of stores valuation, an error of 2% may not be material; he also decides that he needs at least 98% reliability of the result. He is to pick up the requisite number of items of the stores for reliability of the result. The requisite number he can get from the random number table. The question of reliability of the result is directly linked with the reliability of the internal control and of the books and records; when these are satisfactory, lesser degree of reliability of the sampling estimation may suffice – if these are not satisfactory, the auditor may have to decide upon a higher degree of reliability which can only be obtained from a larger sample.

Very often we come across this term when an audit is conducted on the basis of a part checking. This, it is said, owes its origin to the statistical theory of sampling.

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

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

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

6.7 Appropriateness of Sampling Approaches

In statistical sampling, the sample results are measurable as to the adequacy and reliability of the audit objectives whereas in non-statistical sampling the auditor's opinion determines the sample size but it cannot be measured how far the sample size would fulfill the audit objective.

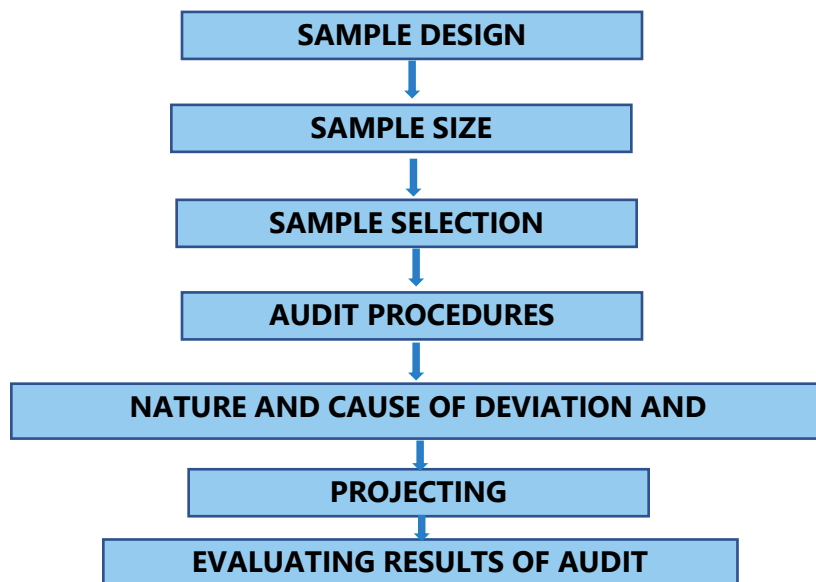
The advantages of statistical sampling may be summarized as follows -

- (1) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.
- (2) The sample selection is more objective and thereby more defensible.
- (3) The method provides a means of estimating the minimum sample size associated with a specified risk and precision.
- (4) It provides a means for deriving a "calculated risk" and corresponding precision (sampling error) *i.e.* the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.
- (5) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.
- (6) It is widely accepted way of sampling as it is more scientific, without personal bias and the result of sample can be evaluated and projected in more reliable way.

Under some audit circumstances, statistical sampling methods may not be appropriate. The auditor should not attempt to use statistical sampling when another approach is either necessary or will provide satisfactory information in less time or with less effort. For instance, when exact accuracy is required or in case of legal requirements etc.

Sometimes the audit staff has no knowledge about sampling technique used, in such circumstances using statistical sampling becomes complex and inappropriate.

6.8 Sampling Process



6.9 Sample Design, Size and Selection of Items for Testing

When designing an audit sample, the auditor shall consider the purpose of the audit procedures and the characteristics of the population from which the sample will be drawn. The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level. The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection. Sample selected must be representative of the population.

6.9.1 Sample Design

When designing an audit sample,

- i) the auditor's consideration includes the ***specific purpose*** to be achieved and the ***combination of audit procedures*** that is likely to best achieve that purpose.
- ii) Consideration of the ***nature of the audit evidence*** sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling.

- iii) In fulfilling the requirement of **SA 500 "Audit Evidence"**, when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

The auditor's consideration of the purpose of the audit procedure includes a clear understanding of what constitutes a deviation or misstatement so that all, and only, those conditions that are relevant to the purpose of the audit procedure are included in the evaluation of deviations or projection of misstatements.

Example

In a test of details relating to the existence of accounts receivable, such as confirmation, payments made by the customer before the confirmation date but received shortly after that date by the client, are not considered a misstatement. Also, a wrong posting between customer accounts does not affect the total accounts receivable balance.

Therefore, it may not be appropriate to consider this a misstatement in evaluating the sample results of this particular audit procedure, even though it may have an important effect on other areas of the audit, such as the assessment of the risk of fraud or the adequacy of the allowance for doubtful accounts.

In considering the characteristics of a population, for tests of controls, the auditor makes an assessment of the expected rate of deviation based on the auditor's understanding of the relevant controls or on the examination of a small number of items from the population. This assessment is made in order to design an audit sample and to determine sample size.

Example

If the expected rate of deviation is unacceptably high, the auditor will normally decide not to perform tests of controls.

Similarly, for tests of details, the auditor makes an assessment of the expected misstatement in the population. If the expected misstatement is high, 100% examination or use of a large sample size may be appropriate when performing tests of details.

A Stratification and Value-Weighted Selection

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection is appropriate.

SA 530 provides guidance to the auditor on the use of stratification and value-weighted sampling techniques.

Stratification: Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic.

The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

When performing *tests of details*, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement.

Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the *allowance for doubtful accounts* in the valuation of accounts receivable, balances may be stratified by age.

Stratification: Dividing a population into discrete sub population which have identifying characteristics is called as Stratification. Each Sub population is called as Stratum and units under those sub population are referred to as Strata.

The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population.

The results of samples from the units drawn under each sub population are projected to that respective stratum. In order to draw an opinion on the overall population, the auditor needs to combine the results of all the stratum to check for possible deviation or risk of material misstatement.

Projected misstatements of each stratum will be combined together to consider the possible effect of misstatement in the account balances and class of transactions.

Example

20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).

Value-Weighted Selection: When performing tests of details, it may be efficient to identify the sampling unit as the individual monetary units that make up the population. Having selected specific monetary units from within the population, for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units.

One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes.

This approach may be used in conjunction with the systematic method of sample selection and is most efficient when selecting items using random selection.

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

6.9.2 Sample Size

The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

The level of sampling risk that the auditor is willing to accept affects the sample size required.

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

The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. There are various factors typically have on the determination of sample size. When circumstances are similar,

the effect on sample size of factors will be similar regardless of whether a statistical or non- statistical approach is chosen.

A Examples of Factors Influencing Sample Size for Tests of Controls

The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

- (i) When there is an increase in the extent to which the auditor's risk assessment takes into account relevant controls. The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls. ***Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of controls*** (and therefore, the sample size is increased). Thus, sample size will increase.

For Example -ABC Manufacturing Ltd. has established a control whereby every credit sale must be approved electronically by the Credit Manager before goods are dispatched. This control is intended to ensure that sales are made only to customers having approved credit limits, thereby reducing the risk of bad debts and unauthorised credit sales.

During the audit, the auditor assesses this control as well-designed and intends to place significant reliance on its operating effectiveness while assessing the risk of material misstatement relating to revenue and trade receivables. If the control is found to be operating effectively throughout the year, the auditor may reduce the extent of certain substantive audit procedures.

Since the audit conclusion will depend substantially on the effectiveness of this control, the auditor needs strong and persuasive audit evidence that the control functioned consistently during the entire reporting period. Accordingly, the auditor selects a larger sample of credit sales transactions from different

months of the year and verifies whether the required electronic approval was obtained before dispatch in each selected case.

When the auditor intends to place greater reliance on a control, the auditor must obtain greater assurance that the control operated effectively throughout the period under audit. A larger sample provides more reliable evidence regarding the consistent operation of the control and reduces the risk of reaching an incorrect conclusion based on the sample. Therefore, greater reliance on controls results in a larger sample size for tests of controls.

- (ii) If there is an increase in the tolerable rate of deviation. Then sample size will decrease, as lower the tolerable rate of deviation, larger the sample size needs to be. Tolerable error is the maximum error in the population that auditor is ready to accept in a given sample size. Smaller the tolerable error, larger will be the sample size.
- (iii) When there is an increase in the expected rate of deviation of the population to be tested then sample size will increase, as **higher the expected rate of deviation, larger the sample size** needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected rate of deviation include the auditor's understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.

Difference between Tolerable Deviation Rate and Expected Deviation Rate

While planning tests of controls, the auditor considers two important concepts—Tolerable Deviation Rate and Expected Deviation Rate. Although both relate to deviations in the operation of controls, they serve different purposes and should not be confused.

1. ***Tolerable Deviation Rate: The Tolerable Deviation Rate is the maximum rate of deviations from a prescribed control that the auditor is willing to accept and still conclude that the control is operating effectively for audit purposes.***

It is a benchmark or acceptance limit established by the auditor before testing begins. If the actual deviation rate found during testing exceeds this limit, the auditor may conclude that the control cannot be relied upon and may need to perform additional substantive audit procedures.

Illustration:

An auditor is testing whether all purchase orders are approved by the Purchase Manager before placing orders. The auditor decides that if more than 4% of the purchase orders are found without proper approval, the control will not be considered reliable.

Here, 4% is the tolerable deviation rate because it represents the highest level of deviations that the auditor is prepared to accept.

- 2. *Expected Deviation Rate: The Expected Deviation Rate is the rate of deviations that the auditor expects to find in the population before conducting the test.***

This expectation is formed using information such as results of previous audits, understanding of the entity's internal controls, changes in personnel, implementation of new systems, and results of preliminary audit procedures.

The expected deviation rate helps the auditor determine the number of items that should be selected for testing. If the auditor expects more deviations, a larger sample is generally required to estimate the actual deviation rate with reasonable precision.

Illustration:

Continuing the above example, suppose the auditor reviewed the previous year's audit file and found that approximately 2% of purchase orders lacked proper approval. No major changes have taken place during the current year. Therefore, before commencing testing, the auditor expects that the current year's deviation rate will also be around 2%.

Here, 2% is the expected deviation rate because it represents the auditor's estimate before testing begins.

- (iv) An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population will **increase the sample size**. Thus, the greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.
- (v) In case of large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence. Therefore, there will be **negligible effect** on sample size due to increase in the number of sampling units in the population.

For Example- *A retail chain processed 60,000 customer invoices during the previous year and 1,20,000 invoices during the current year. Although the number of invoices has doubled, the auditor may not significantly increase the sample because both populations are already very large.*

On the other hand, if the company had only 40 invoices during the year, the auditor might decide to examine every invoice instead of applying sampling.

Once the population is sufficiently large, the number of items in the population has very little influence on the required sample size. For very small populations, examining all items may be more efficient than selecting a sample.

B Examples of Factors Influencing Sample Size for Tests of Details

The following are factors that the auditor may consider when determining the sample size for tests of details. These factors, which need to be considered together, assume the auditor does not modify the approach to tests of controls or otherwise modify the nature or timing of substantive procedures in response to the assessed risks.

- (i) **The higher the auditor's assessment of the risk of material misstatement, the larger the sample size needs to be.** The auditor's assessment of the risk of material misstatement is affected by inherent risk and control risk. For example, if the auditor does not perform tests of controls, the auditor's risk assessment cannot be reduced for the effective operation of internal controls with respect to the particular assertion. Therefore, in order to reduce audit risk to an acceptably low level, the auditor needs a low detection risk and will rely more on substantive procedures. The more audit evidence that is

obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be. Thus we can say that there will be an increase in sample size in case of an increase in the auditor's assessment of the risk of material misstatement.

- (ii) **The more the auditor is relying on other substantive procedures** (tests of details or substantive analytical procedures) to reduce to an acceptable level the detection risk regarding a particular population, the less assurance the auditor will require from sampling and, therefore, **the smaller the sample size can be**. Hence, if there is an increase in the use of other substantive procedures directed at the same assertion, the size of sample will decrease.

For Example-While auditing trade receivables, the auditor performs extensive substantive analytical procedures by comparing monthly sales trends, gross profit margins and debtor turnover ratios with prior years and industry data. In addition, positive external confirmations are obtained from major customers.

Since these procedures provide substantial audit evidence regarding the existence and valuation of trade receivables, the auditor decides that fewer individual customer balances need to be examined through detailed testing.

When other substantive procedures provide reliable audit evidence regarding the same assertion, the auditor requires less evidence from tests of details. Consequently, a smaller sample is sufficient.

- (iii) An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population will **increase the sample size**. Hence, greater the level of assurance that the auditor requires that the results of the sample are in fact indicative of the actual amount of misstatement in the population, the larger the sample size needs to be.
- (iv) **An increase in tolerable misstatement will decrease the sample size** as lower the tolerable misstatement, the larger the sample size needs to be.

For Example-The auditor is verifying office stationery expenses amounting to ₹18 lakh. Considering the relatively small value of this expense in relation to the financial statements as a whole, the auditor concludes that a comparatively higher amount of misstatement can be tolerated without affecting the audit opinion. Accordingly, the auditor selects fewer expense vouchers for detailed verification.

Where the auditor is willing to accept a larger amount of undetected misstatement, fewer items need to be tested. Therefore, a higher tolerable misstatement results in a smaller sample size.

- (v) ***The greater the amount of misstatement the auditor expects to find in the population, the larger the sample size*** needs to be in order to make a reasonable estimate of the actual amount of misstatement in the population. Factors relevant to the auditor's consideration of the expected misstatement amount include the extent, to which item values are determined subjectively, the results of risk assessment procedures, the results of tests of control, the results of audit procedures applied in prior periods, and the results of other substantive procedures. So, sample size will increase in case of an increase in the amount of misstatement the auditor expects to find in the population.

For Example-During the previous year's audit, several pricing errors were identified in inventory records. In the current year, the company has introduced a new inventory management system, and many employees are using it for the first time.

Based on these circumstances, the auditor expects that inventory valuation errors may occur more frequently during the current year. Accordingly, the auditor selects a larger sample of inventory items for detailed testing.

When the auditor expects more misstatements in the population, a larger sample is required to estimate the actual extent of misstatement with reasonable accuracy.

- (vi) ***When stratification of the population is appropriate then sample size will decrease*** as when there is a wide range (variability) in the monetary size of items in the population, it may be useful to stratify the population. When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.

What is Stratification?

Stratification means dividing a population into separate groups (called strata) based on similar characteristics, such as the monetary value of transactions or account balances, before selecting the sample.

The objective is to ensure that each group contains items that are broadly similar. This enables the auditor to apply an appropriate sampling approach to each group instead of treating the entire population as one large group.

Why does stratification reduce the sample size?

When the entire population contains items of widely different values, selecting a single sample from the whole population may require a larger sample because the population is highly varied.

Instead, if the population is divided into groups having similar characteristics—for example, high-value, medium-value and low-value items—the variability within each group becomes much lower. Since each group is more uniform, the auditor can obtain sufficient audit evidence by selecting a relatively smaller sample from each group.

As a result, the combined sample selected from all the groups is often smaller than the sample that would have been required if the entire population had been treated as a single population.

For Example-A company has 8,000 trade receivable balances. Most customer balances are below ₹50,000, while a small number of customers account for balances exceeding ₹1 crore.

Instead of selecting one sample from the entire population, the auditor divides the receivables into different groups based on their monetary value. All high-value balances are examined individually, while sampling is applied only to medium- and low-value balances.

As a result, the total number of items selected across all groups is lower than the sample that would have been required if the entire population had been treated as a single group.

Grouping similar items into separate categories reduces variability within each group. Consequently, the auditor can achieve the required level of assurance with a smaller overall sample.

- (vii) There will be **negligible effect** on sample size due to number of sampling units in the population. For large populations, the actual size of the population has little, if any, effect on sample size. Thus, for small populations, audit sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence. (However, when using monetary unit sampling, an increase in the monetary value of the population increases sample size, unless this is offset by a proportional increase in materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures.)

Monetary Unit Sampling : Under Monetary Unit Sampling (MUS), the sampling unit is each monetary unit (e.g., each rupee) rather than each individual transaction or account balance. Therefore, the larger the total monetary value of the population, the greater the number of monetary units available for selection.

Consequently, if the total value of the population increases, the auditor generally needs to examine more sample items to maintain the same level of audit assurance.

However, if materiality is also increased proportionately, the auditor can tolerate a larger amount of undetected misstatement. In such a case, the increase in sample size may be reduced or may not be required at all.

6.9.3 Selection of Items for Testing

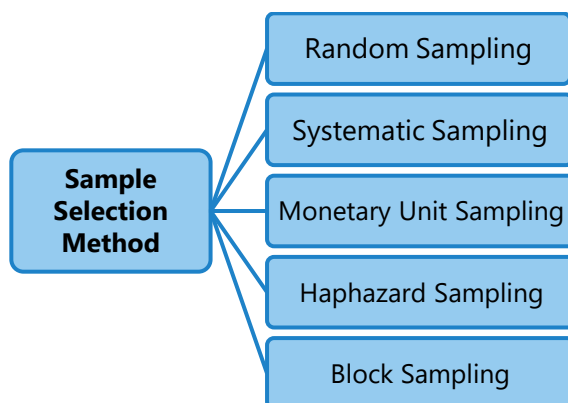
The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

With statistical sampling, sample items are selected in a way that each sampling unit has a known probability of being selected. With non-statistical sampling, judgment is used to select sample items. Because the purpose of sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected, it is important that the auditor selects a representative sample, so that bias is avoided, by choosing sample items which have characteristics typical of the population.

The principal methods of selecting samples are the use of random selection, systematic selection and haphazard selection.

A Sample Selection Methods

Sample should be selected in such a manner that it is representative of the population from which the sample is being selected. It will necessitate that each item in the population has an equal chance of being included in the sample.



Some of the important methods of selecting the sample are discussed below -

(1) Random Sampling: Random selection ensures that all items in the population or within each stratum have a known chance of selection. It may involve use of *random number tables*. Random sampling includes two very popular methods which are discussed below—

(i) Simple Random Sampling: Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected. It is considered that random number tables are simple and easy to use and also provide assurance that the auditors' bias does not affect the selection. ***Each item in a population is selected by use of random number table either with a help of computer or picking up a number in a random way (may be randomly from a drum).*** Today random numbers are also generated using various applications on the cellphones like the random number generator.

This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range i.e it is suitable for a homogeneous population having a similar range.

Example

The population can be considered homogeneous, if say, trade receivables balances fall within the range of ₹ 55,000 to ₹ 2,25,000 and not in the range between ₹ 525 to ₹ 10,50,000.

(ii) Stratified Sampling: This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment.

Example

1. In the above case, trade receivables balances may be divided into four groups as follows:-

- (a) balances in excess of ₹ 10,00,000;
- (b) balances in the range of ₹ 7,75,001 to ₹ 10,00,000;
- (c) balances in the range of ₹ 5,50,001 to ₹ 7,75,000;
- (d) balances in the range of ₹ 2,25,001 to ₹ 5,50,000; and
- (e) balances ₹ 2,25,000 and below.

From these above groups the auditor may pick up different percentage of items from each of the group. From the top group i.e. balances in excess of ₹ 10,00,000, the auditor may examine all the items; from the second group 25 per cent of the items; from the third group 10 per cent of the items; and from the lowest group 2 per cent of the items may be selected. Random sample is chosen from each stratum using random number tables.

The reasoning behind the stratified sampling is that for a **highly diversified population**, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each strata. It can be seen that the stratified sampling is simply an extension of simple random sampling.

Stratification means dividing heterogeneous (Diversified) population into Homogeneous (having similar characteristics) sub population, where samples are drawn from each sub population.

Therefore, we can say that random selection method is applied through random number generators, for example, random number tables.

(2) Interval Sampling or Systematic Sampling: Systematic selection is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having

determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerized random number generator or random number tables.

For Example-An auditor wishes to verify **200 purchase invoices** from a population of **10,000 invoices**.

The sampling interval is calculated as:

Sampling Interval = Population ÷ Sample Size = 10,000 ÷ 200 = 50

The auditor uses a random number generator to select **Invoice No. 23** as the starting point. Thereafter, every 50th invoice is selected, namely:

23, 73, 123, 173, 223, 273, ... and so on until the required sample is obtained.

This method ensures that the selected invoices are spread throughout the population instead of being concentrated in one period.

When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

For Example-A company has 360 monthly expense vouchers, arranged in the following sequence:

- Vouchers relating to the Head Office are recorded first.
- Vouchers relating to the Branch Office are recorded next.

This pattern repeats every month throughout the year.

The auditor decides to use systematic sampling by selecting every 30th voucher.

If the first selected voucher belongs to the Head Office, every subsequent 30th voucher will also belong to the Head Office because the sampling interval coincides with the way the vouchers are arranged.

As a result, only Head Office transactions will be examined, while Branch Office transactions may not be selected at all.

The sample will not represent the entire population because the sampling interval matches the pattern in which the population is organised.

Therefore, systematic sampling when chosen as a method should be carefully applied to bring together every type of transaction within its purview. More than one starting point can be considered to minimize such risk.

To minimise the effect of the possible known buyers through a pattern in the population, more than one starting point may be taken. The multiple random starting point is taken because it minimises the risk of interval sampling pattern with that of the population being sampled.

(3) Monetary Unit Sampling: It is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.

(4) Haphazard sampling: Haphazard selection, in which the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability **(for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page)** and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

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

(5) Block Sampling: This method involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample. Usually, a range of continuous transaction shall have similar characteristics, therefore, selection of a group at one time will not give a reasonable basis for opinion on the overall population as different types of transactions and unusual transactions may not be covered in the group taken all at once. Further, if the client has the idea of the block selection pattern of the auditor, then material misstatements and deviations can be easily overlooked by management's practice of recording them.

Example

Take the first 200 sales invoices from the sales day book in the month of September, alternatively take any four blocks of 50 sales invoices. Therefore, once the first item in the block is selected, the rest of the block follows items to the completion.

There is a close similarity between this method and non-statistical sampling. Consequently, it has similar characteristics, namely, simplicity and economy. On the other hand, there is a risk of bias and of establishing a pattern of selection which may be noted by the auditees.

6.10 Performing Audit Procedures

- (i) The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.
- (ii) If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a **replacement item**.
- (iii) If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation from the prescribed control, in the case of tests of controls, or a misstatement, in the case of tests of details.
- (iv) An example of when it is necessary to perform the procedure on a replacement item is when a cancelled cheque is selected while testing for evidence of payment authorization. If the auditor is satisfied that the check has been properly cancelled such that it does not constitute a deviation, an appropriately chosen replacement is examined. A replacement would then mean a proper and valid cheque through which payment has been made.
- (v) An example of when the auditor is unable to apply the designed audit procedures to a selected item is when documentation relating to that item has been lost. If the documentation of a sales is lost, like the sales order record, sales invoice, document for dispatch etc., then confirmation can be sought from the debtor as per SA 505. If it is a cash sale, the cash book can be cross verified for the existence of such transactions.



- (vi) An example of a suitable alternative procedure might be the examination of subsequent cash receipts together with evidence of their source and the items they are intended to settle when no reply has been received in response to a positive confirmation request.
- (vii) Another example for replacement of a sample could be, if all transactions of computerized sales are being checked, for example sales recorded through a bar code scanner, and incidentally a sample of manual billing gets selected, then such item can be replaced after adequately checking the correctness of the manual bill with the supporting documents available. If replacement is not possible or reasonable, alternative audit procedure can be applied.

6.11 Nature and Cause of Deviations and Misstatements

- (i) In analyzing the deviations and misstatements identified, the auditor may observe that many have a **common feature**, for example, type of transaction, location, product line or period of time.
- (ii) In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures to those items. In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud.
- (iii) Therefore, the auditor shall investigate the nature and causes of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit.
- (iv) In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an **anomaly**, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population.
- (v) The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

Example

ABC Pharmaceuticals Ltd. has branches across the country. The auditor selects a sample of 120 sales transactions to verify whether all credit sales were approved in accordance with the company's credit policy.

During testing, the auditor identifies eight transactions where the prescribed credit approval is missing. On further analysis, the auditor observes that all eight transactions relate to the Jaipur Branch and were recorded during the month of March. No such deviations are found in transactions relating to other branches or other months.

The auditor does not stop with merely reporting these eight deviations. Instead, the auditor investigates the underlying reason and discovers that the Branch Credit Manager was on long leave during March, and sales personnel processed several urgent customer orders without obtaining the required approvals. Since all deviations have a common feature—the same branch and the same period—the auditor extends audit procedures by examining all credit sales made by the Jaipur Branch during March. This helps the auditor determine whether the control failure was confined to the sampled transactions or affected the entire population of transactions having similar characteristics.

While performing the extended procedures, the auditor also considers whether the deviations could have been intentional. Suppose the auditor further discovers that several credit sales were deliberately approved beyond customers' sanctioned credit limits to achieve year-end sales targets. Such circumstances may indicate the possibility of management override or fraudulent financial reporting, requiring the auditor to perform additional audit procedures in other related areas, such as trade receivables, revenue recognition and provisioning for doubtful debts.

Now assume that, during the audit of another account, the auditor selects a sample of 80 purchase invoices and identifies one invoice where the purchase amount has been incorrectly recorded due to a one-time data entry error committed while migrating to a new accounting system. The auditor examines similar transactions processed during the migration period, reviews the migration logs and performs additional substantive procedures. These procedures establish that the error occurred only in that single invoice and did not affect any other purchase transactions.

Based on the additional evidence obtained, the auditor concludes that the misstatement is an anomaly, that is, an isolated error that is not representative of the population. However, such a conclusion should be reached only after obtaining a high degree of assurance through additional audit procedures that similar errors do not exist elsewhere in the population.

Thus, whenever deviations or misstatements are identified, the auditor should investigate their nature, cause and possible implications, determine whether they indicate a wider problem or possible fraud, and, where necessary, extend audit procedures to similar items. Only when sufficient appropriate audit evidence demonstrates that an identified misstatement or deviation is truly exceptional should it be treated as an anomaly rather than as representative of the population. This analysis enables the auditor to draw an appropriate and reliable conclusion regarding the effectiveness of controls or the fairness of the financial statements.

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

6.12 Projecting Misstatements

- (i) The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded.
- (ii) When a misstatement has been established as **an anomaly**, it may **be excluded** when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.
- (iii) For tests of details, the auditor shall project misstatements found in the sample to the population whereas for tests of controls, **no explicit projection of deviations** is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole.

6.13 Evaluating Results of Audit Sampling

The auditor shall evaluate-

- (a) The results of the sample; and
- (b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

Test Your Understanding 8

An auditor, while conducting audit of an entity, has selected samples based upon his personal experience and knowledge. Later on, it turns out that selected samples were not representative and it has led to faulty selection of samples. The auditor contends that samples were selected based upon his personal experience and knowledge. Can auditor escape from his responsibility in this regard?

7. RELATED PARTIES (SA 550)

7.1 Scope of this SA

The Standard on Auditing (SA)550 “Related Parties” 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.

7.2 Definition of Related Party

A party that is either

- (i) A related party as defined in the applicable financial reporting framework; or
- (ii) Where the applicable financial reporting framework establishes minimal or no related party requirements:
 - a. A person or other entity that has **control or significant influence**, directly or indirectly through one or more intermediaries, over the reporting entity;

- b. Another entity over which the reporting entity has **control or significant influence**, directly or indirectly through one or more intermediaries; or
- c. Another entity that is under common control with the reporting entity through having:
 - i. Common controlling ownership;
 - ii. Owners who are close family members; or
 - iii. Common key management.

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

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

Many financial reporting frameworks discuss the concepts of control and significant influence. They generally explain that:

- (a) Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities; and
- (b) Significant influence (which may be gained by share ownership, statute or agreement) is the power to participate in the financial and operating policy decisions of an entity, but is not control over those policies.

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

- (i) Direct or indirect equity holdings or other financial interests in the entity.
- (ii) The entity's holdings of direct or indirect equity or other financial interests in other entities.
- (iii) Being part of those charged with governance or key management (i.e., those members of management who have the authority and responsibility for planning, directing and controlling the activities of the entity).

- (iv) Being a close family member of any person referred to in subparagraph (iii).
- (v) Having a significant business relationship with any person referred to in subparagraph (iii).

7.4 Meaning of Related Parties with Dominant Influence

Related parties, by virtue of their ability to exert control or significant influence, may be in a position to exert dominant influence over the entity or its management. Consideration of such behaviour is relevant when identifying and assessing the risks of material misstatement due to fraud.

7.5 Meaning of Special-Purpose Entities as Related Parties

In some circumstances, a special-purpose entity may be a related party of the entity because the entity may in substance control it, even if the entity owns little or none of the special- purpose entity's equity.

7.6 Nature of Related Party Relationships and Transactions

Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties.

However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.

For example

- (A) Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
- (B) **Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.**
- (C) Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

7.7 Understanding the Entity's Related Party Relationships & Transactions

The auditor shall inquire of management regarding:

- (a) The identity of the entity's related parties, including changes from the prior period;
- (b) The nature of the relationships between the entity and these related parties; and
- (c) Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.

The auditor shall inquire of management and others within the entity, and perform other risk assessment procedures considered appropriate, **to obtain an understanding of the controls**, if any, that management has established to -

- (a) Identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework;
- (b) Authorise and approve significant transactions and arrangements with related parties; and
- (c) Authorise and approve significant transactions and arrangements outside the normal course of business.

7.8 Considerations specific to smaller entities by the auditor

Control environment in smaller entities is likely to be different from larger entities. In particular those charged with governance may not include an outside member, and the role of governance may be undertaken directly by the owner-manager where no other owner exists.

Control activities in smaller entities are likely to be less formal and smaller entities may have no documented processes for dealing with related party relationships and transactions.

An owner-manager may mitigate some of the risks arising from related party transactions, or potentially increase those risks, through active involvement in all the main aspects of the transactions.

For such entities, the auditor may obtain an understanding of the related party relationships and transactions, and any controls that may exist over these, **through inquiry of management combined with other procedures, such as observation** of management's oversight and review activities, and inspection of available relevant documentation.

Question

How can an auditor verify the existence of related party relationships and transactions?

During the audit, the auditor should maintain alertness for related party information while reviewing records and documents. He may inspect the following records or documents that may provide information about related party relationships and transactions, **for example**:

1. Entity income tax returns.
2. Information supplied by the entity to regulatory authorities.
3. Shareholder registers to identify the entity's principal shareholders.
4. Statements of conflicts of interest from management and those charged with governance.
5. Records of the entity's investments and those of its pension plans.
6. Contracts and agreements with key management or those charged with governance.
7. Significant contracts and agreements not in the entity's ordinary course of business.
8. Specific invoices and correspondence from the entity's professional advisors.
9. Life insurance policies acquired by the entity.
10. Significant contracts re-negotiated by the entity during the period.
11. Internal auditors' reports.
12. Documents associated with the entity's filings with a securities regulator e.g, prospectuses)



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

8.1 Definition of Internal Audit Function

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

The objectives and scope of internal audit functions 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:

(1) Activities Relating to Governance

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 to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.

Governance process refers to the system by which an entity is directed, controlled and held accountable. It includes the policies, procedures and oversight mechanisms established by those charged with governance to promote ethical conduct, ensure effective decision-making, monitor performance, manage risks, and safeguard the interests of stakeholders. The internal audit function evaluates whether these governance arrangements are designed appropriately and are operating effectively.

Example –XYZ Ltd. has adopted a Code of Conduct and Whistle-blower Policy for all employees. The internal audit function reviews whether employees have acknowledged the Code of Conduct, examines the mechanism for reporting unethical practices, evaluates whether significant compliance issues are appropriately reported to the Audit Committee, and assesses whether communication between management, the Audit Committee and the statutory auditors is effective.

(2) Activities Relating to Risk Management

- **The internal audit function may assist the entity by identifying and evaluating significant exposures to risk** and contributing to the improvement of risk management and internal control (including effectiveness of the financial reporting process).
- The internal audit function may perform procedures **to assist the entity in the detection of fraud.**

Example– ABC Ltd. manufactures electrical equipment and faces the risk of disruption in the supply of critical raw materials. The internal audit function identifies this as a significant business risk, evaluates whether management has implemented appropriate risk mitigation measures such as alternate suppliers and adequate inventory levels, and recommends improvements to strengthen the risk management process. During its review, the internal audit function also identifies certain unusual purchase transactions and reports them to management for further investigation.

(3) Activities Relating to Internal Control

- **Evaluation of internal control.** The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation, and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control.

For example

the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.

- **Examination of financial and operating information.** The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.

Example – During the internal audit of PQR Ltd., the internal auditors examine a sample of sales transactions by verifying sales orders, despatch documents, invoices and accounting entries. They also verify whether sales have been correctly classified and recorded in the appropriate accounting period.

- **Review of operating activities.** The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non- financial activities of an entity.

Example-LMN Ltd. operates five manufacturing plants across India. The internal audit function reviews the production process, machine utilisation, power consumption and material wastage at each plant. Based on its review, it recommends measures to improve production efficiency and reduce operating costs.

- **Review of compliance with laws and regulations.:** The internal audit function may be assigned to evaluate whether the entity is complying with applicable laws, regulations and other external requirements, as well as management policies, procedures, directives and other internal requirements. Such reviews help identify instances of non-compliance, assess the effectiveness of the entity's compliance framework, and recommend corrective actions wherever necessary.

Example-XYZ Ltd. is required to deduct tax at source (TDS) on specified payments to contractors and deposit the amount within the prescribed time. The internal audit function reviews a sample of contractor payments to verify whether TDS has been correctly deducted, deposited within the due dates and appropriate returns have been filed. It also examines compliance with the company's internal procurement policy.

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

While the objectives of an entity's internal audit function and the external auditor differ, the function may perform audit procedures similar to those performed by the external auditor in an audit of financial statements. If so, the external auditor may make use of the function for purposes of the audit in one or more of the following ways:

- (i) to obtain information that is relevant to the external auditor's assessments of the risks of material misstatement due to error or fraud.
- (ii) Unless prohibited, or restricted to some extent, by law or regulation, the external auditor, after appropriate evaluation, may decide to use work that has been performed by the internal audit function during the period in partial substitution for audit evidence to be obtained directly by the external auditor.

Where law or regulation permits, the external auditor may decide to use the work already performed by the internal audit function instead of repeating all the same audit procedures. However, before doing so, the external auditor must evaluate whether the internal audit function is objective and competent and whether the work performed is reliable and suitable for the purposes of the audit. If satisfied, the external auditor may use that work to reduce the extent of audit procedures that would otherwise have been performed directly. However, the external auditor cannot rely on the internal audit function completely and must perform additional audit procedures wherever necessary. The responsibility for obtaining sufficient appropriate audit evidence and expressing the audit opinion always remains with the external auditor.

For example-The internal audit function of ABC Ltd. has tested the operating effectiveness of controls over the purchase process throughout the year and has documented the results of its work. After evaluating the competence and objectivity of the internal audit function and assessing the quality of the work performed, the statutory auditor concludes that the work is reliable. Accordingly, the auditor uses the work of the internal audit function in determining the extent of further testing, thereby reducing the amount of direct testing required in this area.

- (iii) Unless prohibited, or restricted to some extent, by law or regulation, the external auditor may use internal auditors to perform audit procedures under the direction, supervision and review of the external auditor (**referred to as "direct assistance"**).

Example-During the audit of PQR Ltd., the statutory auditor determines that certain inventory counts at branch locations require physical verification. After evaluating the competence and objectivity of selected internal auditors and ensuring that direct assistance is not prohibited by law or regulation, the external auditor instructs the internal auditors to observe inventory counts and perform test counts at specified locations. The work is carried out under the direction, supervision and review of the external auditor, who evaluates the results before using them as audit evidence.

8.3 Scope of SA 610

Standard on Auditing (SA) 610 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.

Nothing in this SA requires the external auditor to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor; it remains a decision of the external auditor in establishing the overall audit strategy.

8.4 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. This SA, 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.

8.5 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**:

- (a) To determine whether the work of the internal audit function or direct assistance from internal auditors can be used, and if so, in which areas and to what extent; and having made that determination ;

For Example-XYZ Ltd. has an internal audit department that regularly reviews purchase, inventory and payroll controls. During audit planning, the statutory auditor evaluates the competence and objectivity of the internal audit function and considers the nature of the areas audited. The auditor decides that the work of the internal audit function can be used in the low-risk area of purchase controls.

However, for revenue recognition, which has been identified as a significant risk area, the auditor decides not to use the work of the internal audit function and performs all audit procedures independently. The auditor also determines that internal auditors may provide direct assistance in performing inventory count procedures at certain branch locations, under the direction, supervision and review of the external auditor.

- (b) If using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit; and

For Example -ABC Ltd.'s internal audit function has tested the operating effectiveness of controls over the purchase process throughout the year. Before relying on this work, the statutory auditor reviews the internal audit programme, examines the documentation prepared by the internal auditors, re-performs selected tests and evaluates whether the conclusions reached are supported by sufficient evidence. Being satisfied that the work is reliable and relevant for the audit, the auditor uses it while obtaining audit evidence.

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

***For Example-**PQR Ltd. has several warehouses where year-end inventory counts are conducted simultaneously. The statutory auditor uses internal auditors to provide direct assistance in performing inventory count procedures at selected warehouses. The external auditor provides detailed instructions regarding the procedures to be performed, supervises the work during the inventory count, reviews the working papers prepared by the internal auditors and evaluates the results before using them as audit evidence.*

8.6 Evaluating the Internal Audit Function

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**.

Objectivity and Competence

The external auditor exercises professional judgment in determining whether the work of the internal audit function can be used for purposes of the audit, and the nature and extent to which the work of the internal audit function can be used in the circumstances.

The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors and the level of competence of the function are particularly important **in determining whether to use and, if so, the nature and extent of the use of the work of the function that is appropriate in the circumstances.**

A Objectivity and its evaluation

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

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

1. Whether the organizational status of the internal audit function, including the function's authority and accountability, supports **the ability of the function to be free from bias, conflict of interest or undue influence of others** to override professional judgments.

For example

whether the internal audit function reports to those charged with governance or an officer with appropriate authority, or if the function reports to management, whether it has direct access to those charged with governance.

2. Whether those charged with governance **oversee employment decisions** related to the internal audit function.

For example

determining the appropriate remuneration policy.

3. Whether there are **any constraints or restrictions** placed on the internal audit function **by management or those charged with governance, for example**, in communicating the internal audit function's findings to the external auditor.
4. Whether the internal audit function is **free of any conflicting responsibilities, for example**, having managerial or operational duties or responsibilities that are outside of the internal audit function.

B Competence and its evaluation

Competence of the internal audit function refers to the attainment and maintenance of knowledge and skills of the function as a whole at the level required to enable assigned tasks to be performed diligently and in accordance with applicable professional standards.

Factors that may affect the external auditor's determination in relation to competence include the following:

1. Whether the internal audit function is **adequately and appropriately resourced** relative to the size of the entity and the nature of its operations.
2. Whether there are **established policies for hiring, training and assigning internal auditors to internal audit engagements**.
3. Whether the internal auditors have **adequate technical training and proficiency in auditing**.
4. Whether the internal auditors possess the required **knowledge relating to the entity's financial reporting and the applicable financial reporting framework**.

Objectivity and competence may be viewed as a continuum.

Objectivity and competence may be viewed as a continuum. The more the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors and the higher the level of competence of the function, the more likely the external auditor may make use of the work of the function and in more areas. However, an organizational status and relevant policies and procedures that provide strong support for the objectivity of the internal auditors cannot compensate for the lack of sufficient competence of the internal audit function. Equally, a high level of competence of the internal audit function cannot compensate for an organizational status and policies and procedures that do not adequately support the objectivity of the internal auditors.

For Example

ABC Ltd. has an internal audit function that reports directly to the Audit Committee, and its internal auditors are free from management influence while performing their work. However, most of the internal auditors are newly recruited and have limited audit experience. Although the internal audit function enjoys a high degree of objectivity, the statutory auditor decides not to place significant reliance on its work because the level of competence is not sufficient.

On the other hand, XYZ Ltd. has a team of highly qualified and experienced internal auditors. However, the Head of Internal Audit reports to the Finance Manager, who is responsible for the areas being audited, and management frequently influences the scope and findings of internal audit. Although the internal auditors are highly competent, the statutory auditor does not rely extensively on their work because their objectivity is impaired.

C Application of a Systematic and Disciplined Approach

The application of a systematic and disciplined approach to planning, performing, supervising, reviewing and documenting its activities distinguishes the activities of the internal audit function from other monitoring control activities that may be performed within the entity.

Factors that may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach include the following:

1. **The existence, adequacy and use of documented internal audit procedures or guidance covering** such areas as risk assessments, work programs, documentation and reporting, the nature and extent of which is commensurate with the size and circumstances of an entity.
2. Whether the internal audit function has **appropriate quality control policies and procedures.**

8.7 Circumstances When Work of the Internal Audit Function Cannot Be Used

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.

8.8 Determining the Nature and Extent of Work of the Internal Audit Function that Can Be Used

As a basis for determining the areas and the extent to which the work of the internal audit function can be used, the external auditor shall consider the nature and scope of the work that has been performed, or is planned to be performed, by the internal audit function and its relevance to the external auditor's overall audit strategy and audit plan.

In other words, once the external auditor has determined that the work of the internal audit function can be used for purposes of the audit, a first consideration is whether the planned nature and scope of the work of the internal audit function that has been performed, or is planned to be performed, is relevant to the overall audit strategy and audit plan that the external auditor has established.

Examples of work of the internal audit function that can be used by the external auditor include the following:

1. Testing of the operating effectiveness of controls.
2. Substantive procedures involving limited judgment.
3. Observations of inventory counts.
4. Tracing transactions through the information system relevant to financial reporting.
5. Testing of compliance with regulatory requirements.

8.9 Circumstances in which the external auditor shall plan to use less of the work of the Internal audit function and perform more of the work directly

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 if:

- (a) The 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.

8.10 Using the Work of the Internal Audit Function

If the external auditor plans to use the work of the internal audit function, the external auditor shall

- (A) discuss the planned use of its work with the function as a basis for coordinating their respective activities.
- (B) 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.
- (C) perform sufficient audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use to determine its adequacy for purposes of the audit.

Discussion and Coordination with the Internal Audit Function

In discussing the planned use of their work with the internal audit function as a basis for coordinating the respective activities, it may be useful to address the following:

1. The timing of such work.
2. The nature of the work performed.
3. The extent of audit coverage.
4. Materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures), and performance materiality.
5. Proposed methods of item selection and sample sizes.
6. Documentation of the work performed.
7. Review and reporting procedures.

Coordination between the external auditor and the internal audit function is effective when, for example;

1. Discussions take place at appropriate intervals throughout the period.
2. The external auditor informs the internal audit function of significant matters that may affect the function.

3. The external auditor is advised of and has access to relevant reports of the internal audit function and is informed of any significant matters that come to the attention of the function when such matters may affect the work of the external auditor so that the external auditor is able to consider the implications of such matters for the audit engagement.

8.11 Determining Whether, in Which Areas, and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance

Direct assistance refers to the use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

The external auditor **may be prohibited by law or regulation** from obtaining direct assistance from internal auditors.

If using internal auditors to provide direct assistance is not prohibited by law or regulation, and the external auditor plans to use internal auditors to provide direct assistance on the audit, the external auditor shall evaluate the existence and significance of threats to objectivity and the level of competence of the internal auditors who will be providing such assistance. 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.

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

- (a) There are significant threats to the objectivity of the internal auditor; or
- (b) The internal auditor lacks sufficient competence to perform the proposed work.

The external auditor shall not use internal auditors to provide direct assistance to perform procedures that:

- (a) Involve making significant judgments in the audit;
- (b) Relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited;

- (c) Relate to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or
- (d) Relate to decisions the external auditor makes in accordance with this SA regarding the internal audit function and the use of its work or direct assistance.

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

- (a) Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and
- (b) Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

8.12 Basics of Internal Financial Control and Reporting Requirements

You have already read about basics of Internal Financial Control and regulatory/reporting requirements in Chapter 3 in detail. Now, we shall understand distinction between Internal Financial Control and Internal Control over financial reporting.

Distinction between Internal Financial Control and Internal Control over financial reporting

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

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

Therefore, “internal financial control” is a wider term where as “internal controls over financial reporting” is a narrower term restricted to entity’s internal controls over financial reporting only.

Test Your Understanding 9

A company has stipulated a control through its automated software that interest @ 12% p.a. is charged in case of those customers who fail to make payment within a month of a sales transaction. The internal auditor of the company finds that during a certain period, software has failed to charge interest due to certain technical glitches. Does reporting of above situation fall in domain of internal auditor’s work?

Test Your Understanding 10

CA Suresh is external auditor of an entity. He comes to know that there is also an internal auditor in the entity. However, he finds that internal auditor is not reporting directly to higher echelons of the management. CA Suresh has also assessed risk of material misstatement to be high. Discuss, whether it would be proper for CA Suresh to rely upon work of internal auditor extensively in above situation.

CASE STUDY

CA Divyanshu Khandelwal is conducting audit of a company engaged in manufacturing of towels and bedspreads. The company is having its own manufacturing set-up. However, it also gets some manufacturing processes outsourced from third parties. The company has three locations having substantial quantities of inventories in the same city. Besides, due to outsourcing of some processes, inventories are also held in premises of third parties in the same city. As part of audit procedures, she is performing many audit procedures required by different Standards on Auditing.

In particular, she is attending physical inventory count process of the company at year end in accordance with requirements of SA 501. The inventory of the company includes raw materials consisting mainly of natural and dyed yarns, work in process in different stages of manufacturing and finished stocks of towels and bedspreads.

She is also planning sending confirmations to parties to whom the company has sold goods. On reviewing trade receivables list, she finds that the list also contains

large number of parties having small balances. She further finds that these receivables have arisen due to sale of bedspreads to small time retailers and possibility of difference in balances as per company's records and as per records of these small-time retailers is low. Risk of misstatements in relation to trade receivables has been assessed as low. Besides, there is nothing to suggest that small-time retailers would disregard such requests.

While conducting audit, she is testing controls operating in the company. She is also conducting tests of various items of income and expenditure as well as balances appearing in balance sheet. She intends to rely upon sampling extensively.

Based on above description, answer the following questions:

1. Which of the following statements is most appropriate regarding inventory count by auditor in accordance with SA 501?
 - (a) She should inspect the inventory to ascertain its existence and condition at all locations, observe how company personnel are carrying out count procedures and perform test counting.
 - (b) She should inspect the inventory to ascertain its existence at all locations, observe how company personnel are carrying out count procedures and perform test counting. The matter of condition of inventories falls in domain of expert.
 - (c) She should inspect the inventory to ascertain its existence at selected location, observe how company personnel are carrying out count procedures and perform test counting. The matter of condition of inventories falls in domain of expert.
 - (d) She should inspect the inventory to ascertain its existence and condition at all locations and perform counting of each and every item.
2. As regards inventories lying with third parties, which of following statements meets requirements of SA 501?
 - (a) She should request confirmation from third parties regarding quantity and condition of inventories held on behalf of the company as well as request third parties to allow her to inspect inventories held by them. Both requirements are necessary to be complied with.
 - (b) She should request confirmation from third parties regarding quantity and condition of inventories held on behalf of the company or request

third parties to allow her to inspect inventories held by them. Compliance of any one of these or both is required for purposes of SA 501.

- (c) There is no obligation cast upon an auditor in respect of inventories lying with third parties.*
 - (d) She should request confirmation from third parties regarding quantity, condition and value of inventories held on behalf of the company or request third parties to allow her to inspect inventories held by them. Compliance of any one of these is sufficient for purposes of SA 501.*
3. *Keeping in view description regarding trade receivables, identify the most appropriate statement in context of SA 505?*
- (a) She should not plan and design confirmation requests for large number of parties having small balances.*
 - (b) She should plan and design positive confirmation requests for large number of parties having small balances.*
 - (c) She should plan and design positive confirmation requests for large number of parties having small balances and meticulously analyse exception rate*
 - (d) She should plan and design negative confirmation requests for large number of parties having small balances.*
4. *As regards sampling, which of the following statements is most appropriate in terms of requirements of SA 530?*
- (a) Sampling is used in tests of transactions as well as tests of controls.*
 - (b) Sampling is used in tests of balances as well as tests of controls.*
 - (c) Sampling is used in tests of details.*
 - (d) Sampling is used in tests of details as well as tests of controls.*
5. *Since she intends to rely upon sampling extensively, which of the following statements is true about sampling risk?*
- (a) Sampling risk can be eliminated.*
 - (b) Increase in sampling risk would lead to decrease in detection risk.*
 - (c) Decrease in sampling risk would lead to increase in detection risk.*
 - (d) Sampling risk will always be in existence.*

Answers to questions involving Case Study

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

SUMMARY

- ♦ Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.
- ♦ The quality of audit evidence is affected by the relevance and reliability of the information upon which it is based.
- ♦ The auditor has to obtain sufficient appropriate audit evidence to draw reasonable conclusions on financial statements.
- ♦ Sufficiency is the measure of the quantity of audit evidence. Appropriateness is measure of quality of audit evidence.
- ♦ Audit procedures to obtain audit evidence can include inspection, observation, external confirmation, recalculation, reperformance, analytical procedures and inquiry.
- ♦ Inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.
- ♦ Test of controls may be defined as an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.
- ♦ Substantive procedures may be defined as audit procedures designed to detect material misstatements at the assertion level. These comprise of tests of details and substantive analytical procedures. Test of details comprise of tests of transactions and tests of balances.
- ♦ Assertions refer to representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.
- ♦ Audit trails (or audit logs) act as record-keepers that document evidence of certain events, procedures or operations, because their purpose is to reduce

fraud, material errors, and unauthorized use. Audit trails help to enhance internal controls and data security.

- ◆ The auditor may rely on the works of experts employed by management, provided he is satisfied that sufficient and appropriate audit evidence is obtained with reasonable assurance to form an opinion on the financial statements.
- ◆ Internal audit function refers to 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.
- ◆ Audit sampling refers to the application of audit procedures to less than 100% of items within a population of audit relevance, such that all sampling units (i.e all the items in the population) have an equal chance of selection in accordance with SA 530. 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.
- ◆ SA 501- "Audit Evidence- Specific Considerations for Selected Items" 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.
- ◆ SA 505 "External Confirmations" deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of SA 500.
- ◆ Standard on Auditing (SA) 510 "Initial Audit Engagements-Opening Balances" deals with the auditor's responsibilities relating to opening balances when conducting an initial audit engagement.
- ◆ Standard on Auditing (SA)550 "Related Parties" 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.
- ◆ "Analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary

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

- ◆ SA 520 deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.

For a concise revision of the key concepts covered in this chapter, students may refer to the **Saransh Booklet for Paper 5: Auditing and Ethics**, which serves as a useful last-mile revision resource for examination preparation. Saransh Booklet can be accessed at <https://resource.cdn.icai.org/85998bos-aps751-int-p5.pdf>

TEST YOUR KNOWLEDGE

MCQs based Questions

- (1) Which of the following is not one of functions of internal auditor of an organization?
 - (a) Performing assurance activities
 - (b) Performing consulting activities to improve governance of organization
 - (c) Performing risk management activities
 - (d) Expressing independent opinion on financial statements of organization
- (2) An auditor finds during course of an audit that the entity has entered into many related party transactions. Which of the following statements is true?
 - (a) The risk that management may override controls in respect of related party transactions is lower.
 - (b) The risk that management may override controls in respect of related party transactions is higher.
 - (c) There is no effect on the risk that management may override controls in respect of related party transactions.
 - (d) Risk of overriding of controls by management has no relationship at all with related party transactions.

- (3) Which of the following is not an objective of a company's policies for ensuring "internal financial controls"?
- (a) Efficient conduct of business
 - (b) Safeguarding of assets
 - (c) Prevention and detection of frauds and errors
 - (d) Assessing audit risk
- (4) Which of the following is not an advantage of statistical sampling?
- (a) Sample size does not increase in proportion to size of area tested.
 - (b) Sample selection is more objective.
 - (c) It provides a means of deriving a calculated risk and corresponding precision.
 - (d) In case of verifying compliance with specific legal requirements, it is suitable.
- (5) A company auditor receives external confirmation from an entity to whom company has sold goods. The said amount is properly classified in financial statements of company. Which of the following statements is not true in this regard?
- (a) It shows that said trade receivable exists.
 - (b) It shows that said trade receivable is properly valued.
 - (c) It shows that company has a right to said trade receivable.
 - (d) It shows that amount of said trade receivable has been recorded in proper account.

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

1. When auditor inquires the management as part of the audit procedures it should be formal written form only and not informal oral inquiries.
2. Assertions refer to the representations by the auditor to consider the different types of the potential misstatements that may occur.

- 3.. *Universe refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.*
4. *Non Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.*
5. *As per the Standard on Auditing (SA) 520 "Analytical Procedures" 'the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among financial data only.*

Theoretical Questions

1. *M/s Pankaj & Associates, Chartered Accountants, have been appointed as an auditor of ABC Limited. CA Pankaj did not apply any audit procedures regarding opening balances. He argued that since financial statements were audited by the predecessor auditor therefore he is not required to verify them. Is CA Pankaj correct in his approach?*
2. *The nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. Explain with the help of at least three examples.*
3. *When using external confirmation procedures, the auditor shall maintain control over external confirmation requests including sending the requests, including follow-up requests when applicable, to the confirming party. Explain the other points as to when using external confirmation procedures, the auditor would be required to maintain control over external confirmation requests.*
4. *M/s PQR and associates are the statutory auditors of TUV Ltd. for the FY 2025-26. They have been appointed as statutory auditors of TUV Ltd. for the first time. What is the objective of the engagement partner in terms of SA 510?*
5. *CA Shubham, the auditor of Sigma Limited, is performing tests of controls and tests of details using audit sampling. During these procedures, he observed deviations in compliance with management's prescribed procedures for sales transactions of small values of a product at one location during tests of controls. Additionally, misstatements were identified in the sample related to these small-value sales transactions during tests of details. How should he proceed*

to analyse the nature and cause of the deviations and misstatements observed in the sample results?

6. *Expert Industries Limited is engaged in petrochemical business. Due to nature of its business, the company has hired PQR Associates, a reputed firm of chartered engineers, to determine the quantity and valuation of inventories for preparation of financial statements. The auditor of Expert Industries Limited want to use the same as audit evidence. Before using the work of PQR Associates, management's expert, what aspects should be taken care by auditor?*
7. *CA X is contemplating the use of negative confirmation requests as the sole substantive audit procedure to verify certain accounts payable balances reflected in financial statements of a company. Which conditions need to be met to use negative confirmation requests as stated above? Additionally, CA X is of the view that negative confirmations provide same level of persuasive audit evidence as in case of positive confirmations. Do you agree with his viewpoint? Provide reasons for your answer.*
8. *CA Rimi is appointed as an auditor of ASI Pvt. Ltd. During the audit, she decided to use various audit procedures to gather sufficient and appropriate audit evidence such as:*
 - i. *While verifying the fixed asset, she examined factory equipment and verified the presence of each item.*
 - ii. *To verify the company's accounts receivable, she directly sends balance confirmations to some of the customers.*
 - iii. *CA Rimi examined purchase invoices, contracts, and authorisation records to assess the validity of payments and the approval process.*
 - iv. *She independently performs the bank reconciliation that was originally carried out by the accounts department.*
 - v. *She also checked the accuracy of depreciation calculations made by the client.*

Identify and explain the type of abovementioned audit procedure performed by CA Rimi in accordance with relevant SA.

9. *CA Mukul is the external auditor of Beige Ltd., a large company, engaged in the manufacturing of fast-moving consumer (FMCG) goods. After assessing the internal audit function of the company, CA Mukul decided to use the internal*

auditor of the company to provide direct assistance. In this context, what is meant by direct assistance under relevant Standard on Auditing? Also comment whether prior to using internal auditor for direct assistance for the purpose of audit, CA Mukul is required to obtain any written agreements or not. Give examples of procedures in which CA Mukul shall not use an internal auditor to provide direct assistance.

10. ABC Limited is a large drug manufacturing unit, having units at Hyderabad and Ahmedabad. The management has nominated an expert team from different functions of the organization, to conduct the year end verification of inventories and for finalization of accounts for the financial year 2025-26. The statutory auditors also, as a part of their audit verification, wish to attend the year end physical inventory verification planned by the management. The inventory at all the locations are considered material to the financial statements.

The auditor encountered following situations:

Hyderabad unit: Due to administrative reasons, the management had taken up the stock verification of inventory on 15th March 2026 itself.

Ahmedabad unit: The Company had taken up the inventory verification as planned on 31st March 2026. However, there was news of local disturbances in the city of Ahmedabad during the last week of March 2026, whereby the auditor cancelled his planned visit for attending inventory verification.

In the above circumstances, what additional audit procedures are to be undertaken by the statutory auditor for inventory verification?

Your answer should be in tune with relevant standards on auditing.

11. Yamika, an articled clerk, is conducting the audit of Durable Bags Ltd. During the course of the audit, she intends to use the work of the company's internal auditor as per SA 610 "using the work of internal auditor". State the circumstances under which Yamika shall plan to use less of the work of the internal audit function and instead perform more of the audit work directly.
12. (a) Alpha Manufacturing Ltd. and Beta Engineering Ltd. are audited for the year ended 31 March 2026. CA Y plans to perform tests of controls over purchase transactions in both companies.

The following information is available:

Particulars	Alpha Manufacturing Ltd.	Beta Engineering Ltd.
<i>Population of purchase invoices</i>	12,000	12,000
<i>Tolerable deviation rate</i>	5%	5%
<i>Reliance the auditor places on the operating effectiveness of control</i>	Same	Same
<i>Expected deviation rate</i>	2%	6%

- (i) Briefly explain factors to be considered by CA Y in determining the sample size for tests of controls.
 - (ii) Based on the above information, which company will require a larger sample size and why?
13. While auditing the trade receivables of Ocean Limited, CA R plans to select 100 customer balances from a population of 1000 receivables accounts appearing in the trade receivables ledger. For this purpose, he decides to select customer account number 5th as the starting point and thereafter select every 10th account from the ledger until the required sample size is obtained.
Based on the above:
 - (i) Identify and briefly explain the sampling method being used by CA R in the above situation.
 - (ii) State the important consideration that an auditor should keep in mind while using this method and how the risk arising from such sampling can be minimized?
14. With respect to SA 505, "External Confirmations", name the appropriate term that may be used in relation to the below statements:
 - (a) Audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.
 - (b) A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.

- (c) *A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.*
 - (d) *A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.*
 - (e) *A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.*
15. *The auditor should maintain alertness for related party information while reviewing records and documents. He may inspect the records or documents that may provide information about related party relationships and transactions. List any ten documents or records that an auditor may inspect to identify related party relationships and transactions during an audit.*
16. *CA Kavita is statutory auditor of Sigma Limited. While conducting audit for financial year 2025-26, it is noticed that there is risk of material misstatement regarding identified litigation or claims. In these circumstances, it has been considered appropriate by auditor to send a "letter of specific inquiry" to external legal counsel of the company. When is an auditor likely to send a letter of specific inquiry to an entity's external legal counsel instead of a letter of general inquiry? Which matters are likely to be included in "letter of specific inquiry" sent by auditor to external legal counsel?*
17. *During audit of Kavita Ltd., the auditor performs various audit procedures such as inspection, observation, confirmation, recalculation, reperformance, and analytical procedures. Some information obtained supports management's assertions, while other information appears to contradict them. The auditor also considers data obtained from the entity's accounting records and from the previous year's audit.*
- Explain how the auditor obtains sufficient appropriate audit evidence to form an opinion on the financial statements.*
18. *Bell Manufacturing Ltd. has undergone a restructuring during the current year resulting in changes in key personnel and ownership interests. The auditor observes that several new parties have become related to the entity due to these changes. During the audit, the auditor also notices a few transactions that appear unusual and possibly outside the normal course of business.*

Management states that all related party relationships and transactions have been properly identified and recorded.

Explain, with reference to SA 550, inquiries the auditor should make of management and the additional audit procedures to be performed in relation to related parties and related party transactions in this situation.

19. *XYZ Limited is engaged in manufacturing activities. As at 31st March 2025, the Trade Receivables balance amounted to ₹ 8 crores. The statutory auditor selected 25 customer balances for external confirmation in accordance with the applicable Standard on Auditing relating to external confirmations.*

The results of the confirmation procedure were as follows:

- *15 customers responded directly to the auditor indicating agreement with the information requested.*
- *3 responses were received directly to the auditor indicating disagreement with the information provided in the request. These parties were supposed to respond only if they disagree with the information provided in the request.*
- *5 customers did not respond despite follow-up requests.*
- *2 customers responded stating that the balances as per their records were lower than those mentioned in the confirmation requests.*

In the light of the relevant Standard on Auditing, explain how the auditor should evaluate the above responses and state whether further audit procedures are required.

20. *Verma & Kapoor, Chartered Accountants, were appointed as the statutory auditors of Mor Components Ltd. for the financial year 2025-26. The company is engaged in manufacturing automobile spare parts and has a large number of sales transactions during the year.*

While planning the audit of trade receivables amounting to ₹ 48 crore, the engagement partner decided to perform Test of Details using audit sampling in accordance with SA 530 "Audit Sampling". The audit team observed that the population of receivables consisted of a few large balances and a large number of small balances. Further, the engagement partner emphasised that sufficient assurance must be obtained that material misstatement in receivables is not overlooked.

Accordingly, the audit team discussed certain factors that would influence the sample size to be selected for the test of details.

With reference to SA 530 "Audit Sampling", explain briefly the following factors that the auditor may consider while determining the sample size for the Test of Details:

- (i) The desired level of assurance*
- (ii) Stratification of the population*

21. *CA A is the statutory auditor of AB Ltd., a company engaged in manufacturing high-precision industrial components used in the automobile sector. The company has experienced significant fluctuations in its gross profit ratio and raw material consumption during the current year as compared to previous years.*

During the course of audit, CA A decides to apply substantive analytical procedures to evaluate the reasonableness of purchase prices, consumption levels and revenue trends. For this purpose, he plans to rely on various data sources such as internally prepared budgets, cost sheets, management reports and external industry statistics.

However, upon preliminary review, CA A observes that:

- *Budgets appear to be prepared aggressively to achieve performance targets,*
- *Industry data relates to general manufacturing and not specifically to specialized components,*
- *Certain reports are generated from the entity's IT system, but adequacy of controls over such data is unclear.*

Considering the above, CA A is concerned about whether such data can be relied upon for designing substantive analytical procedures.

In the given context, explain the relevant points that CA A should consider while determining the reliability of data for the purpose of designing substantive analytical procedures.

22. Identify and explain briefly the audit procedure used by the auditor to obtain audit evidence in following situations:
- While auditing the books of accounts of ANT Limited for the financial year 2023-24, the auditor checked the complete documents and records of the company in detail to obtain audit evidence.
 - Mr. M, auditor of company, looks at the process of inventory counting by the entity's personnel and of the performance of control activities.
 - XYZ Ltd. is engaged in export of goods to Europe. The sales invoices raised in Euros are converted into Indian rupees as per applicable norms. The auditor wants to verify whether conversion of foreign currency into Indian rupees is proper or not.
 - CA Isha is appointed as auditor of TUV Ltd., during the initial stage of audit, she reviewed the Gross Profit Ratio of the company. She also compared GP ratio of TUV Ltd. with the other companies operating in similar industry.

ANSWERS/SOLUTIONS

Answers to the MCQs based Questions

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

Answers to Correct/Incorrect

- Incorrect:** When auditor inquires the management as part of audit procedures such inquiries may range from formal written inquiries to informal oral inquiries.
- Incorrect:** Assertions refer to representations by management that are embodied in the financial statements as used by the auditor to consider the different types of the potential misstatements that may occur.
- Incorrect:** Population refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.
- Incorrect:** Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.

5. **Incorrect.** As per the Standard on Auditing (SA) 520 "Analytical Procedures" the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.

Answers to the Theoretical Questions

1. Initial audit engagement is an engagement in which either:
- (i) The financial statements for the prior period were not audited; or
 - (ii) The financial statements for the prior period were audited by a predecessor auditor.

From the above, it is quite clear that CA Pankaj is not correct *in* his approach and therefore would be required to follow the initial audit engagement and also apply audit procedures regarding opening balances.

Audit Procedures regarding Opening Balances; The auditor shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.

The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

- (a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;
- (b) Determining whether the opening balances reflect the application of appropriate accounting policies; and
- (c) Performing one or more of the following:
 - (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;
 - (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

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

2. Refer para 7.6
3. When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:
 - (a) Determining the information to be confirmed or requested;
 - (b) Selecting the appropriate confirming party;
 - (c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and
 - (d) Sending the requests, including follow-up requests when applicable, to the confirming party.

4. Refer para 4.3

5. In the given case, while performing tests of details on a sample in respect of sales, misstatements have been found by CA Shubham in selected sample pertaining to the sales transactions of small values. This indicates observance of deviations and misstatements while performing tests of controls and tests of details respectively in selected samples.

Refer para 6.11

6. Refer para 1.13

Before using the work of PQR Associates, management's expert, auditor should ensure that the criteria mentioned above are fulfilled.

7. Refer para 3.7

Therefore, view of CA X is not correct.

8. As per SA 500, "Audit Evidence", auditor perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.
 - (i) **Inspection:** Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset.

- (ii) **External Confirmation:** An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.
 - (iii) **Inspection:** Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production.
 - (iv) **Reperformance:** Repformance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.
 - (v) **Recalculation:** Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.
9. As per SA 610, "Using the work of Internal Auditor", direct assistance refers to the use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

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

- (a) Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor and
- (b) Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

Examples of procedures in which CA Mukul shall not use internal auditor to provide direct assistance to him are: -

- (a) Procedures which involve making significant judgments in the audit;
- (b) Procedures relating to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited.

- (c) Procedures relating to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or
- (d) Procedures relating to decisions the external auditor makes in accordance with this SA regarding the internal audit function and the use of its work or direct assistance.

10. Hyderabad Unit: Physical Inventory Counting Conducted other than at the Date of the Financial Statements: As per SA 501, "Audit Evidence-Specific Considerations for Selected Items", if physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the required procedures, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded/ whether the perpetual inventory records are properly adjusted.

Relevant matters for consideration when designing audit procedures to obtain evidence about whether change in inventory amounts between the count date, or dates, and the final inventory records are properly recorded include:

- i. Reliability of the entity's perpetual inventory records.
- ii. Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records.

Ahmedabad Unit: If attendance at physical inventory counting is impracticable: As per SA 501, Audit Evidence-Specific Considerations for Selected Items", in some cases, 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.

If attendance at physical inventory counting may be impracticable due to factors such as the nature and location of the inventory, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory, 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.

11. Circumstances under which Yamika shall plan to use less of the work of the Internal audit function and perform more of the work directly: Refer para 8.9

12. (i) Refer para 6.9.2A

(ii) Alpha Manufacturing Ltd and Beta Engineering Ltd both have the same population of purchase invoices of 12,000, the same tolerable deviation rate of 5%, and the same level of reliance placed by the auditor on the operating effectiveness of controls. The only difference between the two companies is the expected deviation rate, which is 2% for Alpha Manufacturing Ltd and 6% for Beta Engineering Ltd.

As discussed above, sample size increases when the expected rate of deviation increases. A higher expected deviation rate indicates that the auditor expects more control failures in the population and, therefore, needs to examine a larger number of items to make a reliable estimate of the actual deviation rate.

Accordingly, Beta Engineering Ltd will require a larger sample size because its expected deviation rate of 6% is higher than the 2% expected deviation rate of Alpha Manufacturing Ltd.

13. (i) Interval Sampling or Systematic Sampling: Systematic selection is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example; 10 is the sampling interval in given situation (1000/100) and having determined starting point with customer number 5, each 10th sampling thereafter is selected until the required sample size is obtained. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerized random number generator or random number tables.

(ii) Important considerations an auditor should keep in mind while using this method and how the risk arising from such sampling can be minimised: When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population. Therefore, systematic sampling

when chosen as a method should be carefully applied to bring together every type of transaction within its purview.

To minimise the effect of the possible known buyers through a pattern in the population, more than one starting point may be taken. The multiple random starting point is taken because it minimises the risk of interval sampling pattern with that of the population being sampled.

- (iii) **The method selected by the partner is Block Sampling:** This method involves selection of a block(s) of contiguous items from within the population.

14.

(a)	Audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.	External Confirmation.
(b)	A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.	Positive Confirmation request.
(c)	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 confirmation request.
(d)	A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.	Non-response.

(e)	A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.	Exception.

15. Refer "How can an auditor verify the existence of related party relationships and transactions" described under para 7.8
16. Refer para 2.11
17. Refer Para 1.5.2
18. Refer para 7.7
19. As per SA 505 relating to external confirmations, the auditor shall evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence or whether performing further audit procedures is necessary.

When evaluating the results of individual external confirmation requests, the auditor may categorise such results as follows:

- (a) Positive confirmation request
- (b) Negative confirmation request;
- (c) A non-response; or
- (d) A response indicating an exception.

Applying the above principles to the given case:

- i. 15 responses confirming balances without any difference: These fall under Positive confirmation request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.
- ii 3 responses were received directly to the auditor only if they disagree with the information provided in the request: These fall under Negative confirmation request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.

- iii 5 customers who did not respond despite follow-up requests: These fall under non-response. A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered. A non-response does not provide audit evidence and therefore alternative audit procedures may be required.
- iv. 2 responses indicating lower balances than those stated in the confirmation requests: These fall under a response indicating an exception. A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party. Such exceptions require investigation to determine whether they represent misstatements.

The auditor's evaluation of the above results, when taken into account with other audit procedures performed, shall assist in concluding whether sufficient appropriate audit evidence has been obtained, as required by SA 330.

20 Examples of factors influencing Sample Size for Test of Details:

- (i) **Desired Level of Assurance:** An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population will increase the sample size. Hence, greater the level of assurance that the auditor requires that the results of the sample are in fact indicative of the actual amount of misstatement in the population, the larger the sample size needs to be.
- (ii) **Stratification of Population:** When stratification of the population is appropriate, then sample size will decrease as when there is a wide range (variability) in the monetary size of items in the population, it may be useful to stratify the population. When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.

Thus, while determining the sample size for test of details, the auditor considers factors such as the desired level of assurance and the possibility of stratifying the population, as these directly influence the extent of sampling required.

21. Refer Para 5.9

In view of the above, CA A should critically evaluate the reliability of data by examining its source, comparability, relevance and the effectiveness of controls over its preparation before relying on it for substantive analytical procedures, so as to obtain sufficient and appropriate audit evidence.

22. (i) The audit procedure used by auditor of ANT Limited is known as Inspection because inspection is an audit procedure in which complete documents and records of a company are checked in detail for the purpose of obtaining audit evidence.
- (ii) Mr. M is using Observation as audit procedure as Observation consists of looking at a process or procedure being performed by others.
- (iii) The audit procedure used by auditor is Recalculation. Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.
- (iv) CA Isha is using Analytical Procedure to obtain audit evidence. Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data.

Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

Answers to Questions involving Test Your Understanding

1. The auditor is verifying aging of trade payables. He is "reperforming" the control which was mandated by the management.
2. Inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls. Mere inquiry does not lead to obtaining of sufficient appropriate audit evidence. In the instant case, CA Sooryagaythri should verify whether proper bank reconciliations have been carried out monthly as stipulated by management. Only then, she can be satisfied about operating effectiveness of controls in this regard.
3. The management is carrying out reconciliations of items contained in Property, Plant and Equipment records with physical verification of such items at regular intervals. It means that controls in this regard have operated effectively. The reliability of audit evidence that is generated internally is

increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.

4. As per requirements of SA-501, If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, seek direct communication with the entity's external legal counsel. The above situation warrants direct communication with company's standing external lawyer.
5. When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:
 - (a) Determining the information to be confirmed or requested;
 - (b) Selecting the appropriate confirming party;
 - (c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and
 - (d) Sending the requests, including follow-up requests when applicable, to the confirming party.

In the given case, it appears that external auditor has delegated entire work of sending out external confirmation requests to internal audit department over which he has no control. Further, responses to external confirmation requests are received on mail id of internal audit department. All these acts are not in line with requirements under SA 505.

6. In terms of requirements of SA 505, if management refuses to allow the auditor to send a confirmation request, the auditor shall inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness.

A common reason advanced is the existence of a legal dispute or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely confirmation request. Further, fraud risk factors do not exist. Keeping in view, unwillingness of CFO is justifiable.

7. Analytical procedures in relation to revenue can include:-
 - (i) Comparing revenue of current year with previous year and investigating significant fluctuations
 - (ii) Comparing revenue of current year with budgeted targets and investigating significant fluctuations.
8. In the provided situation, the auditor has selected samples based upon his personal experience and knowledge. It, is a case of non-statistical sampling approach adopted by the auditor. Whatever may be the approach non-statistical or 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 auditor cannot escape his responsibility in this regard.
9. One of the functions of internal auditor includes responsibility for reviewing controls, evaluating their operation, and recommending improvements thereto. In the given case, internal auditor has found that controls relating to levying of interest have not operated. The system has not levied stipulated interest in respect of a certain period. It can result in loss of income for the company and improper financial reporting. Such a matter, definitely, falls in the domain of reporting by internal auditor.
10. In the given case, the organizational status of internal audit function is not commensurate with his duties. He is not reporting directly to higher echelons of management. It shows that such a function is not given its due importance in entity. Since risk of material misstatements has also been assessed as high by CA Sukesh, both the above factors suggest that he should not rely upon work of internal auditor extensively.

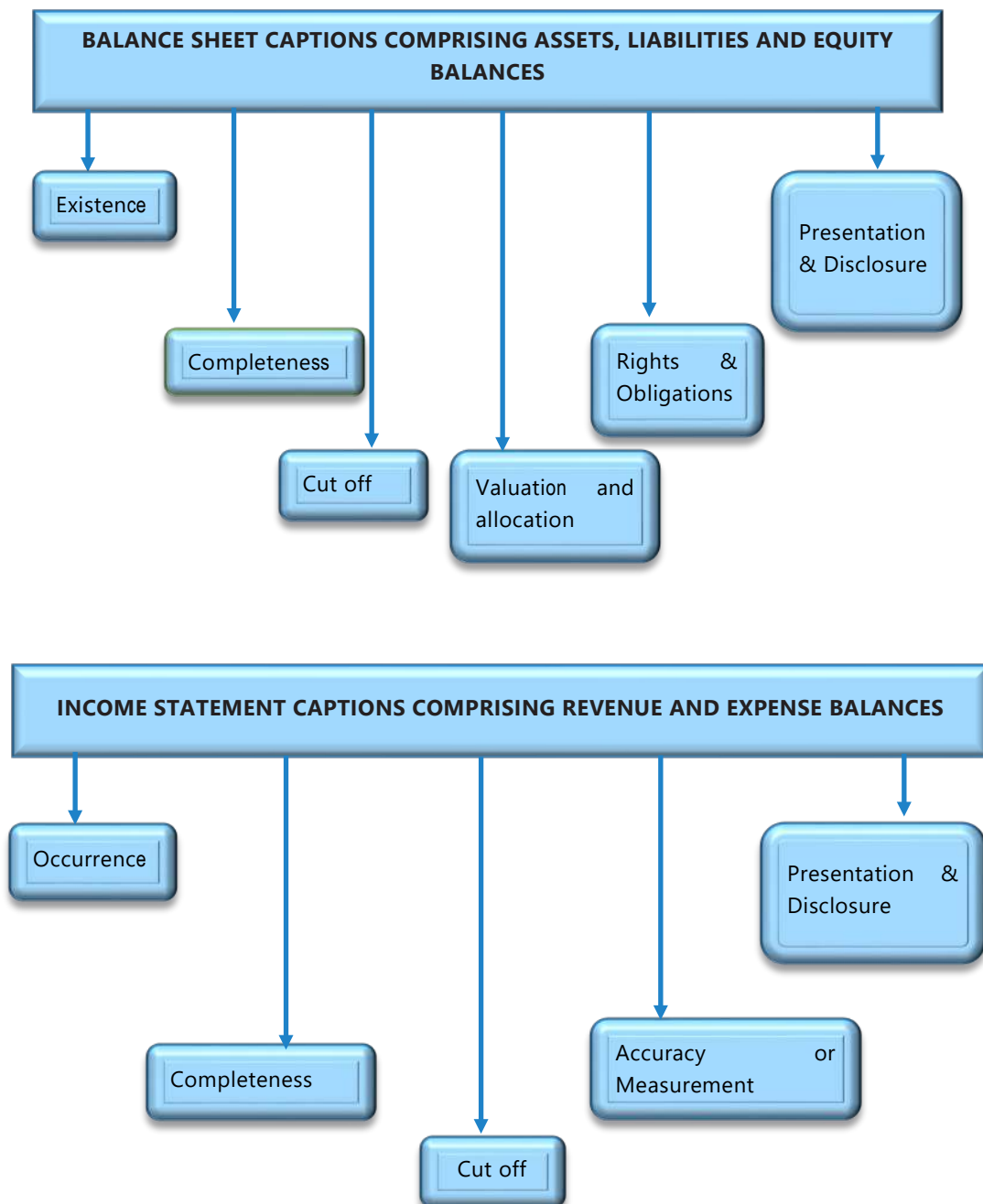
AUDIT OF ITEMS OF FINANCIAL STATEMENTS



LEARNING OUTCOMES

After studying this chapter, you would be able to understand-

- ◆ The general considerations in an audit of financial statements.
- ◆ The specific procedures for auditing heads of balance sheet and statement of profit or loss.
- ◆ Audit procedures in respect of certain disclosures in the financial statements.
- ◆ Practicality of above concepts using examples and case studies.

CHAPTER OVERVIEW

Full import of "Substantive audit procedures" was already ingrained by Sameer. However, he wanted to know how such procedures are actually applied. How such detailed checking is carried out by team carrying out audit? Are there separate yardsticks for verifying "transactions" and "balances"? And what is logic behind detailed checking of "transactions" and "balances"? Recalling the basic premise of preparation of financial statements by the management, it flowed to him logically that such preparation of financial statements ought to involve expressly stated or implied statements. While carrying out detailed checking, auditor basically tries to verify these assertions.

Shekhar had told him that while verifying transactions and balances of the manufacturing company they were auditing, all assertions backing up these were verified. For example, while verifying sales of the company, it was verified that sales pertaining to the company have, in fact, taken place. It was also verified that data in respect of these transactions was recorded correctly. Nonetheless, it was made sure to verify recording of transactions in correct accounting period. And there were others too!

Similarly, while verifying trade receivables, procedures were applied to confirm existence of these balances. It was also checked that money represented by trade receivables was, in fact, recoverable. Were some balances under litigation or under dispute? All such aspects were gone through to obtain assurance that the balances were properly valued. And how can disclosure requirements be left behind? Whether all disclosures have been made in respect of such balances which were required to be made in accordance with applicable financial reporting framework? Besides this, analytical procedures also needed to be performed to bring out variations and fluctuations.

Gathering that transactions and balances reflected in financial statements convey so many things, both stated and understood, he found such a framework quite logical. In this context, requirements of applicable financial reporting framework become too important to be taken lightly. Schedule III of the Companies Act, 2013 came to his mind instantaneously in context of their talks pertaining to a manufacturing company.

Performing audit procedures to verify such assertions provides evidence to auditor which is evaluated in light of overall circumstances. Such procedures are indeed bedrock which help auditor to crystallize his opinion in form of audit report. Wanting to learn comprehensively about such procedures particularly in context of companies, he scrolled mouse to next page.



INTRODUCTION

Companies prepare their financial statements in accordance with the framework of **generally accepted accounting principles (Indian GAAP)**, also commonly referred to as **accounting standards (AS)**.

A **financial statement audit** comprises the examination of an entity's **financial statements** and accompanying disclosures by an independent **auditor**. The result of this examination is a report by the **auditor**, attesting the truth and fairness of preparation and presentation of the **financial statements** and related disclosures. The preparation and presentation of the financial statements is the responsibility of the management.

Further, every financial statement contains an overall representation in addition to various specific assertions. Each financial statement purports to present something as a whole in addition to its component details. For example, an income statement purports to present "the results of operations" a balance sheet purports to present "financial position". The auditor's opinion is typically directed to these overall representations. But to formulate and offer an opinion on the overall truth of these statements he has first to inquire into the truth of many specific assertions that makes up each of these statements. Out of his individual judgements of these specific assertions he arrives at a judgement on the financial statement as a whole. In this chapter, we will be discussing in detail about the various audit procedures that an auditor can perform in order to verify the various assertions appearing in the financial statements. Before discussing about the audit procedures that an auditor can perform to verify the various assertions appearing in the financial statements, let us have a look at the meaning of the term assertion.

DEFINITION OF ASSERTION: It refers to the representations by management, explicit or otherwise, that are embodied *in the financial statements*, as used by the auditor to consider the different types of potential misstatements that may occur.

In preparing financial statements, company's management makes various implicit or explicit claims (i.e. assertions) regarding:

- completeness;
- cut-off;
- existence/ occurrence;

- valuation and allocation/ accuracy or measurement;
- rights and obligations; and
- presentation and disclosure

of **Assets, Liabilities, Equity, Income, Expenses and Disclosures** in accordance with the applicable accounting standards.

Example

If Company X's balance sheet shows Building with carrying amount of ₹ 50 lakh, the auditor shall assume that the management has claimed/ asserted that:

- The building recognized in the balance sheet exists as at the period- end (existence assertion);
- Company X owns and controls such building (Rights and obligations assertion);
- The building has been valued accurately in accordance with the measurement principles (Valuation and allocation assertion);
- All buildings owned and controlled by Company X are included within the carrying amount of ₹ 50 lakh (Completeness assertion).

The auditor then needs to draw an audit programme to verify the assertions made by the management by obtaining sufficient and appropriate audit evidence for each of the claims made on Account Balances, Class of Transactions and Related Disclosures.

ASSERTIONS MAY BE BROADLY CLASSIFIED INTO THE FOLLOWING TYPES

1. INCOME STATEMENT CAPTIONS COMPRISING REVENUE AND EXPENSE BALANCES

Assertions	Explanation	Example: Employee benefit expenses and sales
Occurrence	Transactions recognized in the financial statements have occurred and relate to the entity.	(i) Employee benefit expense has been incurred during the period in respect of the personnel employed by the

		entity. Employee benefit expense does not include the cost of any unauthorized personnel. (ii) Recorded Sales represent goods which were ordered by valid customers and were despatched and invoiced in the period.
Completeness	All transactions that were supposed to be recorded have been recognized in the financial statements. Transactions have not been omitted.	(i) Employee benefit expenses in respect of all personnel have been fully accounted for. (ii) All genuine Sales have been recorded.
Cut-off	Whether all income and expenses are reported in the-correct accounting period. Cut-off is a separate assertion because the substantive procedures to verify it are typically different from those applied to the other components of completeness.	(i) Employee benefit expenses recognized during the period relates to the current accounting period only. (ii) Sales shall include the despatch of goods made at the year end as they belong to the relevant period.
Accuracy or Measurement	Transactions have been recorded accurately at their appropriate amounts in the financial statements. There have been no errors while preparing documents or in posting transactions to ledger. The figures and explanations are not misstated.	(i) Employee benefit expense has been measured/ calculated accurately. Any adjustments such as tax deduction at source have been correctly reconciled and accounted for. (ii) Sales are recorded correctly in the books based on the invoices. Discounts have been

		properly adjusted or accounted for.
Presentation and Disclosure	Transactions have been classified and presented fairly in the financial statements. Transactions and events are appropriately segregated or disaggregated. Presentation and disclosure assertions are considered during the course of the audit to determine that the disclosures are complete and accurate. The disclosures that are most susceptible to material misstatement are those that require significant judgement and qualitative assessments. Audit teams assess the completeness and accuracy of disclosures by determining that the disclosures provide information in a manner that does not materially omit, distort or mislead the user. The description and disclosure of transactions are relevant and easy to understand.	(1) A Company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items:— Employee Benefits Expense [showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) expense on <u>Employee Stock Option Scheme (ESOP)</u> and <u>Employee Stock Purchase Plan (ESPP)</u>, (iv) staff welfare expenses]. (2) In respect of a company other than a finance company revenue from operations shall disclose separately in the notes revenue from— (a) Sale of products; (b) Sale of services; (ba) Grants or donations received (relevant in case of section 8 companies only),] (c) Other operating revenues; Less: (d) Excise duty



2. BALANCE SHEET CAPTIONS COMPRISING ASSETS, LIABILITIES AND EQUITY BALANCES

Assertions	Explanation	Example: Inventory balance
Existence	Assets, liabilities and equity balances exist as at the period end.	Inventory recognized in the balance sheet actually existed as at the period end.
Completeness	All assets, liabilities and equity balances that were supposed to be recorded have been recognized in the financial statements.	All inventory units held by the entity that should have been recorded, have been recognized appropriately in the financial statements. Any inventory held by a third party on behalf of the entity has been included as part of the inventory balance. Inventory held by the entity as a Consignee (on behalf of third party i.e. Consignor) shall be excluded.
Cut-off	Whether all assets and liabilities are reported in the appropriate period.	Inventory balance as at the year-end does not include any element of next financial year. All items of inventory pertaining to the relevant year shall be included regardless of the location.
Valuation and allocation	Assets, liabilities and equity balances have been valued appropriately i.e. the amounts at which they are recorded are appropriate. There has been no overstatement or understatement.	Inventory has been recognized at the lower of - cost and - net realizable value in accordance with AS 2 - Inventories. Any costs that could not be reasonably allocated to the cost of production (e.g. general and administrative costs) and

		any abnormal wastage have been excluded from the cost of inventory. An acceptable valuation basis (eg. FIFO, Weighted average etc.) has been used to value inventory as at the period-end.
Rights & Obligations	Entity has the right to assets i.e. (whether the entity has ownership and legal title to assets) and the liabilities recognized in the financial statements represent all the entity's obligations to repayment as at a given date.	The entity owns or controls the inventory recorded in the financial statements i.e. the purchase invoices have been made in the name of client. Any inventory held by the entity on behalf of another entity has not been recognized as part of inventory of the entity. (Eg: Consignment agreements can be checked).
Presentation and Disclosure	Whether particular items in the financial statements are properly classified, described and disclosed. Presentation and disclosure assertions are considered during the course of the audit to determine that disclosures are complete and accurate. The disclosures that are most susceptible to material misstatement are those that require significant judgement and qualitative assessments. Audit teams assess the completeness and accuracy of disclosures by determining that the	Example 1 Inventories (i) Inventories shall be classified as: (a) Raw materials; (b) Work-in-progress; (c) Finished goods; (d) Stock-in-trade (in respect of goods acquired for trading); (e) Stores and spares; (f) Loose tools; (g) Others (specify nature). (ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories. (iii) Mode of valuation shall be stated. Example 2: For Share capital, a

	disclosures provide information in a manner that does not materially omit, distort or mislead the user. The balances have been appropriately segregated or disaggregated. The related disclosures are understandable in accordance with applicable Financial Reporting framework.	reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period is required to be disclosed in the notes to accounts of the company.

An overview of Assertions in financial statements

Checkbox	Assertions relating to Income Statement captions
✓	Occurrence
✓	Completeness
✓	Cut Off
✓	Accuracy or Measurement
✓	Presentation and Disclosure

Checkbox	Assertions relating to Balance Sheet captions
✓	Existence
✓	Completeness
✓	Cut Off
✓	Valuation and allocation
✓	Rights & Obligations
✓	Presentation and Disclosure

Test Your Understanding 1

A company is engaged in manufacturing of fabrics from yarn purchased from different suppliers. Occasionally, it also manufactures fabrics tailor made in accordance with requirements of certain mills from yarn received from these mills. The company raises bill of its labour charges only on mills for converting yarn into fabrics. The auditor of company tries to ensure that stocks of the company as at year end do not include stocks pertaining to these mills. Which assertion auditor tries to verify in above situation? How he can ensure that?

Following section defines the various procedures an auditor should design to perform around certain Balance Sheet captions:



3. BALANCE SHEET CAPTIONS

3.1 Share Capital

Every company's lifecycle starts with raising of capital. Other than a private company, every other company issues a prospectus, which may be in the abridged form, or a Statement in lieu of Prospectus, before it proceeds towards allotment of share capital. The Prospectus defines the conditions on which allotment will be made (like minimum subscription), the projects on which the amount raised shall be spent (when these have been decided upon in advance) and to specify limits on certain expenses incidental to raising of capital. The **receipt of applications** for shares and **allotment of shares** in pursuance thereto are two important aspects of every issue of capital in the matter of purchase of shares. These, therefore, should receive a



careful attention of the auditor. He must verify that each party, has performed his part of the contract, within the allotted time. For issue of shares, the companies also enter into certain underwriting contracts which become an important part of verification by the auditor.

The below table summarises the audit procedures generally required to be undertaken while auditing share capital:

Brief description	Audit procedures
To establish the EXISTENCE of share capital as at the period-end Equity balances that were supposed to be Recorded have been Recognized in the financial statements. (COMPLETENESS) Equity balances have been VALUED appropriately.	Audit procedures • Tally the period-end share capital balance- authorised, issued and paid up, to the previous year audited financial statements. • In case there in no change during the year, obtain a written confirmation/ representation from the Company Secretary that there were no changes to entity's capital structure during the year. • In case there is any change, verify whether the paid up capital as at the period-end is within the limits of authorised capital. Authorized capital should be verified by examining MOA. • Obtain the certified copies of relevant resolutions passed at the meetings of board of directors, shareholders authorising the increase/ decrease in authorised share capital, if required, or paid up share capital. • In case of Fresh issue made in the current year, check with compliance of the Companies Act 2013 with regard to Return of Allotment, Minimum Subscription, minimum application money to be collected, maintenance of separate Bank account, payment of underwriting commission as per Sec 40 etc.

- No shares have been issued at Discount (Sec. 53 of the Companies Act, 2013)
- Check if Shares are issued for cash or for Consideration other than cash. (Eg: To promoters for their services, underwriters for commission payable to them etc.)
- Compliance with SEBI regulations and Guidelines.
- Also, obtain and verify copies of forms filed with Ministry of Corporate Affairs (MCA) (Form SH-7, notice to Registrar of any alteration of share capital, Form PAS 3 company making allotment of shares/ securities required to file a return of allotment to the Registrar) and with Reserve Bank of India (Form FCGPR in case of Foreign Direct Investment (FDI) by a Non-resident shareholder) and verify the number of securities issued along with the issue price.
- In case there was increase in share capital, verify whether the Company has accurately calculated the required fee and stamp duty payable to MCA.

Shares Issued at Premium:

In case a company has issued shares at a premium, that is, at amount in excess of the nominal value of the shares, whether for cash or otherwise, Section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received as premium to securities premium account and state the purpose for which the amount in the account can be applied.

There is no restriction or conditions prescribed in the Act for issue of shares at premium.

	The provisions of this Act relating to reduction of share capital of a company shall apply as if the securities premium account were the paid-up share capital of the company.
	Application of securities premium account: The securities premium account may be applied by the Company for the following purposes: (a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares; (b) in writing off the preliminary expenses of the Company; (c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company; (d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or (e) for the purchase of its own shares or other securities under Section 68. (Buyback) Prescribed Class of Companies are permitted to apply Securities Premium Account: The securities premium account may be applied by such class of companies, as may be prescribed and whose financial statement comply with the accounting standards prescribed for such class of companies under Section 133: (a) in paying up unissued equity shares of the company to be issued to members of the company as fully paid bonus shares; or (b) in writing off the expenses of or the commission paid or discount allowed on

	any issue of equity shares of the company; or (c) for the purchase of its own shares or other securities under section 68. The auditor needs to verify (i) whether the premium received on shares, if any, has been transferred to a "securities premium account" and (ii) whether the application of any amount out of the said "securities premium account" is only for the purposes mentioned above. Shares issued at a discount: According to Section 53 of the Companies Act, 2013, (1) a company shall not issue shares at a discount, except in the case of an issue of sweat equity shares given under Section 54 of the Companies Act, 2013. (2) any share issued by a company at a discounted price shall be void. (2A) Notwithstanding anything contained in sub-sections (1) and (2), a company may issue shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations specified by the Reserve Bank of India under the Reserve Bank of India Act, 1934 or the Banking (Regulation) Act, 1949. (3) Where any company fails to comply with the provisions of this section, such company and every officer who is in default shall be liable to a penalty which may extend to an amount equal to the amount raised through the issue of

	shares at a discount or five lakh rupees, whichever is less, and the company shall also be liable to refund all monies received with interest at the rate of twelve per cent. per annum from the date of issue of such shares to the persons to whom such shares have been issued. The auditor needs to check (i) the movement in share capital during the year and wherever there is any issue, (ii) he should verify that the Company has not issued any of its shares at a discount by reading the minutes of meeting of its directors and shareholders authorizing issue of share capital and the issue price. (iii) Further, auditor should also verify that whether the company has issued shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations specified by the Reserve Bank of India under the Reserve Bank of India Act, 1934 or the Banking (Regulation) Act, 1949.
	Issue of Sweat Equity Shares: According to Section 54 of the Companies Act, 2013, the employees may be compensated in the form of 'Sweat Equity Shares'. "Sweat Equity Shares" mean equity shares issued by the company to employees or directors at a i. discount or ii. for consideration other than cash

	for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called. The auditor needs to verify that the Sweat Equity Shares issued by the company are of a class of shares already issued and following conditions have been complied with (as per Section 54): (a) the issue is authorized by a special resolution passed by the company; (b) the resolution specifies the number of shares, the current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued; (c) omitted (d) where the equity shares of the company are listed on a recognised stock exchange, the sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board in this behalf and if they are not so listed, the sweat equity shares are issued in accordance with such rules as may be prescribed. Further, the rights, limitations, restrictions and provisions as applicable to equity shares shall be applicable to the sweat equity shares issued under this section and the holders of such shares shall rank pari passu with other equity shareholders.
	Reduction of Capital As a principle of sound financial management, a company is required to keep its capital intact. At times, however, it may become necessary for the company to bring about a reduction in

its capital. Accumulated business losses, assets of reduced or doubtful value like unsound investments proving bad or having paidup capital in excess of the requirements of the company or surplus capital which cannot be employed gainfully, require corrective measures to be taken to keep the financial health of the company in a reasonably well position. Accordingly, the company may find it necessary to reduce its share capital.

Section 66 deals with the reduction of share capital.

For verifying reduction of capital, the auditor needs to examine whether the company has followed the specific requirements as required by Section 66 of the Companies Act, 2013. The auditor shall undertake the following audit procedures:

- (i) Verify that the meeting of the shareholders held to pass the special resolution was properly convened and that the proposal was circularized in advance to all the shareholders;
- (ii) Verify that the Articles of Association authorises reduction of capital;
- (iii) Examine that there has been no default w.r.t repayment of deposits accepted by company or payment of interest on such deposits. Reduction of capital shall not be affected if such default exists.
- (iv) Examine the order of the Tribunal confirming the reduction and verify that a copy of the order and the minutes have been registered and filed with the Registrar of Companies;
- (v) Check the Registrar's Certificate as regards to reduction of capital;
- (vi) Vouch the accounting entries recorded

	to reduce the capital and to write down the assets by reference to the resolution of shareholders and other documentary evidence; also check whether the requirements of Schedule III, Part I, have been complied with in relation to presentation; (vii) Confirm whether the revaluation of assets has been properly disclosed in the Balance Sheet;
	(viii) The company may reduce the capital by reduction in unpaid capital or cancellation of lost capital or paying off excess paid up capital. Verify the adjustment made in the members' accounts in the Register of Members and confirm that either the paid-up amount shown on the old share certificates has been altered or new certificates have been issued in lieu of the old, and the old ones have been cancelled; (ix) Confirm that the words "and reduced", if required by the order of the Tribunal, have been added to the name of the company in the Balance Sheet. (x) Check if the company have complied with all the terms and conditions imposed by the tribunal while confirming reduction of share capital. (xi) Verify that the Memorandum of Association of the company has been suitably altered. Exemption to Buy-Back: According to Section 66 (6), nothing in this section shall apply to buy-back of its own securities by a company under Section 68.

	If the Company has made any buyback of securities, ensure compliance of specific requirements as given under section 68 of the Companies Act 2013.
Required DISCLOSURE for equity have been appropriately made	Ensure whether the following disclosure requirements of Schedule III (Part I) to the Companies Act, 2013 have been complied with: Share Capital For each class of share capital (different classes of preference shares to be treated separately): (a) the number and amount of shares authorised; (b) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid; (c) par value per share; (d) a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period; (e) the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital; (f) shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by or by subsidiaries or associates of the holding company or the ultimate holding company in aggregate; (g) shares in the company held by each shareholder holding more than 5 per cent. shares specifying the number of shares held; (h) shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the

- terms and amounts;
- (i) for the period of five years immediately preceding the date as at which the Balance Sheet is prepared:
- (A) Aggregate number and class of shares allotted as fully paid-up pursuant to contract(s) without payment being received in cash.
- (B) Aggregate number and class of shares allotted as fully paid-up by way of bonus shares.
- (C) Aggregate number and class of shares bought back.
- (j) terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date;
- (k) calls unpaid (showing aggregate value of calls unpaid by Directors and officers);
- (l) forfeited shares (amount originally paid-up).
- (m) A company shall disclose Shareholding of Promoters* as below:

Shares held by promoters at the end of the year				% Change during the year***
S. No.	Promoter Name	No. of shares	% of total shares**	
Total				

* Promoter here means promoter as defined in the Companies Act, 2013.

** Details shall be given separately for each class of shares

	*** percentage change shall be computed with respect to the number at the beginning of the year or if issued during the year for the first time then with respect to the date of issue.] Where in respect of an issue of securities made for a specific purpose, the whole or part of the amount has not been used for the specific purpose at the balance sheet date, there shall be indicated by way of note how such unutilised amounts have been used or invested.

Notes:

To be disclosed as Additional Regulatory Information

Utilisation of Borrowed funds and share premium:

- (A) Where company has advanced or loaned or invested funds (either borrowed funds or share premium or any other sources or kind of funds) to any other person(s) or entity(ies), including foreign entities (Intermediaries) with the understanding (whether recorded in writing or otherwise) that the Intermediary shall
- (i) 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
 - (ii) provide any guarantee, security or the like to or on behalf of the Ultimate Beneficiaries;
- the company shall disclose the following:-
- (I) date and amount of fund advanced or loaned or invested in Intermediaries with complete details of each Intermediary.
 - (II) date and amount of fund further advanced or loaned or invested by such Intermediaries to other intermediaries or Ultimate

Beneficiaries along with complete details of the ultimate beneficiaries.

- (III) date and amount of guarantee, security or the like provided to or on behalf of the Ultimate Beneficiaries
 - (IV) declaration that relevant provisions of the Foreign Exchange Management Act, 1999 (42 of 1999) and Companies Act has been complied with for such transactions and the transactions are not violative of the Prevention of Money-Laundering act, 2002 (15 of 2003);
- (B) Where a company has received any fund from any person(s) or entity(ies), including foreign entities (Funding Party) with the understanding (whether recorded in writing or otherwise) that the company shall
- (i) 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
 - (ii) provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries, the company shall disclose the following:-
 - (I) date and amount of fund received from Funding parties with complete details of each Funding party.
 - (II) date and amount of fund further advanced or loaned or invested other intermediaries or Ultimate Beneficiaries along with complete details of the other intermediaries or ultimate beneficiaries.
 - (III) date and amount of guarantee, security or the like provided to or on behalf of the Ultimate Beneficiaries
 - (IV) declaration that relevant provisions of the Foreign Exchange Management Act, 1999 (42 of 1999) and Companies Act has been complied with for such transactions and the transactions are not violative of the Prevention of Money-Laundering act, 2002 (15 of 2003).]

3.2 Reserves and Surplus

Reserves are the amounts appropriated out of profits that are not intended

- to meet any liability,
- contingency,
- commitment or
- diminution in the value of assets known to exist as at the date of the Balance Sheet.

Reserves are a vital source of financing by internal means. The company utilizes the reserves according to the nature and type of such reserve. The reserves can be segregated as **revenue or capital reserves**.

Revenue reserves represent profits that are available for distribution to shareholders or below purposes such as:

- ♦ to supplement divisible profits in lean years,
- ♦ to finance an extension of business,
- ♦ to augment the working capital of the business or
- ♦ to generally strengthen the company's financial position.

Capital Reserve represents a reserve which does not include any amount regarded as free for distribution. They can be utilized only for certain limited purposes.

Example

Securities premium, capital redemption reserve.

It may be noted that if a company appropriates revenue profit for being credited to the asset replacement reserve with the objective that these are to be used for a capital purpose, such a reserve shall also be in the nature of a capital reserve.

Capital Reserve is created from capital profits earned through sale of capital assets such as sale of fixed assets, profit on sale of shares.

A capital reserve, generally, can be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realized.



But the amount of securities premium or capital redemption reserve account can be utilised only for the purposes specified in Sections 52 and 55 of the Companies Act, 2013, respectively.

The below table summarises the audit procedures generally required to be undertaken while auditing reserves and surplus:

Brief description	Audit procedures
To establish the EXISTENCE of reserves and surplus as at the period-end	Audit procedures Trace and tally the opening balance of reserves and surplus to the previous year audited financial statements. For addition/utilization in current year, in case of:
Reserves and Surplus balances that were supposed to be recorded have been recognized in the financial statements. (COMPLETENESS)	• Profit and Loss balance – • Trace the movement to surplus/ deficit as per the Statement of profit and loss for the year under audit. • The movement should be traced in the Statement of Changes in Equity.
Reserves and Surplus balances have been VALUED appropriately (VALUATION AND ALLOCATION).	• Verify the resolution passed by the board of directors regarding the recommendation of dividend, resolution passed by shareholders declaring the dividend. • Students should note that as per AS-4 (Revised) or IND AS 10, if dividends to holders of equity instruments are proposed or declared after the balance sheet date, an entity should not recognize those dividends as a liability as at the balance sheet date. It should, however, disclose the amount of dividends that were proposed or declared after the balance sheet date, but before the financial statements were approved for issue. • Securities Premium - It needs to be

	confirmed that the company has issued shares in excess of the nominal value of the shares and for the same, the auditor should obtain and verify the resolution passed by the board of directors. As already discussed under the caption - 'share capital', the utilisation of securities premium account could be done only for limited purposes; auditor needs to ensure the same. (Sec 52 of the Companies Act 2013)
Required DISCLOSURES for reserves and surplus have been appropriately made	Ensure whether the following disclosure requirements of Schedule III (Part I) to the Companies Act, 2013 have been complied with: - Reserves and Surplus shall be classified as: - Capital Reserves; - Capital Redemption Reserve; - Securities Premium 8 [Omitted]; - Debenture Redemption Reserve; - Revaluation Reserve; - Share Options Outstanding Account; - Other Reserves– (specify the nature and purpose of each reserve and the amount in respect thereof); - Surplus i.e., balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/ from reserves, etc.; (Additions and deductions since last balance sheet to be shown

	under each of the specified heads); (ii) A reserve specifically represented by earmarked investments shall be termed as a "fund". (iii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head "Surplus". Similarly, the balance of "Reserves and Surplus", after adjusting negative balance of surplus, if any, shall be shown under the head "Reserves and Surplus" even if the resulting figure is in the negative.

3.3 Borrowings

Liabilities are the financial obligations of an enterprise other than owners' funds. Liabilities include borrowings, trade payables and other current liabilities, deferred payment credits and provisions.



Verification of liabilities is as important as that of assets, for, if any liability is omitted or understated or overstated, the financial statements would not show a true and fair view of the state of affairs of the company. Borrowings are monies made available using external sources like bank loans, debentures, public fixed deposits etc.

The below table summarises the audit procedures generally required to be undertaken while auditing borrowings:

Brief description	Audit procedures
All borrowings on the balance sheet represent valid claims by banks or other third parties. (EXISTENCE)	Review board minutes for approval of new lending agreements. During review, ensure that new loan agreements or bond issuances were authorized. Ensure that significant debt commitments were approved by the board of directors.

	Agree details of loans recorded (interest rate, nature and repayment terms) to the loan agreement. Verify that borrowing limits, if any, imposed by agreements are not exceeded.
	Roll out and obtain independent balance confirmations (SA 505) in respect of all the borrowings from the lender (banks/ financial institutions etc.).
	Agree details of leases and hire purchase creditors recorded to underlying contracts/agreements.
	In case of Debentures, examine trust deed for terms and dates of redemption, borrowing restrictions and compliance with covenants.
	- When debt is retired, ensure that a discharge is received on assets securing the debt. - Obtain Written Representation that all the liabilities which have been recorded represent a valid claim by the lenders.
That all borrowings have been accounted for in the books of the company on a timely basis. (COMPLETENESS)	- Obtain a schedule of short term and long term borrowings (including debts outstanding at the end of the previous year, as well as any new debt or renewal of debt) showing beginning and ending balances and borrowings taken and repaid during the year, and perform the following: (a) Consider any evidence of additional debt obtained through examination of minutes of the board of directors, significant contracts, confirmations from banks/ lenders, support for

	subsequent cash disbursements (when testing payables) etc. (b) Trace the closing balances as per the schedules to the general ledger.
	Review subsequent transactions after the end of the reporting period to determine if there are unrecorded liabilities at year-end and the transactions are recorded in the correct period. (Eg: Fresh loan taken near the balance sheet date)
	Direct confirmation procedures - Roll out and obtain independent balance confirmations in respect of all the borrowings from the lender (banks/ financial institutions etc.) and perform the following: (a) Ascertain that the confirmation asks for all information likely to be relevant to the tests of debt and related interest balances (e.g., applicable interest rates, due dates, collateral and security interests). (b) Send reminders for non-replies. (c) Compare the balances as per the confirmations obtained to the books of the accounts. Ask for reconciliations, if there are any differences and test the supporting documents for the reconciling items on a test check basis.
That liability is recorded at the correct amount. (VALUATION AND ALLOCATION)	Determine that the accounting policies and methods of recording debt are appropriate and applied consistently.

	• Agree loan balance and loan payables to the loan agreement. • Recompute the interest and discount or premium on redemption, if any. • Check computation of the amortization of premium or discount, if any. • For foreign currency loans, check the closing exchange rate(s) used and verify the computations of the restatements of foreign currency balances outstanding at year end. (As per AS 11)
	• Read the provisions in loan and debt agreements and perform the following: (a) Test that the entity is in compliance with loan covenants and other significant provisions of the agreements. (b) If there are any provisions with which the entity is not in compliance, determine whether the debt should be classified as current. If enforcement of the provisions has been waived by the lender in case of breach of any covenant by the entity, obtain confirmation of the waiver from the lender. • Examine the due dates on loans for proper classification between long-term and short-term. • Where instalments of long-term loans falling due within the next twelve months have been disclosed in the financial statements (e.g. in parentheses or by way of a footnote), verify the correctness of the amount of such instalments.

	• Examine the debt agreements for any restrictive covenants. Review restrictive covenant and provisions relating to default and ensure disclosure thereof in the financial statements.
	• Examine the important terms in the loan agreements and the documents, if any, evidencing charge in respect of such loans and advances. Examine whether the requirements of the applicable statute regarding creation and registration of charges have been complied with including disclosure of the same to the extent mandated by statute and considered necessary for proper understanding of the user of financial statements. • In case the value of the security falls below the amount of the loan outstanding, examine whether the loan is classified as secured only to the extent of the market value of the security.
	• Examine the hire purchase agreements for the purchase of assets by the entity and ensure the correctness of the amounts shown as outstanding in the accounts, and also examine the security aspect. • He should carefully review the borrowings from related parties and ensure compliance with AS 18 or IND AS 24. • Verify whether liabilities towards bank in respect of bills discounted, bills negotiated, cheques discounted, etc. are correctly reflected and disclosed in the financial statements.

	- The auditor should also verify that the amount borrowed is within the borrowing powers of the company as laid down by the Articles of Association and Memorandum of Association. - Verify that the company has not contravened the restrictions laid down by Section 180 (related to Restrictions on Powers of Board) of the Companies Act, 2013 in respect of the borrowings of the company. Also, check compliance of Sections 185 (related to Loans to Directors, etc.) and 186 (related to Loan and Investment by company) of the Companies Act, 2013. - Examine the purpose for which the amount is borrowed and ensure that the amount is not used against the interest of the company.
	Where the entity has accepted deposits, examine whether the directives issued by the Reserve Bank of India or other appropriate authority have been complied with.
That borrowings have been presented, classified and DISCLOSED in the financial statements in accordance with the requirements of applicable financial reporting framework i.e. the Companies Act, 2013 and applicable Indian GAAP	Ensure whether the following disclosures as required under Schedule III (Part I) to the Companies Act, 2013 are made for each amount disclosed under each of the following headings: Long- Term Borrowings (i) Long-term borrowings shall be classified as: (a) Bonds/debentures; (b) Term loans: (A) from banks. (B) from other parties. (c) Deferred payment liabilities;

	(d) Deposits; (e) Loans and advances from related parties; (f) Long term maturities of finance lease obligations; (g) Other loans and advances (specify nature). (ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case. (iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed. (iv) Bonds/debentures (along with the rate of interest and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where bonds/debentures are redeemable by instalments, the date of maturity for this purpose must be reckoned as the date on which the first instalment becomes due. (v) Particulars of any redeemed bonds/debentures which the company has power to reissue shall be disclosed. (vi) Terms of repayment of term loans and other loans shall be stated. (vii) Period and amount of continuing default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case. Other Long term Liabilities Other Long term Liabilities shall be classified as: (a) Trade Payables;

	(b) Others Short Term Borrowings (i) Short-term borrowings shall be classified as: (a) Loans repayable on demand; (A) from banks. (B) from other parties. (b) Loans and advances from related parties; (c) Deposits; (d) Other loans and advances (specify nature). (ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case. (iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed. (iv) Period and amount of default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case. (v) current maturities of Long term borrowings shall be disclosed separately. Where the company has not used the borrowings from banks and financial institutions for the specific purpose for which it was taken at the balance sheet date, the company shall disclose the details of where they have been used.

Notes:

To be disclosed as Additional Regulatory Information

1. Where the Company has borrowings from banks or financial institutions on the basis of security of current assets, it shall disclose the following:-

- (a) whether quarterly returns or statements of current assets filed by the Company with banks or financial institutions are in agreement with the books of accounts.
- (b) if not, summary of reconciliation and reasons of material discrepancies, if any to be adequately disclosed.

2. Wilful Defaulter*

Where a company is a declared wilful defaulter by any bank or financial institution or other lender, following details shall be given:

- (a) Date of declaration as wilful defaulter,
- (b) Details of defaults (amount and nature of defaults),

* wilful defaulter" here means a person or an issuer who or which is categorized as a wilful defaulter by any bank or financial institution (as defined under the Act) or consortium thereof, in accordance with the guidelines on wilful defaulters issued by the Reserve Bank of India.

3. Registration of charges or satisfaction with Registrar of Companies

Where any charges or satisfaction yet to be registered with Registrar of Companies beyond the statutory period, details and reasons thereof shall be disclosed.

4. Utilisation of Borrowed funds and share premium:

- (A) Where company has advanced or loaned or invested funds (either borrowed funds or share premium or any other sources or kind of funds) to any other person(s) or entity(ies), including foreign entities (Intermediaries) with the understanding (whether recorded in writing or otherwise) that the Intermediary shall
 - (i) 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

- (ii) provide any guarantee, security or the like to or on behalf of the Ultimate Beneficiaries;

the company shall disclose the following:-

- (I) date and amount of fund advanced or loaned or invested in Intermediaries with complete details of each Intermediary.
 - (II) date and amount of fund further advanced or loaned or invested by such Intermediaries to other intermediaries or Ultimate Beneficiaries alongwith complete details of the ultimate beneficiaries.
 - (III) date and amount of guarantee, security or the like provided to or on behalf of the Ultimate Beneficiaries
 - (IV) declaration that relevant provisions of the Foreign Exchange Management Act, 1999 (42 of 1999) and Companies Act has been complied with for such transactions and the transactions are not violative of the Prevention of Money-Laundering act, 2002 (15 of 2003).;
- (B) Where a company has received any fund from any person(s) or entity(ies), including foreign entities (Funding Party) with the understanding (whether recorded in writing or otherwise) that the company shall:
 - (i) 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
 - (ii) provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries, the company shall disclose the following:-
 - (I) date and amount of fund received from Funding parties with complete details of each Funding party.
 - (II) date and amount of fund further advanced or loaned or invested other intermediaries or Ultimate Beneficiaries alongwith complete details of the other intermediaries' or ultimate beneficiaries.

- (III) date and amount of guarantee, security or the like provided to or on behalf of the Ultimate Beneficiaries
- (IV) declaration that relevant provisions of the Foreign Exchange Management Act, 1999 (42 of 1999) and the Companies Act, 2013 has been complied with for such transactions and the transactions are not violative of the Prevention of Money-Laundering act, 2002 (15 of 2003).]

Test Your Understanding 2

A company has availed cash credit facility of ₹ 2 crore (O/s balance ₹ 2 crore as at year end) from a bank for meeting its working capital requirements against security of stocks and debtors and guaranteed by directors of the company. Discuss, how the above cash credit facility, would be classified and disclosed in financial statements of company.

3.4 Trade Receivables

Trade receivable are an essential part of any organisation's balance sheet, often referred to as debtors. Typically, an invoice is raised and issued to the customer with the invoice amount being recorded as a debtor balance. Until the invoice is paid, the invoice amount is recorded in the organization's balance sheet as accounts receivable. If these balances are not recoverable later on, then these amounts need to be written off as bad and charged in the statement of profit and loss.

It is important to carry out Test of Controls for checking the effectiveness of internal control over sales as a part of the debtors' audit procedure. Following points need to be considered in respect of trade receivables:

- Only bona fide sales lead to trade receivables.
- All such sales are made to approved customers.
- All such sales are properly recorded in the books of accounts.
- Once recorded, the debtors can be settled only by receipt of cash or on the authority of a responsible official.
- Segregation of duties at every point in sales transaction. (accounting for debtors, collecting the payments, sending reminders etc.)

- Debtors are collected on time.
- In case debtors are not collected in time, sending reminders and taking legal actions if required.
- Balances are regularly reviewed.
- A proper system of follow up exists and if necessary, adequate provision for bad debt should be made by preparing adequate ageing schedule of the debtors.



After performing Test of Controls over sales, the auditor will decide upon the audit procedure to be applied to verify debtors balance.

The below table summarises the audit procedures generally required to be undertaken while auditing trade receivables:

Brief description	Audit procedures
To establish the EXISTENCE of trade receivables as at the period- end	• Check whether there are controls in place to ensure that invoices cannot be recorded more than once and receivable balances are automatically recorded in the general ledger from the original invoice. • Ask for a period-end accounts receivable ageing report and trace the balance as per the report to the general ledger. • Check whether realization is recorded invoice-wise or not. If not, check that money received from debtors is adjusted chronologically invoice-wise and on FIFO basis i.e. previous bill is adjusted first. If

	realization is made on account, verify whether the Company has obtained confirmations from debtors in respect of the same. • If any large balance is due for a long time, auditor should ask for reasons and justification for the same. Direct confirmation procedures • A significant and important audit activity is to contact customers directly and ask them to confirm the amounts of unpaid accounts receivable as of the end of the reporting period under audit. This should necessarily be done for all significant account balances as at the period- end while certain random customers having smaller outstanding invoices should also be selected. • The auditor employs direct confirmation procedure with the consent of the entity under audit. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain trade receivables. In such cases, the auditor should consider whether there are valid grounds for such a request. In appropriate cases, the auditor may also need to reconsider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations. • The trade receivables may be requested to confirm the balances either (a) as at the date of the balance sheet, or (b) as at any other selected date which is reasonably close to the date of the balance sheet. The date should be decided by the auditor in consultation with the Company.

	The form of requesting confirmation from the trade receivables may be either (a) the form with balance outstanding amount as per the company, wherein the trade receivable is requested to respond whether or not he is in agreement with the balance shown, or (b) the form without any balance mentioned therein, wherein the trade receivable is requested to respond with the balance outstanding as per his records. The use of the form without any balance is preferable.
	- The method of selection of the trade receivables to be circularised should not be revealed to the Company until the trial balance of the trade receivables' ledger is handed over to the auditor. A list of trade receivables selected for confirmation should be given to the entity for preparing request letters for confirmation which should be properly addressed. The auditor should maintain strict control to ensure the correctness and proper despatch of request letters. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client. - Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample. The Company should be asked to investigate and reconcile the discrepancies, if any.
	Where no reply is received, the auditor should perform alternate procedures regarding the balances. This could include:

	— Agreeing the balance to cash received subsequently; — Preparing a detailed analysis of the balance, ensuring it consists of identifiable transactions and confirming that these revenue transactions actually occurred. (examination in depth for those balances) • If there are any related party receivables, review them for collectability as well as whether they were properly authorized and the value of such transactions were reasonable and at arm's length. • Check that the receivables for other than sales or services are not included in the list. • Review a trend line of sales and accounts receivable, or a comparison of the two over time, to check if there are any unusual trends i.e perform analytical procedures. This will enable the auditor to check the reasonableness of balances. Also, measure the average collection period. Make inquiries about reasons for changes in trends with the management and document the same in audit work papers.
All Trade receivable balances that were supposed to be recorded have been recognized in the financial statements. (COMPLETENESS)	• The auditor needs to satisfy himself of the cut-offs. Without a cut-off, sales could be understated or overstated, hence there is a need to perform the following cut off procedure: — For the invoices issued during the last few days (last 5 days of the reporting year) i.e. cut-off date and which have been included in the debtors; check that the goods should have been dispatched and not lying with the Company;

	— Ensure that all goods dispatched prior to the period/ year-end have been invoiced and included in debtors on a test check basis; — Ensure that no goods dispatched after the year- end have been invoiced and included in debtors for the period under audit.
	• Test invoices listed in receivable report. Select few invoices from the accounts receivable ageing report and compare them to supporting documentation to see if they were billed with the correct amounts, to the correct customers, and on the correct dates. • Match invoices to shipping/ dispatch log. Match invoice dates to the shipment dates for those items in the shipping/ dispatch log, to see if sales are being recorded in the correct accounting period. This can include an examination of invoices issued subsequent to the period being audited, to see if they should have been included in the period under audit. • Assess bill and hold sales. If there is a situation where the Company is billing customers for sales despite still retaining the goods on-site (known as "bill and hold"), examine supporting documentation to determine whether a sale has actually taken place or not. • Review the receiving log to see if the Company has recorded an inordinately large amount of customer returns after the audit period, which would suggest that the Company may have shipped more goods near the end of the audit

	period than what the customers had authorized to inflate the profits of the company; • Review the process of giving discounts/incentives and check whether the same were given as per the Company's policy/general industry trends. • Review credit memos, on a sample basis, issued during the audit period to see if they were properly authorized and whether they were issued in the correct period. Also, review credit memos issued after the period end to see if they relate to transactions belonging to the period under audit. Where any deduction has been made against a bill, check the reason and correspondence for the same.
Trade receivable balances have been VALUED appropriately.	• Review the process followed by the Company to derive an allowance for doubtful accounts. This will include a consistency comparison with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment. • Obtain the ageing report of accounts receivable (both Dr/Cr balance). • Also, obtain the list of debtors under litigation and compare with previous year. • Scrutinize the analysis and identify those debtors which appear doubtful; discuss with management about reasons as to why these debtors are not included in the provision for bad debts. Perform further testing where any disputes exist. • He should check if provisions are made at appropriate rates considering the recoverability of amounts due.

	• Prepare schedule of movements of bad debts – Provision accounts and debts written off and compare the proportion of bad debt expense to sales for the current year in comparison to prior years to see if the current expense appears reasonable. • Check that write-offs of the receivable balances have been approved by an appropriate authority i.e. the Board of Directors in case of a company.																												
Required DISCLOSURE for trade receivables have been appropriately made	• Check that the restatement of foreign currency trade receivables has been done properly in accordance with AS 11. • Proper disclosure of Related Party Transactions regarding receivables have been made as per AS 18 or IND AS 24. • Ensure that the transactions with parties covered under Section 189 (Register of Contracts or Arrangements in which Directors are interested) of the Companies Act, 2013 are reported properly in Companies Auditors’ Report Order (CARO), 2020. Ensure whether the following disclosures as required under Schedule III (Part I) to the Companies Act, 2013 are made for each amount disclosed under the heading “Trade Receivables”. <i>(i) Trade Receivables ageing schedule</i> <table><tr><th></th><th></th><th></th><th></th><th></th><th></th><th>(Amount in ₹)</th></tr><tr><th>Particulars</th><th colspan="5">Outstanding for following periods from due date of payment#</th><th></th></tr><tr><th></th><th>Less than 6 months</th><th>6 months-1 year</th><th>1-2 years</th><th>2-3 years</th><th>More than 3 years</th><th>Total</th></tr><tr><td>(i) Undisputed Trade receivables–considered good</td><td></td><td></td><td></td><td></td><td></td><td></td></tr></table>							(Amount in ₹)	Particulars	Outstanding for following periods from due date of payment#							Less than 6 months	6 months-1 year	1-2 years	2-3 years	More than 3 years	Total	(i) Undisputed Trade receivables–considered good						
						(Amount in ₹)																							
Particulars	Outstanding for following periods from due date of payment#																												
	Less than 6 months	6 months-1 year	1-2 years	2-3 years	More than 3 years	Total																							
(i) Undisputed Trade receivables–considered good																													

	(ii) <i>Undisputed Trade Receivable-considered doubtful</i>						
	(iii) <i>Disputed Trade Receivables considered good</i>						
	(iv) <i>Disputed Trade Receivables considered doubtful</i>						
# similar information shall be given where no due date of payment is specified, in that case disclosure shall be from the date of the transaction. Unbilled dues shall be disclosed separately. <u>(ii) Trade receivables shall be sub-classified as:</u> (a) Secured, considered good; (b) Unsecured, considered good; (c) Doubtful. (iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately. (iv) Debts due by - directors or other officers of the company or any of them either severally or jointly with any other person or - firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.							

3.5 Cash and Cash Equivalents

Cash and cash equivalents in the form of cash in hand, stamps in hand, balances held with bank in current accounts/ margin money accounts, cash credit accounts (debit balance), fixed deposits, cheques in hand etc. represent the most liquid assets of an enterprise i.e. readily convertible into cash and subject to insignificant value risk. Utmost professional skepticism needs to be exercised while auditing such balances as they are prone to misappropriation.



The below table summarises the audit procedures generally required to be undertaken while auditing cash and cash equivalents:

Brief description	Audit procedures
To establish the Existence of cash and cash equivalent balances as at the period- end. Cash and cash equivalent balances that were supposed to be recorded have been recorded in the financial statements. (COMPLETENESS)	• Special care is necessary in regard to verification of cash balances. Unless they are checked by surprise, there can be no certainty that the cash produced for inspection was in fact held by the custodian. For this reason, the cash should be checked not only on the last day of the year, but also checked again sometime after the close of the year without giving notice of the auditor's visit either to the entity or to his staff. (Surprise check) • If there are more than one cash balances, e.g., when there is a cashier, a petty cashier, a branch cashier and, in addition, there are imprest balances with employees, all of them should be checked simultaneously, as far as practicable so that the shortage in one balance is not made good by transfer of amount from the others. • It is desirable for the cashier to be present while cash is being counted and he should be made to sign the statement prepared

	containing details of the cash balance counted along with denomination of cash. If he is absent at the time the cash is being verified, he may hold the auditor responsible for the shortage, if any, in cash.
	• If there is any rough Cash Book or details of daily balance are separately kept, the auditor should test entries from the rough Cash Book with those in the Cash Book to prove that entries in the Cash Book are correct. • If the auditor finds any slip, chit or I.O.U.s in respect of temporary advances paid to the employees included as part of the cash balance, he should check whether those are approved by an authorized official and recorded in the appropriate accounts. • The auditor should also perform a cash sensitivity analysis by compiling a summary of total cash receipts and payments each month and analyzing the trends to see if there have been variations in any specific month and request brief descriptions from the management. • The auditor needs to obtain bank reconciliation statements (BRS) for all bank accounts maintained by the entity as at the reporting period and additionally need to understand the client's process and periodicity of making the BRS.
	The auditor should ensure that BRS is signed by the authorized personnel so that he is able to assign responsibility in case of any errors. • Verification of BRS shall entail the following: — Tallying the balance as per bank book to the bank confirmation/ statement. — Checking of all material reconciling items included under <i>cheques issued but presented</i> for payment to the

	underlying bank book forming part of books of account. In addition, the auditor should request for bank statements of subsequent period and should verify if the cheques issued have subsequently been cleared by the bank. For all cases where cheques have become stale i.e. 3 months or more have lapsed since the issue date, the same should not appear in the BRS and should instead be taken back to liabilities. — Checking of all material reconciling items included under <i>cheques deposited but not credited</i> by bank by requesting for bank deposit slips, duly acknowledged by bank and verifying if the balances were credited by bank subsequently by tallying to the bank statement of subsequent period. For any instances related to cheques not cleared beyond reasonable time, the auditor should seek brief descriptions from the management and in case such explanations are found to be unsatisfactory, the auditor should verify the revenue recognition related to such parties was in order and as per the Company's revenue recognition policy. — Checking of all material reconciling items included under amounts or charges debited/ credited by bank but not accounted for by requesting for bank statements for the period under audit and tallying the same. If the amounts are found to be material, the auditor should ensure that the management records the adjustments for the same in its books of account. If

	management does not adjust, the auditor shall consider to qualify his report.
	Direct confirmation procedure • A significant and important audit activity is to contact banks/ financial institutions directly and ask them to confirm the amounts held in current accounts, deposit accounts, EEFC account, cash credit accounts, restrictive use accounts like dividend, escrow accounts as of the end of the reporting period under audit. This should necessarily be done for all account balances as at the period-end. • The Company should be asked to investigate and reconcile the discrepancies, if any, including seeking written explanations/ clarifications from the banks/ financial institutions on any unresolved queries. • The auditor should emphasize for confirmation of 100% of bank account balances. In remote situations, where no reply is received, the auditor should perform additional testing regarding the balances. This testing could include: — Agreeing the balance to bank statement received by the Company or internet/ online login to account in auditor's personal presence; — Sending the audit team member to the bank branch along with the entity's personal to obtain balance confirmation from the bank directly.
Cash and cash equivalent balances have been VALUED appropriately.	In addition to the procedures performed above, the auditor should ensure that all bank accounts holding foreign currency have been restated at the closing exchange rates as per applicable Financial Reporting Framework.

Required DISCLOSURES for cash and cash equivalents have been appropriately made	Ensure whether the following disclosures as required under Schedule III (Part I) to the Companies Act, 2013 have been made: Cash and cash equivalents (i) Cash and cash equivalents shall be classified as: (a) Balances with banks; (b) Cheques, drafts on hand; (c) Cash on hand; (d) Others (specify nature) (ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated. (iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately. (iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated. (v) Bank deposits with more than 12 months' maturity shall be disclosed separately.

3.6 Inventories

Inventories are assets:

- (a) held for sale in the ordinary course of business;
- (b) in the process of production for such sale; or
- (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.



As per AS 2 – “Valuation of Inventories”, Inventory is valued at lower of cost and net realisable value. The basis for valuation shall be applied consistently year on year. Any change in accounting policy shall have adequate disclosures in financial statements.

The below table summarises the audit procedures generally required to be undertaken while auditing inventories:

Brief description	Audit procedures
To establish the EXISTENCE of Inventories as at the period- end.	• Review entity's plan for performing inventory count. • Ensure that consigned goods have been segregated. • Auditor should participate in the inventory count with the management. • Test counts of inventory by auditor should include: — observing employees are adhering to the agreed plan. — assuring that there is appropriate supervision on the count procedure. — assuring that all items are properly tagged. — observing that proper amounts are shown on tags. — determining that tags and summary sheets are controlled and reconciled. — reconciliation of test counts with tags and summary sheets and discrepancies noted, if any, are summarized and agreed with client personnel. — staying alert at all times and specifically being cautious about empty boxes, etc. and obsolete items. — performing cut-off testing by documenting last 5-10 receiving reports and shipping documents as of the period end.

	— ensuring exclusion of third party stock and damaged or obsolete stock. — ensuring the accounting of all stock sheets. — investigating any significant differences between the physical stock take and the stock records as per books. Further, the auditor should ask the entity's personnel to sign all stock count sheets and also agree the variances observed, if any, to avoid any conflicts. • When the entity uses periodic system for inventory count, it should be undertaken at the end of the period. If the entity uses perpetual system with proper and adequate records, inventory may be counted at interim dates. • Confirm or investigate any inventory of the entity lying with a third party (specifically relevant for cases where the entity gets job work done in its process of production).
Only the inventories held by entity have been recorded in the financial statements and do not include any inventories that belong to third parties but does include inventories owned by the entity and lying with a third party (COMPLETENESS)	• Perform analytical procedures (comparison tests with industry averages, budgets, prior years, trend analysis, etc.). — Compute inventory turnover ratio (COGS/ average inventory) — Perform vertical analysis (inventory/ total assets) — Compare budgetary expectations vis-à-vis actuals • Examine non-financial information related to inventory, such as weights and other measurements.

	• Perform purchase and sales cut-off tests. Trace shipping documents (bills of lading and receiving reports, warehouse records, and inventory records) to accounting records immediately before and after year-end. • With respect to tagged inventory, perform tests for omitted transactions and tests for invalid transactions. • Verify the clerical and arithmetical accuracy of inventory listings. • Reconcile physical inventory amounts with perpetual records. • Reconcile physical counts with general ledger control totals. • Reconcile inventories which belong to client but are held with third parties like transporters, warehouses, port authorities etc. • Goods received on consignment basis have been properly segregated from other items of inventory.
The entity has valid legal ownership rights over the inventories claimed to be held by the entity and recorded in the financial statements	• Vouch recorded purchases to underlying documentation (purchase requisition, purchase order, receiving report, vendor invoice and cancelled cheque or payment file). • Evaluate the consigned goods. • Examine client correspondence, sales and receivables records, purchase documents. • Determine existence of collateral agreements. • Review consignment agreements. • Review material purchase commitment agreements.

	• Examine invoices for evidence of ownership i.e. the invoices shall be in the name of the client. • Auditor shall obtain confirmation for significant items of inventory. • For instances of inventory held by third party, the auditor should insist on obtaining declaration from the third party on its business letterhead and signed by an authorized personnel of that third party confirming that the items of inventory belong to the entity and are being held by such third party on behalf of and for the benefit of the entity under audit.
Inventories have been VALUED appropriately and as per generally accepted accounting policies and practices	• Depending on how the business operates, the management may value inventory using First-in first-out (FIFO) or weighted average basis. Consider the reasonableness of the method adopted. • For Raw materials and consumables □ Ascertain what elements of cost are included e.g. carriage inward, non-refundable duties etc. □ If standard costs are used, enquire into basis of standards; how these are compared with actual costs and how variances are analyzed and accounted for/ treated in accounting records. □ Test check cost prices used with purchase invoices received in the month(s) prior to counting. □ Follow up valuation of all damaged or obsolete inventories noted during observance of physical counting with a view to establishing a realistic net realizable value.

	• For Work in progress □ Ascertain how the various stages of production/ value additions are measured and in case estimates are made, understand the basis for such estimates. □ Ascertain what elements of cost are included. If overheads are included, ascertain the basis on which they are included and compare such basis with the available costing and financial data/ information maintained by the entity. □ Ensure that material costs exclude any abnormal wastage factors. • For Finished goods and goods for resale □ Enquire as to what costs are included, how these have been established and ensure that the overheads included have been determined based on normal costs and appear reasonable in relation to the information disclosed in the financial statements. □ Ensure that inventories are valued at net realizable value if they are likely to fetch a value lower than their cost. For any such items, also verify if the relevant semi/ partly processed inventories (work in progress) and raw materials have also been written down.
	Follow up for items that are obsolete, damaged, slow moving and ascertain the possible realizable value of such items. Carefully examine the valuation of obsolete and damaged inventory. For the purpose, request the client to provide inventory ageing split and

	follow up for any inventories which at time of observance of physical counting were noted as being damaged or obsolete. • Compare recorded costs with replacement costs. • Examine vendor price lists to determine if recorded cost is less than current prices. • Calculate inventory turnover ratio. Obsolete inventory may be revealed if ratio is significantly lower. • In manufacturing environments, test overhead allocation rates and ensure that only direct labor, direct material and overhead have been included. • Verify the correct application of lower-of-cost-or-net realizable value principles.
Required DISCLOSURES for inventories have been appropriately made	Ensure whether the following disclosures as required under Schedule III (Part I) to the Companies Act, 2013 have been made: • Whether inventory has been classified as: — Raw materials — Work-in-progress — Finished goods — Stock-in-trade (goods acquired for trading) — Stores and spares — Loose tools — Others (specify nature). • Whether goods-in-transit have been disclosed separately under each sub-head of inventories. • Mode of valuation shall be stated.

3.7 Land, Building, Plant & Equipment, Furniture & Fixtures, Vehicles, Office Equipment, Computers etc. referred to AS “Property, Plant And Equipment” (“PPE”)

The Valuation of PPE becomes a very important aspect of consideration by the auditor in the course of his audit. The auditor should analyze the expenditure incurred on PPE, whether they are of Revenue or Capital in nature.

Recognition Criteria for PPE

The cost of an item of PPE should be recognised as an asset if, and only if:

- (a) It is probable that future economic benefits associated with the item will flow to the enterprise, and
- (b) The cost of the item can be measured reliably.

An enterprise evaluates under this recognition principle all its costs on property, plant and equipment at the time they are incurred. These costs include costs incurred:

- (a) initially to acquire or construct an item of property, plant and equipment; and
- (b) subsequently to add to, replace part of, or service it.

Measurement at Recognition

An item of property, plant and equipment that qualifies for recognition as an asset should be measured at its cost.

Elements of Cost

The cost of an item of property, plant and equipment comprises:

- (a) its purchase price, including import duties and non –refundable purchase taxes, after deducting trade discounts and rebates.
- (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
- (c) the initial estimate of the costs of dismantling, removing the item and restoring the site on which it is located, referred to as decommissioning,

restoration and similar liabilities', the obligation for which an enterprise incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

Examples of directly attributable costs are:

- (a) costs of employee benefits (as defined in AS 15, Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment;
- (b) costs of site preparation;
- (c) initial delivery and handling costs;
- (d) installation and assembly costs;
- (e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and
- (f) professional fees.

Examples of costs that are not costs of an item of property, plant and equipment are:

- (a) costs of opening a new facility or business, such as, inauguration costs;
- (b) costs of introducing a new product or service (including costs of advertising and promotional activities);
- (c) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and
- (d) administration and other general overhead costs.

The expenses have to be analysed and properly classified. The revenue expense like regular repairs on assets have to be charged off to the Statement of Profit and Loss.

The below table summarises the audit procedures generally required to be undertaken while auditing tangible fixed assets:



Brief description	Audit procedures
To establish the EXISTENCE of PPE as at the period-end	• Review entity's plan for performing physical verification of PPE i.e. whether performed by own staff or by a third party and the policy regarding periodicity i.e. whether physical verification shall be done on annual basis or once in two years/three years. • Evidence of appropriate supervision of those performing physical verification of PPE should be examined. • Obtain PPE physical verification report backed by the working sheets from the entity and perform the following procedures: — Assess if all items of PPE are properly tagged and carry identification marks/ numbers and physical verification work papers do capture the asset identification numbers for assets physically verified. — Reconciliation of items of PPE as physically verified with the fixed asset register maintained by the entity as at the date/ period of undertaking physical verification. Specifically verify if the PPE additions up to the date of physical verification have been updated in the fixed asset register. — Verify the discrepancies noted, based on physical verification undertaken and the manner in which such discrepancies have been dealt with in the entity's books and financial statements. For example, any identified shortages/ assets not in working condition

	and/or active use should be accounted for as deletions in the books of account post approvals by the entity's management and depreciation should have ceased to be charged after the date of deletion.
Additions to PPE during the period under audit have been recorded in the financial statements and do not include any PPE that belong to third parties but does include PPE owned and controlled by the entity although lying with a third party (COMPLETENESS)	• Verify the movement in the PPE schedule (asset class-wise like building, Plant & machinery etc.) compiled by the management i.e. Opening balances + Additions during the period – Deletions during the period = Closing balances. Tally the closing balance to the entity's books of account. • Check the arithmetical accuracy of the movement in PPE schedule. Tally the opening balances to the previous year audited financial statements. For additions during the period under audit, obtain a listing of all additions from the management and perform the following procedures: — For all material additions, verify if such expenditure meets the criteria of PPE as per AS 10 (Revised). These costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service it. Verify that the cost of an item of property, plant and equipment is as per AS 10 (Revised). - o Items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with AS 10 (Revised) when they meet the definition of property, plant and equipment. Otherwise, such items are classified as inventory. Ensure that the entity is not recognizing costs of the day-to-day servicing in the carrying amount of an item of property, plant and equipment. - o Test the purchase invoice, installation certificate or report or other similar

	documentation maintained by the entity to verify the date of addition, for all additions samples of PPE during the period under audit. ○ Verify whether the PPE additions have been approved by authorized personnel. ○ Verify whether proper internal processes and procedures like inviting competitive quotations/ floating tenders etc. were followed prior to finalising the vendor for procuring items of PPE/ awarding of work contract for capital projects by checking the supporting documents of the samples selected. ● In relation to deletions to PPE, understand from the management the reason and rationale for deletion (example could be new purchase of similar asset once the old asset was no longer fit to be used in production process) and the manner of disposal. Obtain the management approval and discard note authoring disposal of the asset from its active use. Verify the process followed for sale of discarded PPE, for example - inviting competitive quotes, tenders and the basis of calculation of sales proceeds. Verify that the management has accurately recorded the deletion of PPE (original cost and accumulated depreciation up to the date of disposal) and the resultant gain/ loss on disposal of PPE item in the entity's books of account.
PPE have been VALUED appropriately and as per generally accepted accounting policies and practices	It is a common understanding that the value of fixed assets/ PPE depreciates due to efflux of time, use and obsolescence. The diminution of the value represents an item of cost to the entity for earning revenue during a given period. Unless this cost in the form of depreciation is charged to the accounts, the profit or loss would not be correctly ascertained and the values of PPE would be shown at higher amounts. The auditor should: ● Verify that the entity has charged depreciation on all items of PPE unless any item of PPE is non-depreciable like freehold land;

	- Assess that the depreciation method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. It could be Straight line method, diminishing value method, unit of production method, as applicable. - The auditor should also verify whether the management has done an impairment assessment to determine whether an item of property, plant and equipment is impaired as per the requirements of AS 28 - Impairment of Assets.
The entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements (RIGHTS AND OBLIGATION)	- In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, the auditor while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity. - For all additions to land and building in particular, the auditor should check the conveyance deed/ sale deed to verify whether the entity is the legal and valid owner or not. - The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date. - In case the entity has given such immoveable property as security for any borrowings and the original title deeds are not available with the entity, the auditor should request the entity's management for obtaining a confirmation from the respective lenders that they are holding the original title deeds of immoveable property as security. - In addition, the auditor should also verify the register of charges, available with the entity to assess that any charge has been created against the PPE.

Required DISCLOSURES for PPE have been appropriately made	Ensure whether the following disclosures as required under Schedule III (Part I) to the Companies Act, 2013 have been made under the heading “Property, Plant and Equipment”: (i) Classification shall be given as: (a) Land; (b) Buildings; (c) Plant and Equipment; (d) Furniture and Fixtures; (e) Vehicles; (f) Office equipment; (g) Others (specify nature). (ii) Assets under lease shall be separately specified under each class of asset. (iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment) and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately. (iv) Where sums have been written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

Notes:

To be disclosed as Additional Regulatory Information

(i) Title deeds of Immovable Property not held in name of the Company

The company shall provide the details of all the immovable property (other than properties where the Company is the lessee and the lease agreements are duly executed in favour of the lessee) whose title deeds are not held in the name of the company in format given below and where such immovable property is jointly held with others, details are required to be given to the extent of the company's share.

Relevant line item in the Balance sheet	Description of item of property	Gross carrying value	Title deeds held in the name of	Whether title deed holder is a promoter, director or relative# of promoter*/director or employee of promoter/director	Property held since which date	Reason for not being held in the name of the company**
PPE -	Land Building	-	-	-	-	**also indicate if in dispute
Investment property	Land Building					
PPE retired from active use and held for disposal-	Land Building					
Others						

#Relative here means relative as defined in the Companies Act, 2013.

*Promoter here means promoter as defined in the Companies Act, 2013.

(ii) Where the Company has revalued its Property, Plant and Equipment, the company shall disclose as to whether the revaluation is based on the valuation by a registered valuer as defined under rule 2 of the Companies (Registered Valuers and Valuation) Rules, 2017.

(iii) Capital-Work-in Progress (CWIP)

(a) For Capital-work-in progress, following ageing schedule shall be given:

CWIP ageing schedule

(Amount in ₹)					
	Amount in CWIP for a period of				Total*
CWIP	Less than 1 year	1-2 years	2-3 years	More than 3 years	
Projects in Progress					
Projects temporarily suspended					

*Total shall tally with CWIP amount in the balance sheet.

- (b) For capital-work-in progress, whose completion is overdue or has exceeded its cost compared to its original plan, following CWIP completion schedule shall be given**:

(Amount in ₹)				
	To be completed in			
CWIP	Less than 1 year	1-2 years	2-3 years	More than 3 years
Project 1				
Project 2				

**Details of projects where activity has been suspended shall be given separately.

3.8 Intangible Assets (comprising Goodwill, Brand/Trademarks, Computer Software etc.)

An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. Enterprises frequently spend resources on the acquisition, development, maintenance or enhancement of intangible assets such as scientific or technical knowledge,



design and implementation of new processes or systems, licenses, intellectual property, market knowledge and trademarks (including brand names and publishing titles).

Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licenses, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights. Goodwill is another example of an item of intangible nature which either arises on acquisition or may be internally generated.

Not all the items described in above paragraph will meet the definition of an intangible asset, that is, identifiability, control over a resource and expectation of future economic benefits flowing to the enterprise. If an item covered by this Standard does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred.

As per AS 26 – Intangible Assets, internally generated goodwill should not be recognized as an asset.

Some intangible assets may be contained in or on a physical substance such as a compact disk (in the case of computer software), legal documentation (in the case of a licence or patent) or film (in the case of motion pictures). The cost of the physical substance containing the intangible assets is usually not significant. Accordingly, the physical substance containing an intangible asset, though tangible in nature, is commonly treated as a part of the intangible asset contained in or on it.

In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. Judgement is required to assess as to which element is predominant. For example, computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. The same applies to the operating system of a computer. Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

The below table summarises the audit procedures generally required to be undertaken while auditing intangible fixed assets:

Brief description	Audit procedures
To establish the EXISTENCE of intangible fixed assets as at the period- end	Since an intangible asset is an identifiable non-monetary asset, without physical substance, for establishing the existence of such assets, the auditor should verify whether such intangible asset is in active use in the production or supply of goods or services, for rental to others or for administrative purposes. Example- for verifying the existence of software, the auditor should verify whether such software is in active use by the entity and for the purpose, the auditor should verify the sale of related services/ goods during the period under audit, in which such software has been used. Example- For verifying the existence of design/ drawings, the auditor should verify the production data to establish if such products for which the design/ drawings were purchased, are being produced and sold by the entity. In case any intangible asset is not in active use, deletion should have been recorded in the books of account post approvals by the entity's management and amortization charge should have ceased beyond the date of deletion.
All additions to Intangible assets during the period under audit have been recorded appropriately in the financial statements. (COMPLETENESS)	Verify the movement in the intangible assets schedule (asset class wise like software, designs/ drawings, goodwill etc.) compiled by the management i.e. Opening balances + Additions – Deletions = Closing balances. Tally the closing balances to the entity's books of account.

	• Check the arithmetical accuracy of the movement in intangible assets schedule. For additions during the period under audit, obtain a listing of all additions from the management and undertake the following procedures: □ For all material additions, verify whether such expenditure meets the criterion for recognition of an intangible asset as per AS 26. □ Ensure that no intangible asset arising from research (or from the research phase of an internal project) should be recognised. Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred. Check the certificate or report or other similar documentation maintained by the entity to verify the date of use of the intangible which could be linked to date of commencement of commercial production/ economic use to the entity, for all additions to intangible assets during the period under audit. □ Verify whether the additions (acquisitions) have been approved by appropriate entity's personnel. □ Verify whether proper internal processes and procedures like inviting competitive quotations/ proper tenders etc. were followed prior to finalizing the vendor for procuring item of intangible assets by testing those documents on a sample basis. • In relation to deletions of intangible assets, understand from the management the reason and rationale for deletion and the manner of disposal. Obtain the

	management approval and disposal note authoring disposal of the asset from its active use. Verify the process followed for sale of discarded asset, example inviting competitive quotes, tenders and the basis of calculation of sales proceeds. Verify that the management has accurately recorded the deletion of intangible asset (original cost and accumulated amortization up to the date of disposal) and the resultant gain/ loss on disposal in the entity's books of account.
Intangible assets have been VALUED appropriately and as per generally accepted accounting policies and practices	The value of intangible assets may diminish due to efflux of time, use and/ or obsolescence. The diminution of the value represents cost to the entity for earning revenue during a given period. Unless this cost in the form of amortization is charged to the accounts, the profit or loss would not be correctly ascertained and the values of intangible asset would be shown at higher amounts. The auditor should: • Verify that the entity has charged amortization on all intangible assets; • Verify that the amortization method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. • The auditor should also verify whether the management has done an impairment assessment to determine whether an intangible asset is impaired. For this purpose, the auditor needs to verify whether the entity has applied AS 28 - Impairment of Assets for determining the manner of reviewing the carrying amount of its intangible asset, determining the recoverable amount of the asset to determine impairment loss, if any.

The entity has valid legal ownership rights over the Intangible Assets claimed to be held by the entity and recorded in the financial statements (RIGHTS AND OBLIGATION)	In addition to the procedures for verifying completeness of additions to intangible assets during the period under audit, the auditor while performing testing of additions should also verify that all expense invoices/ purchase contracts are in the name of the entity that entitles legal title of ownership to the entity.
Required DISCLOSURES for Intangible Assets have been appropriately made	Ensure that the following disclosures as required under Schedule III (Part I) to the Companies Act, 2013 have been made <i>under the heading "Intangible Assets":</i> (i) <i>Classification shall be given as:</i> (a) <i>Goodwill;</i> (b) <i>Brands /trademarks;</i> (c) <i>Computer software;</i> (d) <i>Mastheads and publishing titles;</i> (e) <i>Mining rights;</i> (f) <i>Copyrights, and patents and other intellectual property rights, services and operating rights;</i> (g) <i>Recipes, formulae, models, designs and prototypes;</i> (h) <i>Licences and franchise;</i> (i) <i>Others (specify nature).</i> (ii) <i>A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of intangible assets) and other adjustments and the related depreciation and impairment losses or reversals shall be disclosed separately.</i>

	(iii) Where sums have been written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

Notes:

To be disclosed as Additional Regulatory Information.

Intangible assets under development:

- (a) For Intangible assets under development, following ageing schedule shall be given:

Intangible assets under development ageing schedule

(Amount in ₹)					
	Amount in CWIP for a period of				Total*
Intangible asset under development	Less than 1 year	1-2 years	2-3 years	More than 3 years	
Projects in Progress					
Projects temporarily suspended					

* Total shall tally with the amount of Intangible assets under development in the balance sheet.

- (b) For Intangible assets under development, whose completion is overdue or has exceeded its cost compared to its original plan, following Intangible assets under development completion schedule shall be given**:

(Amount in ₹)				
	To be completed in			
Intangible asset under development	Less than 1 year	1-2 years	2-3 years	More than 3 years
Project 1				
Project 2				

***Details of projects where activity has been suspended shall be given separately.*

3.9 Trade Payables and Other Current Liabilities

Liabilities in addition to borrowings (discussed above), include trade payables and other current liabilities, deferred payment credits and provisions. A liability is considered to be current if it is due to be paid within twelve months and held primarily for the purpose of being traded in the entity's normal operating cycle. E.g. Short term debt, dividends etc. Verification of liabilities is as important as that of assets, considering if any liability is omitted or understated or overstated, the financial statements would not show a true and fair view of the state of affairs of the entity.



The below table summarises the audit procedures generally required to be undertaken while auditing trade payables and other current liabilities:

Brief description	Audit procedures
To establish the EXISTENCE of trade payables and other current liabilities as at the period-end	- Check whether there are controls in place to ensure that any purchase/ expense invoice does not get recorded more than once and payable balances are automatically recorded in the general ledger at the time of recording of expense. - Obtain the accounts payable ageing report and trace its balances to the general ledger. If there are any differences, investigate reconciling items. Journal entries specially for large amounts should be carefully examined.

	Direct confirmation procedure An important audit activity is to contact vendors directly/independently and ask them to confirm the amounts of accounts payable as of the end of the reporting period under audit. This should necessarily be done for all significant account payable balances as at the period-end and for parties from whom material purchases have been made during the period under audit even if period-end balance of such parties is not significant.
	• The auditor employs direct confirmation procedure with the consent of the entity under audit. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain trade payables. In such cases, the auditor should consider whether there are valid grounds for such a request. In appropriate cases, the auditor may also need to reconsider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations. • The trade creditors may be requested to confirm the balances either (a) as at the date of the balance sheet, or (b) as at any other selected date which is reasonably close to the date of the balance sheet. The date should be decided by the auditor in consultation with the Company. • The form of requesting confirmation from the trade creditor may be either (a) the form with balance as at year end wherein the trade creditor is requested to respond whether or not he is in agreement with the balance shown, or (b) the form with no balance wherein the trade creditor is requested to respond the balance as per his records. The use of the form with no balance is preferable.

	• The method of selection of the trade creditors to be circularised should not be revealed to the Company until the trial balance of the trade payables' ledger is handed over to the auditor. A list of trade creditors selected for confirmation should be given to the entity for preparing request letters for confirmation which should be properly addressed. The auditor should maintain strict control to ensure the correctness and proper dispatch of request letters. In the alternative, the auditor may request the client to furnish duly authorised confirmation letters and the auditor may fill in the names, addresses and the amounts relating to trade creditors selected by him and mail the letters directly. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client. • Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor, may have a bearing on other accounts not included in the original sample. The entity should be asked to investigate and reconcile the discrepancies. In addition, the auditor should also consider what further tests he can carry out in order to satisfy himself as to the correctness of the amount of trade payables taken as a whole. • Where no reply is received, the auditor should perform additional testing regarding the balances. This testing could include: □ Testing of subsequent payments in respect of the trade payables to whom confirmations were rolled out but no replies received;

	□ Agreeing the details of the respective balance to the underlying vendor invoices; □ Preparing a detailed analysis of the balance, ensuring it consists of identifiable transactions and confirming that these purchases/ expense transactions actually occurred. (examination in depth)
	• If there are any related party payables, review whether they were properly authorized and the value of such transactions were reasonable and at arm's length. • Review a trend line of purchases/ expenses and accounts payable, or a comparison of the two over time, to see if there are any unusual trends. Make inquiries about reasons for changes in trends from the management.
Trade payables and liability balances that were supposed to be recorded have been recognized in the financial statements. (COMPLETENESS)	• The auditor needs to perform the following cut off procedures: □ For the last 5 invoices received/ recorded at the end of the reporting date (cut off date) and which have been included in the trade payables; the goods should have been received/ risk and rewards of ownership in goods should have been transferred in favour of the entity; □ All goods received prior to the period/ year- end should have been booked in the form of purchases and included in trade creditors. • Test purchases/ expenses on a sample basis selecting the same from the accounts payable ledgers and checking their supporting documents to ensure that the purchases were recorded at the correct amounts and correct dates.

	Match purchase invoice dates to the gate entry (inward) dates to check whether the purchases are being recorded in the correct accounting period. This can include an examination of purchase/ expense invoices received subsequent to the period being audited, to see if they should have been included in the period under audit.
	- Review subsequent expense vouchers. Review all material expense vouchers recorded post the balance sheet date to see if they relate to transactions from within the audit period. - For advance received from customers/ revenue received in advance, obtain the customer wise listing along with its ageing and the nature. Enquire from the entity's management if there has been any dispute with the customer and if there is any additional liability to be recorded. For all such advances, the auditor should verify the underlying documentation based on which the entity had received the advance. - In relation to statutory dues liability like withholding tax (TDS) payable, GST payable, luxury tax payable, professional tax payable, PF and ESI payable etc., prepare a reasonability with respect to sales/ purchases/ employee benefit expenses. Example- GST liability for last month may be calculated by applying the applicable rate to the sales made and in case of any variance with the GST liability recorded by the entity, reasons for variance should be requested from client and in case found satisfactory, the same should be maintained as part of audit documentation. Similarly, Provident Fund liability for last month may be calculated by applying the applicable rate to the employee benefit expense and in case of any

	variance with the liability recorded by the entity, reasons for variance should be requested from client and in case found satisfactory, the same should be maintained as part of audit documentation. Further, the auditor should obtain and verify the challans for deposits made subsequent to the period-end for all statutory liabilities as at the balance sheet date and also analyse the reasons, if any, in consultation with the management for any variance between the amounts deposited subsequently vis-à-vis the liability recorded in books of account. • He shall prepare a complete list of all statutory dues and consider his reporting requirements under CARO,2020.
Trade payables and other liability balances have been VALUED appropriately.	• Review the process followed by the Company to identify if any old creditor balance/ liability needs to be written back. This will include a consistency comparison with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment. • Obtain the ageing of payable balances, and the list of vendors with whom the Company has disputes and any claims from customers, under litigation and compare with previous year. • Check that write backs in the liability balances assessed as no longer payable have been approved by an appropriate and authorised member of senior management, for example – CEO/MD.
	• Check that the restatement of foreign currency trade payables has been done properly in accordance with AS 11. Understand management's process to identify the principal amount and the interest due

	thereon (if any) remaining unpaid to any Micro, Small and Medium Sized Enterprises suppliers at the end of accounting year. Test check the management process to assess if the auditor could rely on the management process.
Required DISCLOSURES for trade payables and other liabilities have been appropriately made	Ensure whether the following disclosures as required under Schedule III (Part I) to the Companies Act, 2013 have been made: • Whether the Company has disclosed the following details relating to micro and small enterprises in the notes: □ the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year. □ the amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year. □ the amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006. □ the amount of interest accrued and remaining unpaid at the end of each accounting year. □ the amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose

of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

- **Trade payables due for payment**

The following ageing schedule shall be given for Trade payables due for payment:-

Trade Payables ageing schedule

(Amount in ₹)					
Particulars	Outstanding for following periods from due date of payment#				
	Less than 1 year	1-2 years	2-3 years	More than 3 years	Total
(i) MSME					
(ii) Others					
(iii) Disputed Dues-MSME					
(iv) Disputed Dues Others					

similar information shall be given where no due date of payment is specified in that case disclosure shall be from the date of the transaction.

Unbilled dues shall be disclosed separately.

Other Current Liabilities

- Whether the amount disclosed under other current liabilities are classified as below:
 - Current maturities of finance lease obligations
 - Interest accrued but not due on borrowings
 - *Interest accrued and due on borrowings*
 - Income received in advance
 - Unpaid Dividends
 - *Application money received for allotment of securities and due for refund and interest accrued thereon. Share application money includes advances towards allotment of share capital. The terms and conditions including the*

	<i>number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted shall be disclosed. It shall also be disclosed whether the company has sufficient authorised capital to cover the share capital amount resulting from allotment of shares out of such share application money. Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the document inviting application for shares along with the reason for such share application money being pending shall be disclosed. Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable, i.e., the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under "Other current liabilities";</i> □ Unpaid matured deposits/debentures and interest accrued thereon □ <i>Unpaid matured debentures and interest accrued thereon</i> □ Others (specify nature).

3.10 Loans and Advances and Other Current Assets

Loans and advances include loans and advances to related parties, security deposits, capital advances, amounts recoverable in cash or in kind or for value to be received, e.g., rates, taxes and insurance paid in advance/ prepaid.

Other current assets primarily include balances with statutory/ government authorities etc.



The below table summarises the audit procedures generally required to be undertaken while auditing loans and advances and other current assets:

Brief description	Audit procedures
To establish the EXISTENCE of loans and advances and other current assets as at the period-end	For establishing existence of loans and advances, direct confirmation procedures, similar to those performed for Accounts receivable balances are should be performed with the only difference that while performing circularisation of direct confirmations, in addition to the principal amount, interest receivable, if any, as per the agreed terms between the parties, may also be included as part of the balance to be confirmed.
Loans and advances and other current asset balances that were supposed to be recorded have been recognized in the financial statements. (COMPLETENESS)	- Obtain a list of all advances and other current assets and compare them with balances in the ledger. - Verify loan agreements and acknowledgements of parties in respect of outstanding loans. A loan or an advance, if material, is granted only if authorised by the Memorandum and
	Articles of Association in the case of Company. In addition, the auditor should confirm that

	the loans advanced were within the competence of persons who had advanced the same, directors in the case of a Company, partners in the case of a firm and trustees in the case of a trust. • Inspect the minutes of meeting of board of directors to confirm if all material loans and advances were approved by the board of directors. • Verify that the loan has been acknowledged by the party and in addition, inspect if any security has been deposited against due repayment of the loan. Ascertain if loans are being recovered regularly as per agreed instalments. • If there are any related party loans and advances, review whether they were properly authorized and the value of such transactions were reasonable and at arm's length. • In relation to balances with statutory authorities like GST input credit, prepare a reasonability with respect to purchases/ expenses by applying the applicable rate to the purchases/ expenses and in case of any variance with the asset recorded by the entity, reasons for variance should be requested from the entity. • Further, the auditor should obtain statutory returns filed with the authorities like GST returns and verify whether the amount recorded as per books of account tallies with the claim made with the authorities.
Loans and advances and other current asset balances have been VALUED appropriately.	• Assess the allowance for doubtful accounts. Review the process followed by the Company to derive an allowance for doubtful accounts. This will include a consistency comparison with the method used in the last year, and a determination

	of whether the method is appropriate for the underlying business environment. • Obtain the ageing report of loans and advances. Also, obtain the list of loans and advances under litigation and compare with previous year. • Scrutinize the analysis and identify those loans and advances that appear doubtful; discuss with management about the reasons as to why these loans/ advances are not included in the provision for doubtful balances. • Assess bad loans/ advances write-offs. Prepare schedule of movements on Bad loans/ advances – Provision Accounts and loans/ advances written off. • Check that write-offs or other reductions in the recoverable balances have been approved by the authorised and appropriate senior authority • Check that the restatement of foreign currency loans and advances/ other current assets has been done properly in accordance with AS 11
Required DISCLOSURE for loans and advances and other current assets have been appropriately made	Ensure whether the following disclosures as required under Schedule III (Part I) to the Companies Act, 2013 have been made: <u>Long Term loans & Advances</u> (i) <i>Long-term loans and advances shall be classified as:</i> • <i>Capital Advances;</i> • <i>Loans and advances to related parties (giving details thereof);</i> • <i>Other loans and advances (specify nature).</i> (ii) <i>The above shall also be separately sub-classified as:</i>

- (a) Secured, considered good;
- (b) Unsecured, considered good;
- (c) Doubtful.
- (iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.
- (iv) Loans and advances due by
 - Directors or other officers of the company or any of them either severally or jointly with any other persons or
 - amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Short-term loans and advances

- (i) Short-term loans and advances shall be classified as:
 - (a) Loans and advances to related parties (giving details thereof);
 - (b) Others (specify nature).
- (ii) The above shall also be sub-classified as:
 - (a) Secured, considered good;
 - (b) Unsecured, considered good;
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.
- (iv) Loans and advances due by
 - directors or other officers of the company or any of them either severally or jointly with any other person or
 - amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

Notes:**To be disclosed as Additional Regulatory Information**

- (i) Following disclosures shall be made where Loans or Advances in the nature of loans are granted to promoters, Directors, KMPs and the related parties (as defined under the Companies Act, 2013,) either severally or jointly with any other person, that are:
- (a) repayable on demand or
 - (b) without specifying any terms or period of repayment

Type of Borrower	Amount of loan or advance in the nature of loan outstanding	Percentage to the total Loans and Advances in the nature of loans
Promoters		
Directors		
KMPs		
Related Parties		

3.11 Provisions and Contingent Liabilities

A provision is a liability which can be measured only by using a substantial degree of estimation.

A provision is recognised when:

- (i) an entity has a present obligation (legal or constructive) as a result of a past event;
- (ii) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- (iii) a reliable estimate can be made of the amount of the obligation.

If the above conditions are not met, no provision is recognised.

Example

Provision may include provision for litigation, provision for warranties etc.

A contingent liability is:

- (i) a possible obligation that arises from past events and whose existence will be

confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

- (ii) a present obligation that arises from past events but is not recognized because:
- it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - the amount of the obligation cannot be measured with sufficient reliability.

The below table summarises the audit procedures generally required to be undertaken while auditing provisions and contingent liabilities:

Brief description	Audit procedures
To establish the EXISTENCE of provisions as at the period-end Provisions that were supposed to be recorded have been recognized in the financial statements. (COMPLETENESS) Provision balances have been valued appropriately. (VALUATION AND ALLOCATION)	• Obtain a list of all provisions and compare them with balances in the ledger. • Inspect the underlying agreements like agreement with customers to assess warranty commitments, any legal and other claims on the entity i.e. litigations. • Obtain the underlying working and the basis for each of the provisions made, from the management and verify whether the same is complete and accurate. • Wherever required, obtain expert's report, calculation and underlying working for the provision amount, example for warranty involving complex calculations, some entities get that valued through an actuary. In such a case, the auditor may request the management to share the actuarial valuation report and in case of any matter under legal dispute, the auditor should request for assessment made by a legal expert in relation to likelihood of a liability devolving on the entity i.e.

	whether probable or possible or remote as defined above. The auditor should then verify the underlying assumptions used by the expert with the data shared by the management.
	• As per SA 500 – “Audit Evidence”, issued by ICAI, when using the work of a management’s expert, audit evidence that the auditor should obtain include: □ Evaluate the competence, capabilities and objectivity of that expert: ▪ Whether the expert is employed by the entity or is an outside party. ▪ Whether the expert is independent in respect of the entity. ▪ Auditor’s previous experience of the work of the expert. ▪ Knowledge of the expert, his qualification, membership of a professional body or industry association, etc. □ Obtain an understanding of the work of that expert: ▪ Whether the auditor has expertise to evaluate the work of the expert. ▪ Evaluating the assumptions and methods used by the management. ▪ Evaluating the nature of internal or external data used by the expert.

	□ Evaluate the appropriateness of his work as audit evidence for the relevant assertion: ▪ Relevance and reasonableness of the expert's findings or conclusions ▪ Evaluating the relevance, completeness and accuracy of the source data used by the expert. □ The auditor shall obtain written representation from the management that it has made all the provisions which were required to be made as per the recognized accounting principles.
Required DISCLOSURE for provisions have been appropriately made	Ensure whether the following disclosures as required under Schedule III (Part I) to the Companies Act, 2013 have been made: <u>Long-term provisions</u> <i>The amounts shall be classified as:</i> (a) Provision for employee benefits; (b) Others (specify nature). <u>Short-term provisions</u> <i>The amounts shall be classified as:</i> (a) Provision for employee benefits. (b) Others (specify nature). <u>Contingent liabilities and commitments (to the extent not provided for)</u> (i) Contingent liabilities shall be classified as: (a) Claims against the company not acknowledged as debt; (b) Guarantees; (c) Other money for which the company is contingently liable.

	(ii) <i>Commitments shall be classified as:</i> (a) <i>Estimated amount of contracts remaining to be executed on capital account and not provided for;</i> (b) <i>Uncalled liability on shares and other investments partly paid;</i> (c) <i>Other commitments (specify nature).</i> <i>In terms of AS 29, "Provisions, Contingent Liabilities and Contingent Assets", ensure whether following disclosures have been made:</i> • For each class of provision, an enterprise shall disclose: □ the carrying amount at the beginning and end of the period; □ additional provisions made in the period, including increases to existing provisions; □ amounts used (i.e. incurred and charged against the provision) during the period; □ unused amounts reversed during the period. • An enterprise shall disclose the following for each class of provision: □ a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits; □ an indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning future events; and

	□ the amount of any expected reimbursement, stating the amount of any asset that has been recognized for that expected reimbursement. • Unless the possibility of any outflow in settlement is remote, <i>an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:</i> □ an estimate of its financial effect □ an indication of the uncertainties relating to <i>any outflow</i>; and □ the possibility of any reimbursement. Where any of the information required by above paragraph is not disclosed because it is not practicable to do so, that fact should be stated.

Other information as per requirement of Part I, Schedule III, to be disclosed as Additional Regulatory Information

1. Details of Benami Property held

Where any proceedings have been initiated or pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and the rules made thereunder, the company shall disclose the following:-

- (a) Details of such property, including year of acquisition,
- (b) Amount thereof,
- (c) Details of Beneficiaries,
- (d) If property is in the books, then reference to the item in the Balance Sheet,
- (e) If property is not in the books, then the fact shall be stated with reasons,

- (f) Where there are proceedings against the company under this law as an abettor of the transaction or as the transferor then the details shall be provided,
- (g) Nature of proceedings, status of same and company's view on same.

2. Relationship with Struck off Companies

Where the company has any transactions with companies struck off under section 248 of the Companies Act, 2013 or section 560 of the Companies Act, 1956, the Company shall disclose the following details:-

Name of struck off Company	Nature of transactions with struck off Company	Balance outstanding	Relationship with the Struck off company, if any, to be disclosed
	Investments in securities		
	Receivables		
	Payables		
	Shares held by struck off company		
	Other outstanding balances (to be specified)		

3. Following Ratios to be disclosed:-

- (a) Current Ratio,
- (b) Debt-Equity Ratio,
- (c) Debt Service Coverage Ratio,
- (d) Return on Equity Ratio,
- (e) Inventory turnover ratio,
- (f) Trade Receivables turnover ratio,
- (g) Trade payables turnover ratio,
- (h) Net capital turnover ratio,
- (i) Net profit ratio,

- (j) Return on Capital employed,
- (k) Return on investment.

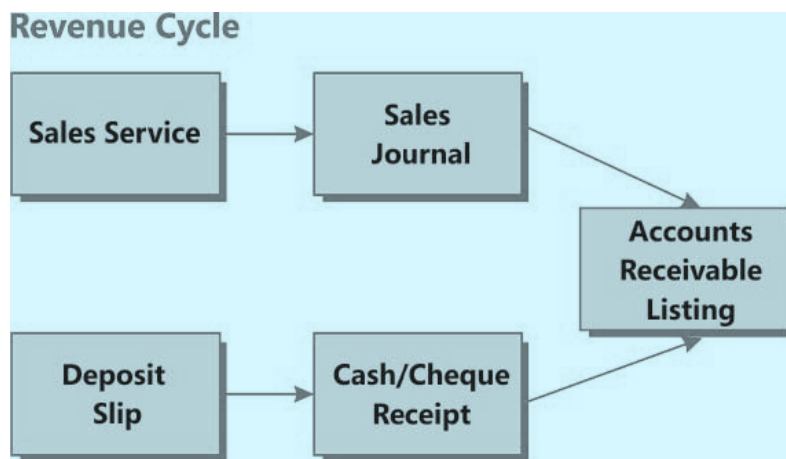
The company shall explain the items included in numerator and denominator for computing the above ratios. Further explanation shall be provided for any change in the ratio by more than 25% as compared to the preceding year.

4. STATEMENT OF PROFIT AND LOSS-CAPTIONS

4.1 Sale of Products and Services

The sales and collections cycle in a business refers to the set of processes that begin when a customer purchases goods or services and ends when the entity receives complete payment against the sales. Sales is one of the most important item in the financial statements which will have a considerable effect on the profit generated, closing stock etc. As per SA 315, the risk of material misstatement in case of revenue items is generally high.

As part of the year-end audit of an entity's financial statements, auditors test sales transactions and the internal controls over those transactions to ensure that the entity is not materially misstating its revenues or accounts receivable.



Auditor needs to obtain a clear understanding about the organisation and its revenue centres.

Example

Type of services or products the entity provides, demand for the services or products, major selling product/service, introduction of new products/service line, discontinuance of products/services, major customers, sales term (Credit or cash sales).

1. An auditor needs to obtain an understanding of the management control (internal control) in respect of sales process.

Example

Whether segregation of duties exist, who checks the credit limit (if applicable), who authorizes sales orders, who raises sales invoice, when and how the goods are delivered/despatched or services are provided, who collects and records the amounts received from debtors, who ensures that the risks and rewards are transferred to the customer, how the sales have been recognised in the system.

2. An auditor tests the controls the entity has set up for the sales cycle to determine how strong and reliable they are. If they are strong and operating effectively, the auditor can reduce the extent of substantive testing. Any deficiencies in the internal control shall be communicated as per SA 265.

Example

Common internal controls over the sales cycle include pre -numbered sales invoices, proper authority for approval of orders, execution of sales order, customer purchase order authorization over a certain limit and authorization over receivables write-offs.

3. The auditor selects a random sample of transactions and examines the related customer purchase orders, invoices and customer statements to ensure that the control being tested is a numbered sales invoice. This will enable the auditor to determine the nature, timing and extent of his substantive procedures to be applied.

Example

The auditor ensures that all numbers in a section are accounted for and that none are missing.

4. Performing substantive audit procedures is a must. Substantive analytical procedures will consist of sales trend analysis, comparison with previous accounting period, category-wise sales analysis, any analysis the auditor may find relevant and most important of all, building a sales expectation and comparing that with the client's sales records. The auditor will need to know the sales prices of the products or services over the year, monthly average sales price per product or service, discount policy.

Example

For a manufacturing company, if the average sales price of product X is ₹ 10 and 1,500 units were sold in that month, the auditors expected sales will be ₹ 15,000. The auditor should compare this figure with the client's data and see what they have recorded against Product X. The auditor should consider discussing any variances (see if there were discounts or sales were wrongly booked in the system) between his expectations and client's records. The auditor will have to also identify and understand how the entity accounts for their sales discounts and sales return in the system and how those affect the gross sales.

The below table summarises the audit procedures generally required to be undertaken while auditing sales:

Brief description	Audit procedures
Recorded sales represent goods shipped/ services performed during the period (OCCURRENCE)	• Ensure revenue is not overstated by performing following audit procedures: □ Check whether a single sales invoice is recorded twice or a cancelled sales invoice could also be recorded. □ Test check few invoices with their relevant entries in sales journal. □ Obtain confirmation from few customers to ensure genuineness of sales transaction □ Whether any fictitious customers and sales have been recorded. □ Whether any shipments were done without the consent and agreement of the customer, especially at the year end to inflate the sales figure

	□ Whether unearned revenue recorded as earned. □ Whether any substantial uncertainty exists about collectability. □ Whether customer obligations are contingent on other actions (financing, resale, etc.).
	• Review sequence of sales invoices • Review journal entries for unusual transactions • Calculate the ratio of sales return to sales and compare it with previous year and enquire for the reasons for increase/ decrease. • Check the sales return with sales invoice, challan, credit note, stock register, etc.
All sales made during the period were recorded and there is no understatement or overstatement. (COMPLETENESS)	• Perform cut-off procedures to ensure that revenues are recognised in the current accounting period and sales were not tampered towards the period end. • Cut-off errors will usually arise when companies recognise revenue based on the date on which the sales invoices are generated rather than the date on which the risks and rewards are transferred to the buyer. In order to perform a robust sales cut-off test, auditors need to understand and consider the specific cut-off error risk of each engagement. • Auditors should also verify the credit notes issued after the accounting period. Sometimes sales team or sales personnel can make fictitious sales before the year-end to meet performance target and cancel out those sales with a post year end credit note. • Trace from the shipping documents to the sales journal. • Check whether quantity is appearing in sales register or not and check reconciliation of total sales/goods dispatched as per stock

	records and financial records and statutory records like GST. Review GST tax and GST returns and ensure that the same are reconciled with revenue reported in the profit and loss account. Verify reasonability say of GST by applying the applicable rate to the gross sales value and compare the amount of GST as per statutory returns and analyze the reasons for variance, if any.
All sales are accurately measured as per applicable accounting standards and correctly journalized, summarized, and posted (ACCURACY OR MEASUREMENT)	- Trace a few transactions from inception to completion. (Examination in depth) E.g: Take few sales transaction, and check from the receipt of sales order to the payment of receivable balance, every underlying document to ensure if it is properly recorded at every stage and measured accurately taking into consideration all the incentives, discounts, if any. The recognition shall be according to the revenue recognition policy of the entity. - if the client is engaged in export sales, then compliance with AS 11 shall be ensured. - Auditor must understand client's operations and related GAAP issues e.g. point of sale revenue recognition vs. percentage of completion, wherever applicable. - Compare the rate of sales affected with related parties and review them for collectability, as well as whether they were properly authorized and the value of such transactions were reasonable and at arm's length.
Required DISCLOSURE for sales have been appropriately made	Ensure whether the following disclosures as required under Schedule III (Part II) to the Companies Act, 2013 have been made: (A) In respect of a company other than a finance company revenue from operations shall disclose separately in the notes revenue from—

	(a) Sale of products; (b) Sale of services; (ba) Grants or donations received (relevant in case of section 8 companies only),] (c) Other operating revenues; Less: (d) Excise duty. (B) In respect of a finance company, revenue from operations shall include revenue from— (a) Interest; and (b) Other financial services. Revenue under each of the above heads shall be disclosed separately by way of notes to accounts to the extent applicable. • Whether brokerage and discount on sales other than usual trade discount has been disclosed. • Whether the transactions with related parties are appropriately disclosed in notes to accounts.

4.2 Other Income comprising interest income, dividend income, Gain/ Loss on sale of investments etc.

Any form of income earned by an entity which is not linked to the entity's core business operations is generally classified as other income. Examples – interest on excess funds parked in fixed deposits with banks (the entity not being a bank or financial institution), interest on loans given to third parties/ within the group, return on mutual fund investment etc.

- **Interest income** on fixed deposits is recognized on a time proportion basis taking into account the amount outstanding and the applicable interest rate.
- **Dividends** are recognised in the statement of profit and loss only when:
 - (i) the entity's right to receive payment of the dividend is established;
 - (ii) it is probable that the economic benefits associated with the dividend will flow to the entity; and

(iii) the amount of the dividend can be measured reliably.

- **Gain/(loss) on sale of investment** in mutual funds is recorded as other income on transfer of title from the entity and is determined as the difference between the redemption price and carrying value of the investments.

Brief description	Audit procedures
Recorded other income was earned during the Period (OCCURRENCE) Other income earned during the period was appropriately recorded and there in no understatement or overstatement. (COMPLETENESS) Other income has been measured appropriately as per the applicable accounting standards (ACCURACY OR MEASUREMENT)	• For verifying interest income on fixed deposits: □ Obtain a listing of fixed deposits opened during the period under audit along with the applicable interest rate and the number of days for which the deposit was outstanding during the period. □ Verify the arithmetical accuracy of the interest calculation made by the entity by recomputing i.e. multiplying the deposit amount with the applicable rate and number of days during the period under audit. □ For deposits still outstanding as at the period- end, trace the same to the direct confirmations obtained from the respective bank/ financial institution. □ Obtain a confirmation of interest income from the bank and verify that the interest income as per bank reconciles to the calculation shared by the entity. □ Also, obtain a copy of Form 26AS (TDS withholding by the bank/ financial institution) and reconcile the interest reflected

	therein to the calculation shared by client.
	• For Dividends, verify that the same are recognised in the statement of profit and loss only when the entity's right to receive payment of the dividend is established. • Verify that Gain/(loss) on sale of investment in mutual funds is recorded as other income only on □ transfer of title from the entity AND □ is determined as the difference between the redemption price and carrying value of the investments. For the purpose, obtain the mutual fund statement and trace the gain / loss as recorded in the books of account to the gain/ loss as reflected in the statement.
Required DISCLOSURE for other income have been appropriately made	Ensure whether the following disclosures as required under Schedule III (Part II) to the Companies Act, 2013 have been made: Other income Other income shall be classified as: (a) Interest Income (in case of a company other than a finance company); (b) Dividend Income; (c) Net gain/loss on sale of investments; (d) Other non-operating income (net of expenses directly attributable to such income).

Note:**To be disclosed as Additional Information****Undisclosed income**

The Company shall give details of any transaction not recorded in the books of accounts that has been surrendered or disclosed as income during the year in the tax assessments under the Income Tax Act, 1961 (such as, search or survey or any other relevant provisions of the Income Tax Act, 1961), unless there is immunity for disclosure under any scheme and also shall state whether the previously unrecorded income and related assets have been properly recorded in the books of account during the year.

4.3 Purchases

Purchases is another significant process of an entity. Similar to sales as discussed above, purchases and disbursement cycle in a business refers to the set of processes that begin when an order for buying goods or services is placed based on requirements of the production/ user department and ends when the entity receives the product and makes complete payment to the vendor. As part of the year-end audit of an entity's financial statements, auditors test purchase transactions and the internal controls over those transactions to ensure that the entity is not materially misstating its purchases or accounts payables.

Auditor needs to obtain a clear understanding about the organisation and its production centres e.g. type of services or products they procure that are used in the production/ rendering of services, sources of procurement whether domestic or overseas, general availability and terms and conditions of purchase of the service or products, major vendors, credit period, quality checks, purchase terms (Credit or cash purchase) etc.

1. An auditor needs to identify the control points over purchases e.g. whether segregation of duties exist, whether competitive quotes are invited, whether a purchase committee exists who authorises purchase price, issues and authorizes purchase orders, when and how the goods are received and acknowledged, who checks the quality, quantity and specifications of the goods received and prepares Goods Receipt Note (GRN), who approves the vendor invoice, whether a 2 way/ 3 way match process exists (i.e. tally between purchase order, GRN and vendor invoice), how the purchases have been recognised in the system.

2. An auditor tests the controls the entity has set up for the purchase cycle to determine whether they are effective or not. If the controls are effective, the auditor can reduce the extent of substantive testing. Common internal controls over the purchase cycle include inviting competitive quotations for shortlisting the vendors, numbered purchase orders, purchase order authorization over a certain limit, generation of GRN on receipt of goods, quality inspection of goods, 2 way/ 3-way match, authorization of purchase invoices, appropriate authority to recognise the purchases in the system.
3. The auditor selects a random sample of transactions and examines the related purchase orders, GRN, purchase invoices, inward gate entry register and vendor reconciliation/ statements.
4. Performing substantive audit procedures is must. Substantive analytical procedure will consist of purchase trend analysis, comparison with previous accounting period, category wise purchases, any analysis auditor may find relevant and most important of all setting a purchase expectation in relation to the sales made during the period under audit and compare that with the client's purchase records. The auditor would need to know the purchase prices of the products or services over the year, monthly average purchase price per product or service etc. E.g: If the purchase price is 100 and if 15000 units were received under multiple orders during the year, the auditor expects the purchases to be 15,00,000. If there is a variance in the amount recorded in the books, he shall check for additional details like discounts received, change of purchase price for few orders due to excess demand etc.

The below table summarises the audit procedures generally required to be undertaken while auditing purchases:

Brief description	Audit procedures
Recorded purchases represent goods actually received/ services availed during the period (OCCURRENCE)	Ensure purchases are not understated/ overstated by performing following audit procedures: - Whether any fictitious vendors have been booked or purchases have been recorded by reviewing the vendor selection process followed by the entity and also performing procedures to ensure existence of the vendors. - Whether the goods were received at the factory gate and whether there exists an entry in the security gate inward register

	• Whether quality inspection of goods was done. • Whether a goods receipt note was prepared and signed by an appropriate client personnel. • Whether the purchase invoice was approved as per delegation of authority and whether a 3 or 2-way match (as discussed above) was done. • Whether stock record has been updated by the stores personnel. Special considerations during audit of purchases • The purchase invoice received should be the "Original" copy (and not photocopy/ carbon copy) against which the entity has recorded the purchase in its books of account. • Purchase invoice should have been booked only once risk and reward incidental to ownership has been transferred to the entity. Specific consideration for cases where the terms of delivery as agreed with vendor are F.O.B., C.I.F. etc. • Purchase invoice should be in the name of entity. However, in case of different branches, it should be addressed to the appropriate branch. • Input tax component should have been booked in the input tax ledger. The auditor should obtain tax returns filed with the authorities and tally the input tax as reflected in the books to the amount disclosed in the returns. • In case of purchases made from related parties or allied and associated concerns, the auditor needs to verify if requisite approval from Board of Directors

	(appropriate authority) has been obtained and should verify the selected samples and perform analytical procedures in relation to price of goods to confirm that the price charged is at arm's length.
	- The auditor should review whether purchases should be capitalized or expensed off in Statement of Profit and loss according to his professional judgement. - Review journal entries for unusual transactions.
All purchases made during the period were recorded and there in no understatement or overstatement. (COMPLETENESS) All purchases have been measured appropriately (ACCURACY OR MEASUREMENT)	In addition to the procedures for establishing occurrence of purchases as discussed above, the auditor should: - Perform cut-off test to ensure that purchases are recognised in the correct accounting period. For the purpose, the auditor should examine material inward records, say, last 5 transactions at the period end to check that all corresponding invoices have been duly entered in the Purchases book and none have been omitted. - Ensure correct accounting treatment of goods – in – transit as per the agreed terms with the vendor regarding transfer of risk and reward of ownership in goods. - Obtain written representation from the management that all the purchases that took place during the year have been properly recorded in the books. - Perform analytical procedures to obtain audit evidence as to overall reasonableness of purchase quantity and price which may include: Consumption Analysis: Auditor should scrutinize raw material

	consumed as per manufacturing account and compare the same with previous years with closing stock and ask for the reasons from the management, if any significant variations are found. □ Stock Composition Analysis: Auditor to collect the reports from management for composition of stock i.e. raw materials as a percentage of total stock and compare the same with previous year and ask for reasons from management in case of significant variations.
	□ Ratios: Auditor should compare the creditors turnover ratios and stock turnover ratios of the current year with previous years. □ Auditor should review quantitative reconciliation of closing stocks with opening stock, purchases and consumption.
Required DISCLOSURES for purchases have been appropriately made	Ensure whether the following disclosures as required under Schedule III (Part II) to the Companies Act, 2013 have been made: • Whether purchases of stock-in-trade have been specifically disclosed. • Whether changes in inventories of finished goods, stock-in-trade and work-in-progress have been specifically disclosed. • Whether the transactions with related parties are appropriately disclosed in notes to accounts.

4.4 Employee Benefits Expenses

Employee benefits expenses or commonly called as payroll expenses represent the aggregate sum an entity pays as a consideration to its employees for their labour/ efforts along with associated expenses such as perquisites/ benefits, post-employment benefits like gratuity, superannuation, leave encashment, provident fund contribution etc. as well as towards their hiring, their welfare and training. In many industries, employee benefits expense is the biggest expense category and hence it is critical for businesses to manage this expenditure shrewdly and for the auditors to verify and ensure that such expenditure is appropriate and has been accounted as per applicable accounting standards and generally accepted accounting principles.

Auditor needs to obtain a clear understanding about the organisation and its hiring, appraisal and retirement process in the following manner:

1. An auditor tests the controls the entity has set around employee benefit payment process to determine how effective they are. If they are effective, the auditor can reduce the substantive testing. Common internal controls over the employee benefit payment cycle includes maintaining of attendance records, employee master, authorisation and approval of monthly payroll processing and disbursement, computation of employee deductions like payroll taxes, accrual of other benefits like gratuity, leave encashment, bonus etc.
2. The auditor selects a random sample of transactions and examines the related appointment letters, appraisal letters, attendance records, HR policies, employee master etc.
3. Performing substantive audit procedures is must. Substantive analytical procedure will consist of monthly expense reasonability, comparison with previous accounting period, any analysis auditor may find relevant and most important of all setting an expectation in relation to the expense incurred during the period under audit and compare that with the client's business operations and overall trend in the industry.

The below table summarises the audit procedures generally required to be undertaken while auditing employee benefits expenses:

Brief description	Audit procedures
Recorded employee benefit expenses were actually incurred during the period	Obtain an understanding of entity's process of capturing employee attendance. There is always a risk that an

(OCCURRENCE) Employee benefit expenses pertaining to the period have been recorded appropriately (COMPLETENESS) Employee benefit expenses have been measured appropriately. There is no understatement or overstatement. (ACCURACY OR MEASUREMENT)	entity could record expense for fictitious employees. To address this risk, the auditor may choose to meet the employees in person, on a sample basis. Further, the auditor may choose to select a sample of employees and ask the payroll department to share their bank details/ identity proofs of the employees. • Obtain a list of employees as at the period-end along with a monthly movement split between new hires, leavers and continuing employees. • For a sample (selected randomly) of new hires, obtain the appointment letter and verify whether the salary for first month and subsequent months was processed as per the agreed terms. • For a sample (selected randomly) of resigned employees, obtain their full and final computation and verify whether all their dues including post-retirement benefits like gratuity, leave encashment have been paid and whether the respective employee's acknowledgement on final computation has been obtained. • Obtain the monthly salary registers for all 12 months. Compile a monthly payroll reasonability by calculating the average salary per employee per month and compare with the previous year and preceding month and analyse the reasons for variance which could be attributable to annual increments, an employee at senior level joining/ leaving the entity, bonus pay-out etc.
	• Verify if accrual/ provision has been made for all employee benefits and obligations like bonus, gratuity, leave encashment, etc.

	• In case provident fund (PF), employee state insurance (ESI) are applicable to the entity, compile a reasonability by applying the rate to the basic wages and comparing to the amount recorded in books and analyse reasons for variance, if any. Also, obtain monthly deposit challans to verify if the month on month liability was subsequently deposited with the authorities and within the defined timelines. • Perform analytical procedures to obtain audit evidence as to overall reasonableness of employee benefit expenses which may include production per employee analysis. Auditor should analyse units produced per employee and compare the same with previous years and present industry trends and ask for the reasons from the management, if any significant variations are found.
Required DISCLOSURES for employee benefit expenses have been appropriately made	Ensure whether the following disclosures as required under Schedule III (Part II) to the Companies Act, 2013 have been made: (a) Employee Benefits Expense [showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (iv) staff welfare expenses].

4.5 Depreciation and Amortisation

One of the key principles of accrual basis of accounting requires that an asset's cost is proportionally expensed based on the period over which the asset is expected to be used. Both depreciation and amortization are methods that are used to prorate

the cost of a specific type of asset over its useful life. Depreciation represents systematic allocation of the depreciable value of an item of PPE over its useful life while amortisation represents systematic allocation of the depreciable amount of an intangible asset over its useful life.

Depreciation and amortisation generally constitute an entity's significant part of overall expenses and have direct impact on the profit/ loss of the entity, hence auditors need to verify and ensure that such expenditure is appropriate, accurately calculated and has been accounted as per applicable provisions of the Companies Act, 2013 or other statutes, to the extent applicable on the respective industry and as per generally accepted accounting principles.

Auditor needs to consider the following attributes while verifying for depreciation and amortisation expenses:

- Obtain the understanding of entity's accounting policy related to depreciation and amortisation.
- Ensure the Company policy for charging depreciation and amortisation is as per the relevant provisions of the Companies Act, 2013/ applicable accounting standards.
- The accounting policy has been applied consistently year on year. Any change in the accounting policy has been adequately disclosed.
- Whether the depreciation has been calculated after making adjustment of residual value from the cost of the assets.
- Whether depreciation and amortisation charges are valid.
- Whether depreciation and amortisation charges are accurately calculated and recorded.
- Whether all depreciation and amortisation charges are recorded in the appropriate period.
- Whether each part of an item of PPE with a cost that is significant in relation to the total cost of the item have been depreciated separately.

Example: It may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease.

- Whether the most appropriate depreciation method for each separately depreciable component has been used.

The below table summarises the audit procedures generally required to be undertaken while auditing depreciation and amortization expense:

Brief description	Audit procedures
Depreciation and amortization expenses pertaining to the period have been recorded appropriately and there is no understatement/overstatement. Depreciation and amortisation expenses have been measured appropriately. Recorded depreciation and amortisation expenses were actually incurred during the period.	• Obtain an understanding of entity's process of charging depreciation and amortization. • Obtain the fixed asset register maintained by the entity. There is always a risk that an entity could capitalize expense of revenue nature to increase its profit or charge capital expenditure directly in income and expense statement to reduce its profit. To address this risk, the auditor may choose to check the nature of asset from fixed asset register and further, there is always a risk that fake asset has been capitalized in the books and to mitigate this risk, auditors should physically verify the fixed assets, at least the ones that are material in value. Obtain a list of all additions/deletions along with their proper approval from the authorised person for the same. • Select the sample of assets from the Fixed Assets Register, on materiality considerations and verify the rates of depreciation and depreciation calculations. ▪ Obtain the list of all the components identified by the management. ▪ Ensure Intangible assets like patents, goodwill, copy rights have been properly amortized over the period. ▪ Ensure depreciation is charged on the assets from the date when it is ready

	to use and not from the date of actual usage. In other words, depreciation of an asset begins when it is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by the management. ▪ Ensure depreciation on revalued amount has been properly accounted from revaluation reserve. ▪ Depreciation computation as per Income tax Act, 1961- Ensure that additions are tallying with the additions as per the Companies Act, 2013 and the opening WDV to the Tax audit schedule for the assessment year preceding the previous year under audit.
	▪ Perform analytical procedures to obtain audit evidence as to overall reasonableness of depreciation and amortisation expense - check the arithmetical accuracy of records and perform independent calculations. For example- Re-compute the depreciation expense for the year. ▪ Ensure that the depreciation and amortization has been charged as per the useful lives of PPE and intangible assets. ▪ Ensure that residual values have been properly verified as that impacts the computation of depreciation. ▪ Ensure that the depreciation and amortization has been computed prospectively whenever there is any change in useful lives of PPE and intangible assets.

Required disclosures for depreciation and amortisation have been appropriately made	Ensure whether the following disclosures as required have been made: ▪ Accounting policy for depreciation and amortization. ▪ Useful lives of assets as per Schedule II to the Companies Act, 2013. ▪ Residual value of assets. ▪ Depreciation method.

4.6 Other Expenses like Power and Fuel, Rent, Repair to Building, Plant and Machinery, Insurance, Travelling, Legal and Professional, Miscellaneous Expenses

An entity in addition to making purchases and incurring employee benefit expenses, also incurs other expenditures like rent, power and fuel, repairs and maintenance, insurance, travelling, miscellaneous expenses etc., that are essential and incidental to running of business operations.

While the auditor may choose to analyse the monthly trends for expenses like rent, power and fuel, an auditor generally prefers to vouch for other expenses to verify following attributes:

- ◆ Whether the expenditure pertained to current period under audit;
- ◆ Whether the expenditure qualified as a revenue and not capital expenditure;
- ◆ Whether the expenditure had a valid supporting documents like travel tickets, insurance policy, third party invoice etc.;
- ◆ Whether the expenditure has been classified under the correct expense head;
- ◆ Whether the expenditure was authorised as per the delegation of authority matrix;
- ◆ Whether the expenditure was in relation to the entity's business and not a personal expenditure.

The below table summarises the audit procedures generally required to be undertaken while auditing other expenses:

Brief description	Audit procedures
Recorded other expenses were actually incurred during the period Other expenses pertaining to the period have been recorded appropriately and there is no understatement or overstatement Other expenses have been measured appropriately	Rent expense- - Obtain a month wise expense schedule along with the rent agreements. - Verify if expense has been recorded for all 12 months and whether the rent amount is as per the underlying agreement. - Specific consideration should be given to escalation clause in the agreement to verify if the rent was required to be recorded on a straight-line basis during the period under audit. - Also, verify if the agreement is in the name of the entity and whether the expense pertains to premises used for running business operations of the entity. Power and fuel expense - - Obtain a month wise expense schedule along with the power bills. - Verify if expense has been recorded for all 12 months. - Also, compile a month wise summary of power units consumed and the applicable rate and check the arithmetical accuracy of the bill raised on monthly basis. - In relation to the units consumed, analyse the monthly power units consumed by linking it to units of finished goods produced and investigate reasons for variance in monthly trends.
	Insurance expense - - Obtain a summary of insurance policies taken along with their validity period. - Verify whether the expense has been correctly classified between prepaid and expense for the period based on number of days.

	Legal and professional expenses - • Obtain a month-wise and consultant-wise summary. • In case of monthly retainership agreements, verify whether the expenditure for all 12 months has been recorded correctly. • For non- recurring expenses, select a sample and vouch for the attributes discussed above. • The auditor should be cautious while vouching for legal expenses as the same may highlight a dispute for which the entity may not have made any provision and the matter may also not have been discussed/ highlighted to the auditor for his specific consideration. Travel, repair and maintenance, printing and stationery, miscellaneous expenses – • The auditor should select a sample and vouch for the attributes discussed above. Wherever possible, the auditor should try to prepare a summary of expenditure on monthly basis and then analytically compare the trends. • Perform analytical procedures to obtain audit evidence as to overall reasonableness of other expense which may include expenditure per unit of production analysis. • Auditor should analyse expense per unit produced and compare the same with previous years and present industry trends and ask for the reasons from the management, if any significant variations are found.

Required DISCLOSURE for other expenses have been appropriately made	• Ensure other expense have been classified under: • Rent. • Insurance. • Power and fuel. • Repairs and maintenance- Building, Plant and machinery, others. • Legal and professional. • Printing and stationary. • Travel expenses. • Miscellaneous expenses.

Notes:

To be disclosed as Additional Information

1. Corporate Social Responsibility (CSR)

Where the company covered under section 135 of the Companies Act, 2013 the following shall be disclosed with regard to CSR activities:-

- amount required to be spent by the company during the year,
- amount of expenditure incurred,
- shortfall at the end of the year,
- total of previous years shortfall,
- reason for shortfall,
- nature of CSR activities,
- details of related party transactions, e.g., contribution to a trust controlled by the company in relation to CSR expenditure as per relevant Accounting Standard,
- where a provision is made with respect to a liability incurred by entering into a contractual obligation, the movements in the provision during the year should be shown separately.

2. Details of Crypto Currency or Virtual Currency

Where the Company has traded or invested in Crypto currency or Virtual Currency during the financial year, the following shall be disclosed:-

- (a) profit or loss on transactions involving Crypto currency or Virtual Currency
- (b) amount of currency held as at the reporting date,
- (c) deposits or advances from any person for the purpose of trading or investing in Crypto Currency/ virtual currency.

Test Your Understanding 3

Various ratios of current year and preceding year are disclosed in financial statements of a company in accordance with requirements of Schedule III of the Companies Act, 2013. Discuss requirements of law in this regard (Do not list out names of ratios)

Test Your Understanding 4

An auditor of a company is focusing upon revenues of a company. In this regard, besides performing usual detailed checking of sales, he wants to perform substantive analytical procedures in respect of sales. Discuss how he can perform such procedures.

Test Your Understanding 5

While verifying depreciation charged to statement of profit and loss account of a company, it is noticed by auditor that one new machinery was purchased and installed in month of April. The necessary trials were carried out and machinery was ready for use in April itself. However, owing to lack of orders in the market, the said machinery was put into actual operation from 1st October. The company has, accordingly, provided depreciation in its books on this machinery w.e.f. 1st October. Is above recording of deprecation by company proper in its books?

CASE STUDY

Sunsteel Ltd. is a company engaged in the manufacture of variety of stainless steel household items ranging from hot pot, pressure cooker, cutlery set, bottles, to serving trays. The company has its corporate office in Delhi and its plant in Raigarh, a city in the state of Chhattisgarh. The company is planning to expand its manufacturing activities by setting up two new plants in the Raipur district of the state. For this purpose, the company also raised funds by making a follow-on public offer during the financial year 2025-26. R K Maheshwari & Associates are the statutory auditors of the company since the year 2023-24. The engagement team consisted of 5 members, with CA Raman as the engagement partner, CA Madhu as the senior associate and three articled trainees namely, Aman, Chetanya and Depesh.

The company raised fresh capital of ₹ 5 Cr during the FY 2025-26. The shares with the nominal value of ₹ 10 per share were issued at a premium of ₹ 5 per share.

The company has the Reserves and Surplus totaling to ₹ 2 Cr, comprising of securities premium and general reserve.

CA Raman directed CA Madhu to verify the issue of the share capital in detail giving special consideration to the utilization of the securities premium amount.

The audit engagement team discussed with the management about the performance of the company during the year under consideration. To this, the management told the engagement team that the company is performing very well and the company has doubled its revenue during the year as compared to the last year. The management of the company also told the auditors that during the year the company has made majority of its sales on credit basis to its customers. CA Raman directed Mr. Aman to send balance confirmation requests to debtors having balance in excess of ₹ 1 lakh.

During the course of audit, CA Raman, Chetanya and Depesh also visited the power plants in Raigarh to get a detailed understanding of the manufacturing process. The team performed analytical procedures to obtain audit evidence with respect to the overall reasonableness of purchase quantity and price of inventory. More specifically, Chetanya collected the reports from the management for composition of stock i.e. raw materials as a percentage of total stock and compared the same

with the data of the previous year. CA Raman and Chetanya thereafter, discussed the reasons for the variations with the management.

Also, while considering the presentation and disclosure requirements as per Schedule III to the Companies Act, 2013 CA Madhu discussed with CA Raman the disclosure with respect to the following account balances:

- Current maturities to long term borrowings
- Long term maturities of finance lease obligations
- Interest accrued but not due on borrowings
- Interest accrued and due on borrowings

Based on the above facts, answer the following questions:

1. Which of the following is not correct with respect to shares issued at premium and securities premium account in terms of Section 52 of the Companies Act, 2013?
 - (a) Where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to a securities premium account.
 - (b) The securities premium account can be applied by the company in paying up unissued equity shares of the company to be issued to members of the company as fully paid bonus shares.
 - (c) The securities premium account cannot be applied by the company in writing off the expenses of or the commission paid or discount allowed on any issue of equity shares of the company.
 - (d) The securities premium account can be applied by the company for the purchase of its own shares or securities under section 68.
2. Which of the following is not an example of capital reserve?
 - (a) Revaluation reserve arising from revaluation of fixed assets
 - (b) Securities Premium
 - (c) Capital redemption reserve
 - (d) General reserve

3. **Statement 1:** *Confirmations as well as undelivered letters should be given/ returned to the auditor and not to the client.*

Statement 2: *When no reply is received, the auditor should perform alternate procedures regarding the balances.*

- (a) *Only statement 1 is correct*
 - (b) *Only statement 2 is correct*
 - (c) *Both statements 1 & 2 are correct*
 - (d) *Both statements 1 & 2 are incorrect*
4. *Mr. Chetanya performed which of the following analytical procedures to obtain the audit evidence with respect to the overall reasonableness of purchase quantity and price of raw material?*
- (a) *Consumption Analysis*
 - (b) *Stock Composition Analysis*
 - (c) *Reasonableness test*
 - (d) *Ratio analysis*
5. *Which of the following is not correct with respect to the disclosure requirements of Schedule III to the Companies Act, 2013?*
- (a) *Current maturities of long term borrowings is to be disclosed under the head long term borrowings*
 - (b) *Long term maturities of finance lease obligations is to be disclosed under the head long term borrowings*
 - (c) *Interest accrued but not due on borrowings is to be disclosed under the head Other Current Liabilities*
 - (d) *Interest accrued and due on borrowings is to be disclosed under the head Other Current Liabilities*

Answers to Questions involving case study

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

Important Note:

Students are advised to refer Advanced Accounting Study Material (Paper-1) wherever reference to Accounting Standards is given and also to Corporate and Other Laws Study Material (Paper-2) wherever reference to Sections of the Companies Act, 2013 is given.

SUMMARY

- ◆ Assertion refers to the representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.
- ◆ Assertions pertaining to Balance sheet captions comprise of existence, completeness, cut-off, rights and obligations, valuation and presentation and disclosure.
- ◆ Assertions pertaining to Income statement captions comprise of occurrence, completeness, cut-off, measurement and presentation and disclosure.
- ◆ Audit procedures are performed by auditor to verify assertions pertaining to Balance sheet captions and income statement captions.
- ◆ Requirements of Schedule III of the Companies Act, 2013 have to be kept in mind while verifying assertions in case of a company.
- ◆ Performance of such audit procedures to verify these assertions leads to obtaining of audit evidence which is evaluated by auditor.

For a concise revision of the key concepts covered in this chapter, students may refer to the Saransh Booklet for Paper 5: Auditing and Ethics, which serves as a useful last-mile revision resource for examination preparation. Saransh Booklet can be accessed at <https://resource.cdn.icai.org/85998bos-aps751-int-p5.pdf>

TEST YOUR KNOWLEDGE

MCQs based Questions

1. *An auditor is verifying purchases to ensure their genuineness. Consequently, he is also trying to verify that no fake "trade payables" are present in financial statements. Which assertions concerning purchase transactions and trade payables respectively are being verified by auditor?*
 - (a) *Occurrence; Existence*
 - (b) *Occurrence; Completeness*
 - (c) *Existence; Occurrence*
 - (d) *Completeness; Occurrence*
2. *Which of the following statement is most appropriate as regards to disclosure of goods in transit in financial statements of a company?*
 - (a) *No separate disclosure of goods in transit is required.*
 - (b) *Disclosure of total goods in transit under head of inventories is required.*
 - (c) *Disclosure of goods in transit under each sub-head of inventories is required.*
 - (d) *Disclosure of goods in transit for raw material and finished goods is required.*
3. *Sweat Equity shares are issued by a company at a discount or for consideration other than cash to its:-*
 - (a) *Directors only*
 - (b) *Clients only*
 - (c) *Directors or employees*
 - (d) *Auditors only*
4. *Which of the following is not an element of cost of an item of machinery included under head "Property, Plant and Equipment"?*
 - (a) *Installation costs*
 - (b) *Freight cost of bringing the item to its location*

- (c) *Inaugural costs*
 - (d) *Employee benefit cost for making such an item suitable for production*
5. Which of the classification is not required by a company in respect of its "Cash and cash equivalents?"
- (a) *Balance with Banks*
 - (b) *Balance with scheduled banks*
 - (c) *Cash on hand*
 - (d) *Cheques on hand*

Correct/Incorrect

State with reasons (in short) whether the following statement is correct or incorrect:

1. *Employee benefits expenses represent the sum an entity pays to its employees for their labour/ efforts only.*
2. *Dividends are recognised in the statement of profit and loss only when the entity's right to receive payment of the dividend is established.*
3. *"Sweat Equity Shares" means equity shares issued by the company to employees or directors at a premium or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.*
4. *Capital reserves represent profits that are available for distribution to shareholders held for the time being or any one or more purpose.*
5. *A capital reserve, generally, can be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realised.*
6. *If Company X's balance sheet shows building with carrying amount of ₹ 100 lakh, the auditor shall assume only one point that the management has only asserted that the building recognized in the balance sheet exists as at the period-end.*
7. *The securities premium account may only be applied by the Company towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares.*

8. *Material and wages are considered to be revenue expenditure when incurred for construction of building.*
9. *PPE are depreciated when the asset is actually put to active use.*
10. *Increase in authorised capital of the company requires special resolution to be passed at the general meeting.*
11. *Capital redemption reserve can be used for distribution of dividends.*
12. *Dividends are recommended by the Board, and declared by the Shareholders.*
13. *In verifying Trade Receivables balance, Direct Confirmation Procedure is one of the important audit activity.*

Theoretical Questions

1. *How will you vouch and/or verify the following:*
 - (a) *Goods sent out on Sale or Return Basis.*
 - (b) *Borrowing from Banks.*
2. *How will you vouch/verify the following:*
 - (a) *Goods sent on consignment.*
 - (b) *Foreign travel expenses.*
 - (c) *Receipt of capital subsidy.*
 - (d) *Provision for income tax.*
3. *How will you vouch and/or verify payment of taxes?*
4. *How would you vouch/verify the following:*
 - (a) *Advertisement Expenses.*
 - (b) *Sale of Scrap.*
5. *ABC Ltd. has issued shares for cash at a premium. Section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account. Advise the means in which the amount in the account can be applied.*
6. *The auditor A of ABC & Co.- firm of auditors is conducting the audit of XYZ Ltd and while performing testing of additions wanted to verify that all PPE (Property Plant and Equipment) purchase invoices are in the name of the entity*

he is auditing. For all additions to land, building in particular, the auditor desires to have concrete evidence about ownership. The auditor is worried about whether the entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements. Advise the auditor.

7. Write the audit Procedure for verification of existence of Trade Receivables.
8. MNO & Associates are the statutory auditor of Venus Ltd. for the FY 2025-26. During the course of audit, one of the audit team members, Mr. Viaan noticed that the company has made loans totaling to ₹ 50 lakhs to the promoters of the company, namely, Mr. Raj and Mr. Rajeew without specifying the period of repayment. Mr. Viaan discussed with Mr. Manik, the engagement partner, about the disclosure requirements with respect to such loans required by Schedule III to the Companies Act, 2013. What should Mr. Manik advise Mr. Viaan?
9. What are the disclosures requirements as per Part I of Schedule III to the Companies Act, 2013 with respect to the cash & cash equivalents held by a company?
10. Mercury Ltd. is a company engaged in the manufacture of floor mats. The company sells its goods on credit. The debtors balance as on 31.03.2026 amounted to ₹ 20 cr. What is the disclosure requirement as per Schedule III to the Companies Act 2013, with respect to the ageing schedule of debtors of the company?
11. You are the statutory auditor of Jupiter Ltd. for the FY 2025-26. During the course of audit, you noticed that the company has PPE under construction i.e. Capital Work in Progress. What disclosures should the company give with respect to the ageing schedule of such capital work in progress as required by Schedule III to the Companies Act, 2013?
12. The auditor of Saturn Ltd. wants to verify whether the company has valid legal ownership rights over the inventories recorded in the balance sheet as on 31.03.2026. What audit procedures should the statutory auditor of the company perform?
13. ABC & Co., a Chartered Accountant firm, has been appointed as the statutory auditors of Pen Private Limited for the F.Y 2025-26. During the audit, one of the team members, Mr. R noticed that Pen Private Limited has purchased

software amounting to ₹2.00 crore and the said software is not an integral part of the related hardware. Mr. R further observed that Pen Private Limited has conducted some research of an internal project work amounting to ₹1.00 crore. Pen Private Limited, following Indian GAAP, has presented the aforesaid details in the Balance Sheet as on 31st March, 2026 as follows:

Property, Plant, and Equipment	₹
- Software	2.00 crore
- Research	1.00 crore

Mr. R approached the engagement partner with above details and enquired about the correctness of the presentation made by Pen Private Limited in terms of Schedule III to the Companies Act, 2013. Mr. R further wanted to ensure that all additions to Intangible assets during the year 2025-26 have been recorded appropriately in the financial statements of Pen Private Limited. Guide Mr. R.

14. The accounts team of Infant Garments Private Ltd., while ascertaining the cost of Property, Plant and Equipment (PPE), included various expenses such as:

- Cost of testing a machine: ₹1,80,000
- Cost of inauguration of the new machine: ₹1,00,000

As a Senior auditor, guide the team regarding the recognition criteria of PPE and the elements of costs to be included at the time of recognition.

15. Identify and explain the assertions that the auditor will check by performing the following audit procedures-

- Inventory recognised in the balance sheet actually existed as at the period end.
- All the items of inventory pertaining to the relevant year shall be included regardless of the location.
- All goods dispatched prior to the period/ year-end have been invoiced and included in debtors on a test check basis.
- Examine client correspondence, sales and receivables records, purchase documents.
- Verifying that the entity has charged depreciation on all items of PPE unless any item of PPE is non-depreciable like freehold land.

16. *CA Sohail, while conducting statutory audit of a company, has noticed that there are items such as computer software, patents appearing in its books of accounts. These are identifiable non-monetary assets, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. He wants to ensure that such items are properly valued in financial statements of the company. Suggest few audit procedures to be performed by him in this regard.*
17. *SRT Pvt. Ltd., based in Mumbai, is engaged in export of brassware goods. The company has huge export receivables as on 31st March 2026. It is also analysed from Export Sales account of the company that large number of small shipments were almost despatched daily during the month of March 2026. The auditor is ensuring that all goods despatched prior to the year-end have been invoiced. Which assertion concerning trade receivables is being verified by auditor? List out few audit procedures you would adopt as an auditor to verify this assertion.*
18. *M/s Veer and Associates is appointed as auditor of KMP limited. During the audit, auditor wants to verify that trade payables and liability balances that were supposed to be recorded have been recognized in the financial statements. Which assertion auditor wants to ensure and what audit procedures should be followed by him in this regard?*
19. *BOTS is a manufacturing entity having material Property, Plant and Equipment (PPE) items in its financial statements. The auditor of the entity wants to verify that PPE items have been valued appropriately as per generally accepted accounting policies and practices. Comment on significance of such verification. Suggest a few audit procedures in this regard.*
20. *You are appointed as the auditor of JK Apparels Ltd., a public limited company. The company entered into an arrangement during the financial year 2025-26 with one of its promoters Mr. K whose son is a director in JK Apparels Ltd. Under this arrangement, the company acquired an immovable property owned by the promoter. As consideration for the purchase, the company allotted 2% of its equity share capital to the promoter instead of making payment in cash. The title deed of the property has been duly transferred and held in the name of the company.*

Discuss the disclosure requirements of Shareholding of Promoters under Schedule III (Part I) of the Companies Act, 2013.
21. *While auditing the financial statements of Moon Ltd. for the year ended 31 March 2026, the auditor was verifying the disclosures relating to trade*

payables and other liabilities. During the course of the audit, it was noticed that the company has certain outstanding balance payable to Micro and Small Enterprises.

The auditor decided to ensure that the disclosures required under Schedule III of the Companies Act 2013, in respect of such enterprises have been appropriately made in the notes to accounts.

State the disclosures that the auditor should verify in respect of Micro and Small Enterprises while auditing trade payables and other liabilities.

22. *Identify and explain the assertions that the auditor will check by performing the following audit procedures:*
- (i) *Any inventory held by the entity on behalf of another entity has not been recognised as part of inventory of the entity.*
 - (ii) *Employee benefit expense has been incurred during the period in respect of the personnel employed by the entity.*
 - (iii) *Inventory has been recognised at the lower of cost and net realisable value in accordance with AS 2 - Inventories.*
 - (iv) *Sales shall include the despatch of goods made at the year-end as they belong to the relevant period.*
 - (v) *Any inventory held by a third party on behalf of the entity has been included as part of the inventory balance.*
23. *Kyte Private Limited acquired an immovable property of substantial value during the financial year 2025-26, which is recorded in the financial statements as an addition in the Schedule of PPE. The auditor also observed that this immovable property has been mortgaged to a bank for availing credit facilities. How should the auditor verify the rights and obligations assertion for this property to ensure the entity's legal ownership and identify any charges against it?*
24. *CA J is appointed as statutory auditor of Sigma and Beta Limited for the year 2025-26. During the audit he observed trade receivables amounting to ₹ 50 crores are reflected in the financial statements of the company. He wants to obtain sufficient appropriate evidence to conclude that trade receivables have been valued Appropriately. Suggest few audit procedures in this regard.*
25. *Zed Limited is engaged in the manufacturing and export of shoes. The statutory auditor of the company wants to reasonably ensure that only the inventories recorded in the financial statements are exclusively owned by the company and*

do not include any inventories that belong to third parties but includes inventories owned by the company but lying with third party. Advise the auditor on the audit procedures to be performed to achieve this assurance.

26. *While verifying cash and cash equivalents of a company, CA D engagement partner, is very particular that Bank reconciliation statement (BRS) prepared by the management in respect of bank account maintained by the company is proper to rule out misstatements in cash and cash equivalents reflected in the financial statements of the company. The company does not use net banking and prefers to issue cheques to its creditors and receives substantial payments locally through account payee cheques. Which aspects need to be taken care of and verified by CA D in respect of BRS?*
27. *Identify and explain the assertions that the auditor will check by performing the following audit procedures:*
- (i) Employee benefit expenses recognised during the period relates to the current accounting period only.*
 - (ii) Employee benefit expenses in respect of all personnel have been fully accounted for.*
 - (iii) Any inventory held by the entity on behalf of another entity has not been recognised as part of inventory of the entity.*
 - (iv) Recorded sales represent goods which were ordered by valid customers and were despatched and invoiced in the period.*
28. *During the audit of Rapid Industries Private Limited, CA Akshat notices that inventories of raw materials & consumables and work-in- progress amounting ₹ 2.50 crores and ₹ 0.25 crores appear in the financial statements of the company as on March 31st, 2026. He wants to verify that the above-mentioned inventories have been valued appropriately and as per generally accepted accounting policies and practices. How should he proceed to verify the above?*
29. *LMN Ltd., a mid-sized manufacturing company, generates revenue primarily through the sale of consumer electronics in domestic and international market. The company reported sales of ₹ 2 crores in the Financial Year 2025-26. The company generates revenue through sale of standard electronics devices, customized product orders with specific delivery terms and extended warranties and after-sales services.*

The auditor has to verify that all sales are accurately measured as per applicable accounting standards and correctly journalized, summarized and posted in the financial statements,

Explain the audit procedures to ensure the same.

30. *While auditing the accounts of PQR Ltd., a member of the audit team wants to carry out test of controls for checking the effectiveness of internal control over sales as a part of debtor's audit procedure. State any four points that need to be considered in respect of trade receivables.*

ANSWERS/SOLUTIONS

Answers to MCQs

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

Answers to Correct/Incorrect

- 1. Incorrect:** Employee benefits expenses, commonly called payroll expenses, represent the aggregate sum an entity pays to its employees for their labour/ efforts, as well as associated expenses such as perquisites/ benefits, post-employment benefits like gratuity, superannuation, leave encashment, provident fund contribution etc. as well as towards their hiring, their welfare and training.
- 2. Incorrect:** Dividends are recognised in the statement of profit and loss only when:
 - the entity's right to receive payment of the dividend is established;
 - it is probable that the economic benefits associated with the dividend will flow to the entity; and
 - the amount of the dividend can be measured reliably.
- 3. Incorrect:** "Sweat Equity Shares" means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.
- 4. Incorrect:** Revenue reserves represent profits that are available for distribution to shareholders.

5. **Correct:** A capital reserve, generally, can be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realised. But the amount of share premium or capital redemption reserve account can be utilised only for the purpose specified in Sections 52 and 55 respectively of the Companies Act, 2013.
6. **Incorrect:** If Company X's balance sheet shows building with carrying amount of ₹ 100 lakh, the auditor shall assume that the management has claimed/ asserted that:
- The building recognized in the balance sheet exists as at the period-end (existence assertion);
 - Company X owns and controls such building (Rights and obligations assertion);
 - The building has been valued accurately in accordance with the measurement principles (Valuation and allocation assertion);
 - All buildings owned and controlled by Company X are included within the carrying amount of ₹ 100 lakh (Completeness assertion).
7. **Incorrect:** The securities premium account may be applied by the Company:
- (a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;
 - (b) in writing off the preliminary expenses of the Company;
 - (c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;
 - (d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
 - (e) for the purchase of its own shares or other securities under section 68.
8. **Incorrect:** Material and Wages incurred on construction of building qualify to be capital expenditure as per AS 10 "Property, Plant and Equipment". Therefore, these have to be added to the cost of the asset i.e building and shall not be expensed off to Statement of Profit and Loss.
9. **Incorrect:** Depreciation is a fall in value of asset due to obsolescence, usage and effluxion of time, Therefore, depreciation is charged when the asset is ready for use. Active use of asset is not a mandatory criteria for charge of depreciation.

10. **Incorrect:** Increase in Authorised capital requires alteration of capital clause of memorandum of Association. Therefore, ordinary resolution is passed for increase in authorised capital of the company as per the Companies Act, 2013.
11. **Incorrect:** Capital Redemption reserve is not a free reserve. It is a restrictive reserve and can be used only for purposes given in the Act. Since it is not a free reserve, it cannot be utilised for payment of dividends. CRR can be used only for the purpose of issuing fully paid up bonus shares.
12. **Correct:** The dividends are recommended by the Board of Directors by passing a resolution at the board meeting. The Shareholders declare the dividends at the AGM by passing an ordinary resolution. Declaration of dividend is an item of ordinary business. However, the shareholders can decrease the amount of dividends recommended by the board but cannot increase it.
13. **Correct:** While auditing trade receivable balance, direct confirmations as per SA 505, is considered to be the most important audit activity. Direct confirmation can be sought from the debtors directly confirming their balance due. The replies to the confirmation can be then matched with the records maintained by the client. Any discrepancies so revealed, can be investigated and checked in detail for possibility of any risk of material misstatement. Auditor selects few debtors' balances and ask the client to prepare the confirmations properly addressed to the debtors. Auditor maintains strict control over this process.

Answer to Theoretical Questions

1. (a) **Goods Sent Out on Sale or Return Basis:**
- (i) Check whether a separate memoranda record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.
 - (ii) Verify that price of such goods is unloaded from the sales account and the trade receivables record. Check the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.

- (iii) Ensure that the goods in respect of which the period of approval has expired at the end of the year, have either been received back or customers' accounts have been debited.
 - (iv) Confirm that the inventory of goods sent out on approval, the period of approval in respect of which had not expired till the end of the year lying with the party, has been included in the closing inventory.
- (b) Borrowing from Banks:** Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows-
- (i) Reconcile the balances in the overdrafts or loan accounts with that shown in the pass book(s) and confirm the last mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.
 - (ii) Obtain independent balance confirmation from the bank showing balances, particulars of securities deposited with the bank as security for the loans or of the charge created on an asset and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges.
 - (iii) Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.
 - (iv) Confirm, in the case of a company, that the restraint contained in Section 180 of the Companies Act, 2013 as regards the maximum amount of loan that the company can raise has not been contravened.

Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the entity.

2. (a) Goods Sent on Consignment:

- (i) Verify the accounts sales submitted by the consignee showing goods sold and inventory of goods in hand.

- (ii) Reconcile the figure of the goods on hand, as given in the last accounts sales, with the Performa invoices and accounts sales received during the year. If any consignment inventory was in the hands of the consignee at the beginning of the year, the same should be taken into account in the reconciliation.
- (iii) Obtain confirmation from the consignee for the goods held on consignment on the balance sheet date. Verify the terms of agreement between the consignor and the consignee to check the commission and other expenses debited to the consignment account and credited to the consignee's account. The accounts sales also must be correspondingly checked.
- (iv) Ensure that the quantity of goods in hand with the consignee has been valued at cost plus proportionate non-recurring expenses, e.g., freight, dock dues, customs due, etc., unless the value is lower. In case net realisable value is lower, the inventory in hand of the consignee should be valued at net realisable value. Also see that the allowance has been made for damaged and obsolete goods in making the valuation.
- (v) See that goods in hand with the consignee have been shown separately under the head inventories.

(b) Foreign Travel Expenses:

- (i) Examine Travelling Allowance bills submitted by the employees stating the details of tour, details of expenses, etc.
- (ii) Verify that the tour programme was properly authorised by the competent authority.
- (iii) Check the T.A. bills along with accompanying supporting documents such as air tickets, travel agents bill and hotel bills with reference to the internal rules for entitlement of the employees and also make sure that the bills are properly passed.
- (iv) See that the tour report accompanies the T.A. bill. The tour report will show the purpose of the tour. Satisfy that the purpose of the tour as shown by the tour report conforms to the authorisation for the tour.

- (v) Check Reserve Bank of India's permission, if necessary, for withdrawing the foreign exchange. For a company the amount of foreign exchange spent is to be disclosed separately in the accounts as per requirement of Schedule III to the Companies Act, 2013 and Accounting Standard 11 "The Effects of Changes in Foreign Exchange Rates".

(c) Receipt of Capital Subsidy:

- (i) Check the application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.
- (ii) Examine documents for the grant of subsidy and note the conditions attached with the same relating to its use, etc.
- (iii) Ensure that the conditions to be fulfilled and other terms especially whether the same is for a specific asset or is for setting up a factory at a specific location.
- (iv) Check relevant entries for receipt of subsidy.
- (v) Check compliance with requirements of AS 12 on "Accounting for Government Grants" i.e. whether it relates to specific amount or in the form of promoters' contribution and accordingly accounted for as also compliance with the disclosure requirements.

(d) Provision for Income Tax:

- (i) Obtain the computation of income and income tax prepared by the entity and verify whether it is as per the Income-tax Act, 1961 and Rules made thereunder.
- (ii) Review adjustments, expenses, disallowed special rebates, etc. with particular reference to the last available completed assessment.
- (iii) Examine relevant records and documents pertaining to advance tax, self-assessment tax and other demands.
- (iv) Compute tax payable as per the latest applicable rates in the Finance Act.

- (v) Ensure that overall provisions on the date of the balance sheet is adequate having regard to current year provision, advance tax paid, assessment orders, etc.
- (vi) Ensure that the requirements of AS 22 on Accounting for Taxes on Income have been appropriately followed for the period under audit.

3. Vouching of Payment of Taxes:

- (i) Payment on account of income-tax and other taxes consequent upon a regular assessment should be verified by reference to the copy of the assessment order, assessment form, notice of demand and the receipted challan.
- (ii) Payments or advance payments of income-tax should also be verified with the notice of demand and the receipted challan acknowledging the amount paid.
- (iii) The interest allowed on advance payments of income-tax should be included as income and penal interest charged for non-payment should be debited to the interest account.
- (iv) Nowadays, electronic payment of taxes is also in trend. Electronic payment of taxes means payment of taxes by way of internet banking facility or credit or debit cards.
- (v) The entity can make electronic payment of taxes also from the account of any other person. However, the challan for making such payment must clearly indicate the Permanent Account Number (PAN) of the assessee on whose behalf the payment is made. This should be checked by the auditor.
- (vi) It is not necessary for the entity to make payment of taxes from his own account in an authorized bank. While vouching such e-payment, the auditor should cross verify the payments of taxes through the receipted challan along with PAN No /TAN No. etc.

4. (a) Advertisement Expenses:

- (i) Verify the bills/invoices from advertising agency to ensure that rates charged for different types of advertisement are as per the contract.
- (ii) See that the advertisement relates to client's business.
- (iii) Inspect the receipt issued by the agency.
- (iv) Ascertain the nature of expenditure – revenue or capital expenditure and see that it has been recorded properly.
- (v) Ascertain the period for which payment is made and see that prepaid amount, if any, is carried to the balance sheet.
- (vi) See that all outstanding advertisement bills have been provided for.

(b) Sale of Scrap:

- (i) Review the internal control as regards generation, storage and disposal of scrap.
- (ii) Check whether the organization is maintaining reasonable record for generation of scrap.
- (iii) Analyze the raw material used, production and generation pattern of scrap and compare the same with figures of earlier year.
- (iv) Check the rates at which scrap has been sold and compare the rate with previous year.
- (v) Vouch sales, with invoices raised, advertisement for tender, rate contract with scrap dealers.
- (vi) Ensure that there exists a proper control procedure to identify scrap and good units and they are not mixed up and sold as scrap.
- (vii) Make an overall assessment of the value of realization from scrap as to its reasonableness.

5. Shares Issued at Premium: In case a company has issued shares at a premium, that is, at amount in excess of the nominal value of the shares, whether for cash or otherwise, section 52 of the Companies Act, 2013

provides that a Company shall transfer the amount received by it as securities premium to securities premium account and state the means in which the amount in the account can be applied. As per the section, where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to a "securities premium account" and the provisions of this Act relating to reduction of share capital of a company shall apply as if the securities premium account were the paid-up share capital of the company.

Application of securities premium account: The securities premium account may be applied by the Company:

- (a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;
- (b) in writing off the preliminary expenses of the Company;
- (c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;
- (d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
- (e) for the purchase of its own shares or other securities under section 68.

The auditor needs to verify whether the premium received on shares, if any, has been transferred to a "securities premium account" and whether the application of any amount out of the said "securities premium account" is only for the purposes mentioned above

6. In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, the auditor while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity. For all additions to land, building in particular, the auditor should obtain copies of conveyance deed/ sale deed to establish whether the entity is mentioned to be the legal and valid owner.

The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date. In case the entity has given such immoveable property as security for any borrowings and the original title

deeds are not available with the entity, the auditor should request the entity's management for obtaining a confirmation from the respective lenders that they are holding the original title deeds of immoveable property as security. In addition, the auditor should also verify the register of charges, available with the entity to assess that any charge has been created against the PPE.

7. For Verification of Existence of Trade Receivables, the auditor should check the following :

- i. Check whether there are controls in place to ensure that invoices cannot be recorded more than once and receivable balances are automatically recorded in the general ledger from the original invoice.

Ask for a period-end accounts receivable ageing report and trace the balance as per the report to the general ledger.

- ii. Check whether realization is recorded invoice-wise or not. If not, check that money received from debtors is adjusted chronologically invoice-wise and on FIFO basis i.e. previous bill is adjusted first.
- iii. If any large balance is due for a long time, auditor should ask for reasons and justification for the same.
- iv. A list of trade receivables selected for confirmation should be given to the entity for preparing request letters for confirmation which should be properly addressed.
- v. The auditor should maintain strict control to ensure the correctness and proper despatch of request letters. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.
- vi. Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample.
- vii. Where no reply is received, the auditor should perform alternate procedures regarding the balances.
- viii. Agreeing the balance to cash received subsequently;

- ix. Preparing a detailed analysis of the balance, ensuring it consists of identifiable transactions and confirming that these revenue transactions actually occurred. (examination in depth for those balances)
 - x. If there are any related party receivables, review them for collectability as well as whether they were properly authorized and the value of such transactions were reasonable and at arm's length.
 - xi. Check that receivables for other than sales or services are not included in the list.
 - xii. Review a trend line of sales and accounts receivable, or a comparison of the two over time, to check if there are any unusual trends i.e. perform Analytical procedures. Make inquiries about reasons for changes in trends with the management and document the same in audit work papers.
8. Mr. Manik should advise Mr. Viaan to consider whether the following disclosures as required by Schedule III to the Companies Act, 2013, has been made in respect of the loans granted to promoters, namely, Mr. Raj and Mr. Rajeev, either severally or jointly with any other person, that are:
- (a) repayable on demand or
 - (b) without specifying any terms or period of repayment

Type of Borrower	Amount of loan or advance in the nature of loan outstanding	Percentage to the total Loans and Advances in the nature of loans
Promoters		
Directors		
KMPs		
Related Parties		

9. The following are the disclosure requirements as per Schedule III to the Companies Act, 2013, with respect to the cash & cash equivalents held by the company:

Cash and cash equivalents

- (i) Cash and cash equivalents shall be classified as:
 - (a) Balances with banks;
 - (b) Cheques, drafts on hand;
 - (c) Cash on hand;
 - (d) Others (specify nature)
 - (ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.
 - (iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.
 - (iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.
 - (v) Bank deposits with more than 12 months' maturity shall be disclosed separately.
- 10.** The following are the disclosure requirement as per Schedule III to the Companies Act 2013, with respect to the ageing schedule of debtors of the company:

Trade Receivables ageing schedule

					(Amount in ₹)	
Particulars	Outstanding for following periods from due date of payment#					
	Less than 6 months	6 months - 1 year	1-2 years	2-3 years	More than 3 years	Total
(i) Undisputed Trade receivables – considered good						
(ii) Undisputed Trade Receivables – considered doubtful						

(iii)	Disputed Receivables considered good	Trade						
(iv)	Disputed Receivables considered doubtful	Trade						

similar information shall be given where no due date of payment is specified, in that case disclosure shall be from the date of the transaction.

Unbilled dues shall be disclosed separately.

11. Capital-Work-in Progress

- (a) For Capital-work-in progress, following ageing schedule shall be given:

CWIP ageing schedule

(Amount in ₹)					
	Amount in CWIP for a period of				Total*
CWIP	Less than 1 year	1-2 years	2-3 years	More than 3 years	
Projects in Progress					
Projects temporarily suspended					

*Total shall tally with CWIP amount in the balance sheet.

- (b) For capital-work-in progress, whose completion is overdue or has exceeded its cost compared to its original plan, following CWIP completion schedule shall be given**:

(Amount in ₹)				
	To be completed in			
CWIP	Less than 1 year	1-2 years	2-3 years	More than 3 years
Project 1				
Project 2				

**Details of projects where activity has been suspended shall be given separately.

12. The statutory auditor of Saturn Ltd. should perform the following audit procedures to verify if the company has valid legal ownership rights over the inventories recorded in the balance sheet as on 31.03.2026. The auditor should:

- vouch recorded purchases to underlying documentation (purchase requisition, purchase order, receiving report, vendor invoice and cancelled cheque or payment file).
- evaluate the consigned goods.
- examine client correspondence, sales and receivables records, purchase documents.
- determine existence of collateral agreements.
- review consignment agreements.
- review material purchase commitment agreements.
- examine invoices for evidence of ownership i.e. the invoices shall be in the name of the client.
- obtain confirmation for significant items of inventory.

For instances of inventory held by third party, the auditor should insist on obtaining declaration from the third party on its business letterhead and signed by an authorized personnel of that third party confirming that the items of inventory belong to the entity and are being held by such third party on behalf of and for the benefit of the entity under audit.

13. Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset. Thus, purchase of software, which is not an integral part of related hardware, amounting to ₹ 2 crore by Pen Private Limited should be presented in the Balance Sheet under the head intangible asset not under the head Fixed Asset.

Further, Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred. Therefore, presentation of research amounting to ₹ 1 crore of an integral project work by Pen Private Limited under the head Property, Plant and Equipment as Research is not correct as it should be recognised as an expense.

Audit Procedure for ensuring all additions to Intangible assets during the year have been recorded appropriately in the financial statements of Pen Private Limited:

- For all material additions, verify whether such expenditure meets the criterion for recognition of an intangible asset as per AS 26.
- Ensure that no intangible asset arising from research (or from the research phase of an internal project) should be recognised. Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred.
- Check the certificate or report or other similar documentation maintained by the entity to verify the date of use of the intangible which could be linked to date of commencement of commercial production/ economic use to the entity, for all additions to intangible assets during the period under audit.
- Verify whether the additions (acquisitions) have been approved by appropriate entity's personnel.
- Verify whether proper internal processes and procedures like inviting competitive quotations/ proper tenders etc. were followed prior to finalizing the vendor for procuring item of intangible assets by testing those documents on a sample basis

14. Recognition Criteria for PPE: The cost of an item of PPE should be recognised as an asset if, and only if:

- (1) It is probable that future economic benefits associated with the item will flow to the enterprise, and
- (2) The cost of the item can be measured reliably.

Elements of Cost to be included at the time of recognition: The cost of an item of property, plant and equipment comprises:

- (1) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
- (2) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

- (3) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located (decommissioning, restoration and similar liabilities), the obligation for which is incurred on acquisition of the asset or as a consequence of its use.

Treatment of expenses given in the question

- **Cost of testing the machine (₹ 1,80,000):** Testing costs incurred to check whether the asset is functioning properly before it is put to use are directly attributable costs and are therefore capitalised as part of the cost of PPE.
 - **Cost of inauguration of the new machine (₹ 1,00,000):** Inauguration expenses are not directly attributable to bringing the asset to the condition necessary for its intended use and do not generate future economic benefits. Hence, such costs are not capitalised and should be charged to the Statement of Profit and Loss.
15. (i) The auditor will check the Existence Assertion to ensure Assets, liabilities and equity balances exist as at the period end.
- (ii) The auditor will check the Cut-off assertion to ensure that all assets and liabilities are reported in the appropriate period.
- (iii) The auditor will check Completeness Assertion to ensure all Trade receivable balances that were supposed to be recorded have been recognized in the financial statements.
- (iv) The auditor will check Rights & Obligations assertion to ensure that the entity has valid legal ownership rights over the inventories claimed to be held by the entity and recorded in the financial statements.
- (v) The auditor will check Valuation and allocation assertion to ensure PPE have been valued appropriately and as per generally accepted accounting policies and practices
16. Computer software and patents are examples of intangible assets. The value of intangible assets may diminish due to efflux of time, use and/ or obsolescence. The diminution of the value represents cost to the entity for earning revenue during a given period. Unless this cost in the form of amortization is charged to the accounts, the profit or loss would not be correctly ascertained, and the values of intangible asset would be shown at higher amounts.

The auditor should: -

- Verify that the entity has charged amortization on all intangible assets;
- Verify that the amortization method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity.
- The auditor should also verify whether the management has done an impairment assessment to determine whether an intangible asset is impaired. For this purpose, the auditor needs to verify whether the entity has applied AS 28 Impairment of Assets for determining the manner of reviewing the carrying amount of its intangible asset, determining the recoverable amount of the asset determine impairment loss, if any.

- 17.** In the given situation, the auditor is verifying Completeness assertion by ensuring that all goods dispatched prior to the year-end have been invoiced.

Audit procedures to be adopted by the auditor to verify the Completeness assertion are as under:

- Check that in respect of invoices raised in last few days nearing the cut-off date, goods have been actually dispatched and not lying with the company.
- Test invoices listed in receivable report. Select few invoices from the accounts receivable ageing report and compare them to supporting documentation to see if they were billed with the correct amounts, to the correct customers, and on the correct dates.
- Match invoices to shipping/ dispatch log. Match invoice dates to the shipment dates for those items in the shipping/ dispatch log, to see if sales are being recorded in the correct accounting period. This can include an examination of invoices issued subsequent to the period being audited, to see if they should have been included in the period under audit.
- Assess bill and hold sales. If there is a situation where the Company is billing customers for sales despite still retaining the goods on-site (known as "bill and hold"), examine supporting documentation to determine whether a sale has actually taken place or not.

- Review the receiving log to see if the Company has recorded an inordinately large amount of customer returns after the audit period, which would suggest that the Company may have shipped more goods near the end of the audit period than what the customers had authorized to inflate the profits of the company.
- Review the process of giving discounts/ incentives and check whether the same were given as per the Company's policy/ general industry trends.

18. Refer Completeness in Para 3.9

19. It is a common understanding that the value of fixed assets/ PPE depreciates due to efflux of time, use and obsolescence. The diminution of the value represents an item of cost to the entity for earning revenue during a given period. Unless this cost in the form of depreciation is charged to the accounts, the profit or loss would not be correctly ascertained, and the values of PPE would be shown at higher amounts. Therefore, such verification is significant.

Audit procedures that the auditor should follow to verify that the PPE items have been valued appropriately as per generally accepted accounting policies and practices are: -

- Verify that the entity has charged depreciation on all items of PPE unless any item of PPE is non- depreciable like freehold land.
- Assess that the depreciation method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. It could be Straight line method, diminishing value method, unit of production method, as applicable.
- The auditor should also verify whether the management has done an impairment assessment to determine whether an item of property, plant and equipment is impaired as per the requirements of AS 28 Impairment of Assets.

20. A company shall disclose Shareholding of Promoters* as below:

Shares held by promoters at the end of the year				% Change during the year***
S. No.	Promoter Name	No. of shares	% of total shares**	
Total				

* Promoter here means promoter as defined in the Companies Act, 2013.

** Details shall be given separately for each class of shares

***percentage change shall be computed with respect to the number at the beginning of the year or if issued during the year for the first time then with respect to the date of issue.

21. **The auditor should ensure whether the following disclosures as required under Schedule III (Part I) to Companies Act, 2013 have been made:**

Whether the Company has disclosed the following details relating to micro and small enterprises in the notes to accounts:

- (i) the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year.
- (ii) the amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year.
- (iii) the amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006.
- (iv) the amount of interest accrued and remaining unpaid at the end of each accounting year.
- (v) the amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

- (vi) The following ageing schedule shall be given for Trade payables due for payment:

Trade Payables ageing schedule

<i>(Amount in ₹)</i>					
Particulars	Outstanding for following periods from due date of payment#				
	Less than 1 year	1-2 years	2-3 years	More than 3 years	Total
(i) MSME					
(ii) Others					
(iii) Disputed Dues- MSME					
(iv) Disputed Dues Others					

Similar information shall be given where no due date of payment is specified in that case disclosure shall be from the date of the transaction. Unbilled dues shall be disclosed separately.

- 22.** (i) The auditor will check **Rights & Obligations assertion** to ensure that the entity has the right to assets i.e. (whether the entity has ownership and legal title to assets) and the liabilities recognised in the financial statements represent all the entity's obligations to repayment as at a given date.
- (ii) The auditor will check **Occurrence assertion** to ensure that the transactions recognized in the financial statements have occurred and relate to the entity.
- (iii) The auditor will check **Valuation and allocation assertion** to ensure assets, liabilities and equity balances have been valued appropriately i.e. the amounts at which they are recorded are appropriate. There has been no overstatement or understatement.
- (iv) The auditor will check **Cut-off assertion** to ensure that all income and expenses are reported in the-correct accounting period. Cut-off is a separate assertion because the substantive procedures to verify it are

typically different from those applied to the other components of completeness.

- (v) The auditor will verify **Completeness assertion** to ensure that all assets, liabilities and equity balances that were supposed to be recorded have been recognized in the financial statements.

23. To verify the rights and obligations assertion regarding Property, Plant, and Equipment (PPE), the auditor must ensure the entity has valid legal ownership and identify any charges against it. The audit procedures should include the following:

- In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, the auditor while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity.
- For all additions to land and building in particular, the auditor should check the conveyance deed/ sale deed to verify whether the entity is the legal and valid owner or not.
- The auditor should insist and verify title deeds for immoveable property acquired.
- In case, the entity has given such immoveable property as security for any borrowings and the original title deeds are not likely to be available with the entity, the auditor should request the entity's management for obtaining a confirmation from the respective lenders that they are holding the original title deeds of immoveable property as security.
- The auditor should also verify the register of charges, available with the entity to assess that any charge has been created against the PPE.

24. Few audit procedures to obtain sufficient appropriate audit evidence to conclude that trade receivables have been valued appropriately are as under:-

- Review the process followed by the Company to derive an allowance for doubtful accounts. This will include a consistency comparison with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment.

- Obtain the ageing report receivable (both Dr/Cr balance).
 - Also, obtain the list of debtors under litigation and compare with previous year.
 - Scrutinize the analysis and identify those debtors which appear doubtful; discuss with management about reasons as to why these debtors are not included in the provision for bad debts. Perform further testing where any disputes exist.
 - He should check if provisions are made at appropriate rates considering recoverability of amounts due.
 - Prepare schedule of movements of bad debts – Provision accounts and debts written off and compare the proportion of bad debt expense to sales for the current year in comparison to prior years to see if the current expense appears reasonable.
 - Check that write-offs of the receivable balances have been authority appropriate approved by an appropriate authority i.e. the Board of Directors in case of a company.
- 25.** Audit procedures to be followed by the statutory auditor of Zed Limited to ensure that only the inventories held by entity have been recorded in the financial statements and do not include any inventories that belong to third parties but does include inventories owned by the entity and lying with a third party are as under: -
- Perform analytical procedures (comparison tests with industry averages, budgets, prior years, trend analysis, etc.).
 - Compute inventory turnover ratio (COGS/ average inventory)
 - Perform vertical analysis (inventory/ total assets)
 - Compare budgetary expectations vis-à-vis actuals
 - Examine non-financial information related to inventory, such as weights and other measurements.
 - Perform purchase and sales cut-off tests. Trace shipping documents (bills of lading and receiving reports, warehouse records, and inventory records) to accounting records immediately before and after year-end.

- With respect to tagged inventory, perform tests for omitted transactions and tests for invalid transactions.
 - Verify the clerical and arithmetical accuracy of inventory listings.
 - Reconcile physical inventory amounts with perpetual records.
 - Reconcile physical counts with ledger control totals.
 - Reconcile inventories which belong to client but are held with third parties like transporters, warehouses, port authorities etc.
 - Goods received on a consignment basis have been properly segregated from other items of inventory.
- 26.** CA D should ensure that BRS is signed by the authorized personnel so that he is able to assign responsibility in case of any errors.

Verification of BRS shall entail the following: -

- Tallying the balance as per bank book to the bank confirmation/statement.
- Checking of all material reconciling items included under cheques issued but presented for payment to the underlying bank book forming part of books of account. In addition, the auditor should request for bank statements of subsequent period and should verify if the cheques issued have subsequently been cleared by the bank. For all cases where cheques have become stale i.e. 3 months or more have lapsed since the issue date, the same should not appear in the BRS and should instead be taken back to liabilities.
- Checking of all material reconciling items included under cheques deposited but not credited by bank by requesting for bank deposit slips, duly acknowledged by bank and verifying if the balances were credited by bank subsequently by tallying to the bank statement of subsequent period. For any instances related to cheques not cleared beyond reasonable time, the auditor should seek brief descriptions from the management and in case such explanations are found to be unsatisfactory, the auditor should verify the revenue recognition related to such parties was in order and as per the Company's revenue recognition policy.

- Checking of all material reconciling items included under amounts or charges debited/ credited by bank but not accounted for by requesting for bank statements for the period under audit and tallying the same. If the amounts are found to be material, the auditor should ensure that the management records the adjustments for the same in its books of account.
- 27.** (i) The auditor will check the cut-off assertion to ensure that whether all income and expenses are reported in the-correct accounting period. Cut-off is a separate assertion because the substantive procedures to verify it are typically different from those applied to the other components of completeness.
- (ii) The auditor will check the completeness assertion for the same to ensure that all transactions that were supposed to be recorded have been recognised in the financial statements. Transactions have not been omitted.
- (iii) The auditor will check rights & obligations assertion to ensure that the entity has the right to assets i.e. (whether the entity has ownership and legal title to assets) and the liabilities recognised in the financial statements represent all the entity's obligations to repayment as at a given date.
- (iv) The auditor will check the occurrence assertion for the same to ensure that transactions recognised in the financial statements have occurred and relate to the entity.
- 28.** To verify that inventories of raw material & consumables and work-in-progress have been valued appropriately and as per generally accepted accounting policies and practices, the following procedures should be performed by CA Akshat:

For Raw materials and consumables:

- Ascertain what elements of cost are included e.g. carriage inward, non-refundable duties etc.
- If standard costs are used, enquire into basis of standards; how these are compared with actual costs and how variances are analysed and accounted for/ treated in accounting records.

- Test check cost prices used with purchase invoices received in the month(s) prior to counting.
- Follow up valuation of all damaged or obsolete inventories noted during observance of physical counting with a view to establishing a realistic net realizable value.

For Work in Progress:

- Ascertain how the various stages of production/ value additions are measured and in case estimates are made, understand the basis for such estimates.
 - Ascertain what elements of cost are included. If overheads are included, ascertain the basis on which they are included and compare such basis with the available costing and financial data/ information maintained by the entity.
 - Ensure that material costs exclude any abnormal wastage factors.
- 29.** The auditor will apply the following audit procedures to verify that all sales are accurately measured as per applicable accounting standards and correctly journalised, summarised, and posted in the financial statements are:
- Trace a few transactions from inception to completion. (Examination in depth)
 - Eg: Take few sales transaction, and check from the receipt of sales order to the payment of receivable balance, every underlying document to ensure if it is properly recorded at every stage and measured accurately taking into consideration all the incentives, discounts, if any. The recognition shall be according to the revenue recognition policy of the entity.
 - If the client is engaged in export sales, then compliance with AS 11 shall be ensured.
 - Auditor must understand client's operations and related GAAP issues e.g. point of sale revenue recognition vs. percentage of completion, wherever applicable.
 - Compare the rate of sales affected with related parties and review them for collectability, as well as whether they were properly authorised and the value of such transactions were reasonable and at arm's length.

- 30.** To carry out test of controls for checking the effectiveness of internal control over sales as a part of the debtors' audit procedure, following points need to be considered in respect of trade receivables by audit team of PQR Ltd:
- Only bona fide sales lead to trade receivables.
 - All such sales are made to approved customers.
 - All such sales are properly recorded in the books of accounts.
 - Once recorded, the debtors can be settled only by receipt of cash or on the authority of a responsible official.
 - Segregation of duties at every point in sales transaction. (accounting for debtors, collecting the payments, sending reminders etc.)
 - Debtors are collected on time.
 - In case debtors are not collected in time, sending reminders and taking legal actions if required.
 - Balances are regularly reviewed.
 - A proper system of follow up exists and if necessary, adequate provision for bad debt should be made by preparing adequate ageing schedule of the debtors.

Answers to Questions involving Test Your Understanding

- 1.** The auditor is trying to verify assertion relating to "Rights and Obligations". He is verifying that the company owns or controls the inventory recorded in the financial statements. Any inventory held by the company on behalf of another entity has not been recognized as part of inventory of the company.
- This can be achieved by verifying stock records pertaining to goods received from mills and sent back to mills after carrying out necessary operations. Besides, agreements with such mills may also be verified.
- 2.** It shall be shown under the head "Borrowings" and classified as Short-term secured borrowings specifying nature of security. The above said outstanding amount shall be further sub-classified under heading "Loans repayable on Demand" from Banks. As per requirements of Schedule III of the Companies Act, 2013, where loans have been guaranteed by directors

or others, aggregate amount of such loans under each head shall be disclosed.

3. A company has to disclose various ratios in its financial statements in accordance with requirements of Schedule III of the Companies Act, 2013. The company shall also explain the terms included in numerator and denominator for computing the above ratios. Further explanation shall be provided for any change in the ratio by more than 25% as compared to the preceding year.
4. Substantive analytical procedures in respect of sales will consist of sales trend analysis, comparison with previous accounting period, category-wise sales analysis, any analysis the auditor may find relevant and most important of all, building a sales expectation and comparing that with the client's sales records. The auditor will need to know the sales prices of the products or services over the year, monthly average sales price per product or service, discount policy.
5. Depreciation of an asset begins when it is available for use i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by the management. Depreciation on asset is charged on asset from the date when it is ready for use and not from date of actual usage.

Hence, recording of depreciation by company w.e.f. 1st October is not proper.

AUDIT DOCUMENTATION

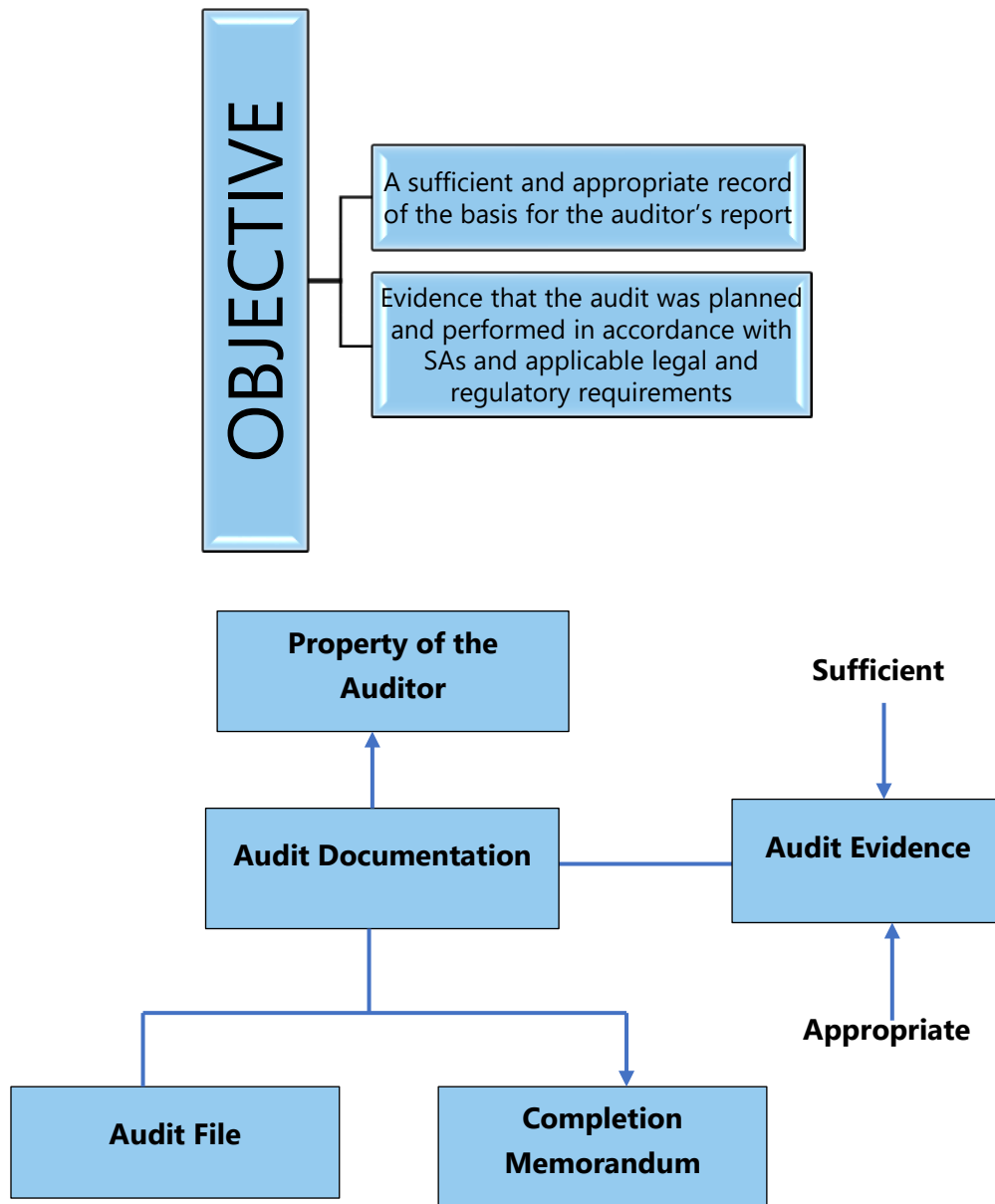


LEARNING OUTCOMES

After studying this chapter, you would be able to understand-

- ◆ Audit Documentation.
- ◆ Nature and purpose of audit documentation.
- ◆ Form, content and extent of audit documentation.
- ◆ Audit documentation summary.
- ◆ Audit file.
- ◆ Assembly of the final audit file.
- ◆ Ownership of audit documentation.
- ◆ Practicality of above concepts by studying through examples and case studies.

CHAPTER OVERVIEW



Sameer received a news alert on his mobile pointing to unconfirmed media reports of providing a Digi locker type facility to auditors for keeping audit documentation in times to come. He immediately grasped the idea as Aadhar card, senior secondary school mark sheet and driving license were being stored by him in such an electronic locker. "Such a facility, if it happened to materialize in future in whatever form, would provide many benefits which come with such an electronic storage", he pondered.

Audit evidence which an auditor obtains by performing various audit procedures along with details of those procedures have to be put into writing. Further, inferences drawn upon by the auditor from evidence obtained and conclusions reached are also documented. Sameer was spontaneously nodding that auditing was, indeed, a logical process.

Without proper documentation, an audit has no legs to stand upon. It is audit documentation which serves as a record of audit work performed. He was also mulling over that, in fact, audit documentation throws up a sort of protective shield around auditors. If an auditor plans and performs his work professionally, his working papers will come to his rescue, in case such a situation arises. Conclusions reached by him can be traced to his working papers.

"Oh! That is importance of documentation", he exclaimed. Now, he understood why Shekhar's seniors used to prompt him to make correspondence with company's officers on mail. Because, it is the documentation that makes the difference. They were right because consequences of not making proper documentation were known to them and poor guys like us were still on learning curve.



1. AUDIT DOCUMENTATION

SA 230 on "Audit Documentation", deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements. It is to be adapted as necessary in the circumstances when applied to audits of other historical financial information. The specific documentation requirements of other SAs do not limit the application of this SA. Laws or regulations may establish additional documentation requirements.

1.1 Definition of Audit Documentation

Audit Documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. (terms such as “working papers” or “work papers” are also sometimes used.)

record of audit procedures performed

relevant audit evidence obtained

conclusions the auditor reached

1.2 Objective of the Auditor

The objective of the auditor is to prepare documentation that provides:

- (a) A sufficient and appropriate record of the basis for the auditor’s report; and
- (b) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Objective of the Auditor

- To prepare documentation that provides:
 - a) A sufficient and appropriate record of the basis for the auditor’s report; and
 - b) Evidence that the audit was planned and performed in accordance with SAs.

1.3 Nature of Audit Documentation

Audit documentation provides:

- (a) evidence of the auditor’s basis for a conclusion about the achievement of the overall objectives of the auditor; and
- (b) evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

1.4 Purpose of Audit Documentation

The following are the purpose of Audit documentation:

1. Assisting the engagement team to plan and perform the audit.
2. Assisting members of the engagement team to direct and supervise the audit work, and to discharge their review responsibilities.
3. Enabling the engagement team to be accountable for its work.
4. Retaining a record of matters of continuing significance to future audits.
5. Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.
6. Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

ILLUSTRATION 1

A new team member of the auditors of Extremely Vibrant Limited was of the view that Audit Documentation does not help in planning the audit of any company. Explain whether Audit Documentation has any relation with regard to planning the audit of a company.

SOLUTION

Audit Documentation helps in planning the audit of a company in a proper manner and also helps in conducting the audit of that company in a more effective way.

1.5 Form, Content and Extent of Audit Documentation

- ◆ The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:
 - (a) The nature, timing and extent of the audit procedures performed.
 - (b) The results of the audit procedures performed and the audit evidence obtained and
 - (c) Significant matters arising during the audit and the conclusions reached thereon and significant professional judgements made in reaching those conclusions.

- ◆ Further in documenting the nature, timing and extent of audit procedures performed, the auditor shall record:
 - (a) The identifying characteristics of the specific items or matters tested.
 - (b) Who performed the audit work and the date such work was completed; and
 - (c) Who reviewed the audit work performed and the date and extent of such review.
- ◆ The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place.
- ◆ If the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency

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

1. The size and complexity of the entity.
2. The nature of the audit procedures to be performed.
3. The identified risks of material misstatement.
4. The significance of the audit evidence obtained.
5. The nature and extent of exceptions identified.
6. The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
7. The audit methodology and tools used.

1.6 Examples of Audit Documentation

Audit documentation may be recorded on paper or on electronic or other media.

Example

Audit Documentation include:

Audit programmes.

Analyses.

Issues memoranda.

Summaries of significant matters.

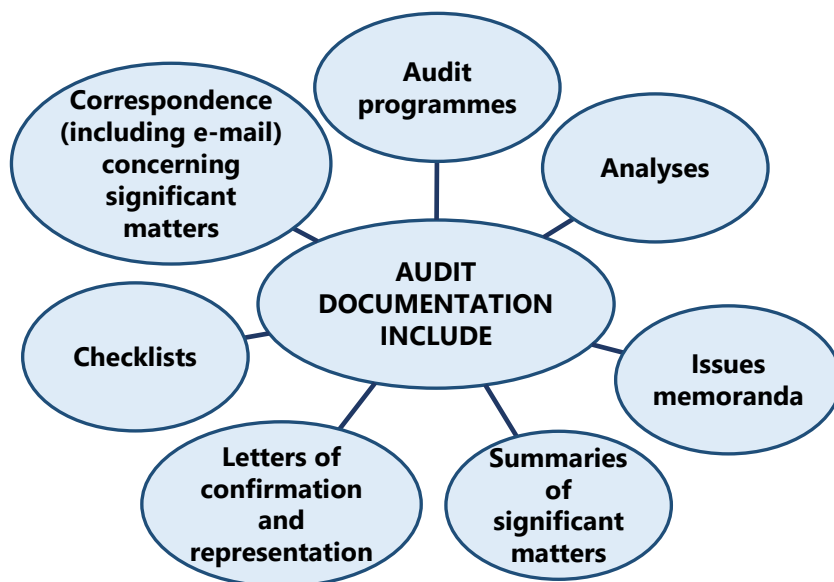
Letters of confirmation and representation.

Checklists.

Correspondence (including e-mail) concerning significant matters.

The auditor may include copies of the entity's records (**for example**, significant and specific contracts and agreements) as part of audit documentation. Audit documentation is not a substitute for the entity's accounting records.

The auditor need not include in audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.



1.7 Timely Preparation of Audit Documentation

The auditor shall prepare audit documentation on a timely basis. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalised. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

1.8 Audit File

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

one or more folders or other storage media

in physical or electronic form, containing the **record** that comprise

the audit documentation for a **specific engagement**

ILLUSTRATION 2

While auditing the books of accounts of Very Careful Limited for the financial year 2025-26, a team member of the auditors of Very Careful Limited was of the view that with regard to audit of the company, no relation exists between Audit File and Audit Documentation. Explain the relationship between Audit File and Audit Documentation.

SOLUTION

Audit file may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement. The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

1.9 Assembly of the Final Audit File

The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

- ◆ SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files.
- ◆ An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.
- ◆ Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.

Examples of such changes include:

- Deleting or discarding superseded documentation.
 - Sorting, collating and cross-referencing working papers.
 - Signing off on completion checklists relating to the file assembly process.
 - Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.
- ◆ After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.
 - ◆ SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements 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.

1.10 Documentation of Significant Matters and Related Significant Professional Judgements

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

Examples of significant matters include:

Matters that give rise to significant risks.

- ◆ Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
- ◆ Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- ◆ Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter Paragraph in the auditor's report.

An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgement exercised in performing the work and evaluating the results.

Documentation of the professional judgements made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgement.

Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits, when reviewing matters of continuing significance (**for example**, when performing a retrospective review of accounting estimates).

Some examples of circumstances in which it is appropriate to prepare audit documentation relating to the use of professional judgement include, where the matters and judgements are significant:

The rationale for the auditor's conclusion when a requirement provides that the auditor 'shall consider' certain information or factors, and that consideration is significant in the context of the particular engagement.

The basis for the auditor's conclusion on the reasonableness of areas of subjective judgements (for example, the reasonableness of significant accounting estimates).

The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

1.11 Completion Memorandum or Audit Documentation Summary

The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes-

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

Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist auditor's consideration of the significant matters. It may also help the auditor to consider whether there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

1.12 Ownership of Audit Documentation

- ◆ Standard on Quality Control (SQC) 1 provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor.
- ◆ He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

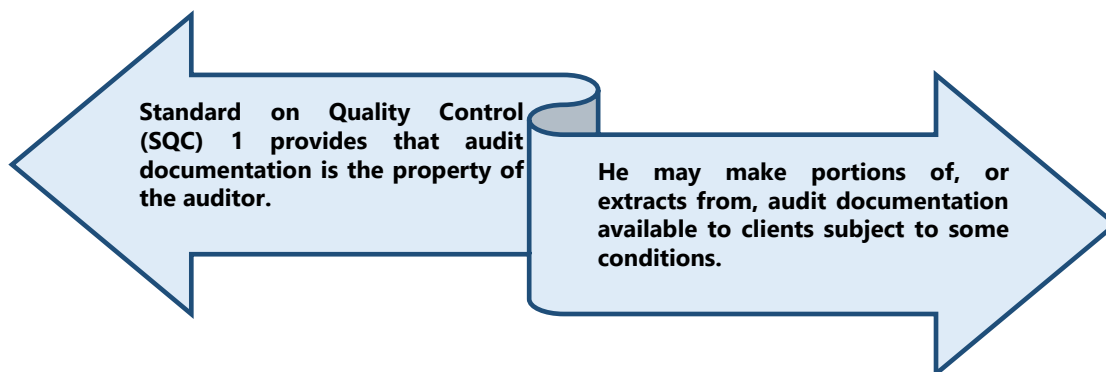


ILLUSTRATION 3

A director of Very Different Limited was of the view that Audit Documentation of a company is the property of that company. Comment on the contention of the director regarding the audit documentation of the company.

SOLUTION

Audit Documentation of a company is not the property of the company rather Audit Documentation is the property of Auditor of that company.

Test Your Understanding 1

During the course of audit of a company, an issue arose relating to treatment of interest costs of company on its restructured loans taken from a bank. This important matter was discussed with CFO of the company and was properly resolved. Is it necessary for the auditor to include in its working papers?

Test Your Understanding 2

CA Sonali Morarka has completed audit of a listed company. The audit report dated 15th July, 2025 has been issued. However, audit working papers including record of discussions with management, details of audit procedures performed to obtain audit evidence and conclusions reached by her have not been properly assembled. More than six months have elapsed after issue of audit report. Subsequently, she has received a letter from regulator in connection with audit of the company requesting her to share copy of audit file.

The letter has woken up her from deep slumber. She hurriedly assembled audit file and inserted some more papers which were necessary. However, she put current date on these inserted papers and the copy of audit file was sent to regulator. Discuss, the issues involved, in context of "audit documentation".

CASE STUDY

CA Rajan is heading the engagement team conducting audit of a company. While audit is in progress, consider following issues regarding audit documentation:-

- (A) Audit programme was prepared assigning responsibilities for different types of works to be performed to team members. The engagement team consists of 4 members Mohit (CA final student), Rohit (CA final student), CA Shobhit (employee) and CA Rajan (partner of audit firm).
- (B) The team has determined materiality for financial statements as a whole.
- (C) The team has assessed risks of material misstatements to be low.
- (D) CA Shobhit is responsible for attending inventory count process and putting down its documentation part.
- (E) During the course of audit, many related party transactions have come to notice.

On the basis of above, answer the following questions:

- (1) *Work relating to verification of revenue was assigned to Mohit in audit programme. However, it is being performed by Rohit actually. Verification of trade receivables was planned to be carried out by Rohit in audit programme. However, it being performed by CA Rajan due to last minute practical issues. Which of the following statements is most appropriate in this regard relating to audit documentation?*
 - (a) *Audit programme contains names of persons and work to be performed. It is immaterial whether work assigned to one person is performed by another person.*
 - (b) *Audit programme was already prepared. Only persons assigned specific responsibilities can perform those duties.*

- (c) *It is necessary that audit programme be suitably updated or notes are given in working papers to this effect so that planned duties are in accordance with actual work performance.*
 - (d) *Changes in audit programme or notes clarifying the matter are required only when a person not forming part of engagement team is deputed to perform a duty. Otherwise, this issue of inter-shuffling of team members is frivolous.*
- (2) *As regards materiality, which of the following statements is most appropriate in context of audit documentation?*
- (a) *Materiality has already been determined. There is no need to put it into working papers.*
 - (b) *Materiality depends upon professional judgment of auditor. Whatever amount has been determined can be documented in working papers.*
 - (c) *Materiality arrived on basis of professional judgment along with factors considered in the determination has to be documented.*
 - (d) *Materiality has been arrived upon professional judgment. It also depends upon professional judgment of auditor whether he wants to document it or not.*
- (3) *As regards team's assessment that risk of material misstatements is low, which of the following statements is odd one relating to documentation of risk?*
- (a) *Discussion amongst engagement team members and detail of significant decisions reached has to be documented.*
 - (b) *Details of risk assessment procedures have to be documented.*
 - (c) *Details about how understanding of each component of internal control was obtained has to be documented.*
 - (d) *Precise calculation of risk of material misstatements has to be documented.*

- (4) CA Shobhit is responsible for attending physical inventory count of the company. Which of the following is not true in this regard relating to audit documentation?
- (a) Dates on which physical inventory count process was attended by him should be documented. It may also include photographs of that date showing his attendance of inventory counting process at a particular location.
 - (b) Detail of test counting undertaken should form part of audit documentation.
 - (c) Detail of obsolete goods found should form part of audit documentation.
 - (d) Reports showing that stocks conform to quality control standards in accordance with law are essential part of audit documentation.
- (5) As regards related party transactions, which of the following should not be part of audit documentation?
- (a) Management representation letter in this regard.
 - (b) Related party transaction policy of the company.
 - (c) Documentation to show that such transactions are at arm's length basis.
 - (d) Documentation to show that such transactions are at close length basis.

Answers to Questions involving case study

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

SUMMARY

- ◆ SA 230 on "Audit Documentation", deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements.
- ◆ Audit documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. Terms such as "working papers" or "work papers" are also sometimes used.
- ◆ The objective of auditor is to prepare audit documentation that provides a sufficient and appropriate record of the basis for auditor's report and evidence that audit was planned and performed in accordance with Standards on Auditing and applicable legal and regulatory requirements.

- ◆ The form, content and extent of audit documentation depend on number of factors.
- ◆ Audit documentation may be recorded on paper or on electronic or other media.
- ◆ The auditor shall prepare audit documentation on a timely basis. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized.
- ◆ Audit file may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.
- ◆ The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.
- ◆ An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.
- ◆ After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.
- ◆ The retention period of documentation for audit engagements 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.
- ◆ Unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

For a concise revision of the key concepts covered in this chapter, students may refer to the **Saransh Booklet for Paper 5: Auditing and Ethics**, which serves as a useful last-mile revision resource for examination preparation.

Saransh Booklet can be accessed at <https://resource.cdn.icai.org/85998bos-aps751-int-p5.pdf>

TEST YOUR KNOWLEDGE

MCQs based Questions

- (1) Which of the following statement is appropriately suited to preparation of audit documentation?
 - (a) Audit documentation has to be prepared simultaneously as audit progresses.
 - (b) Audit documentation has to be prepared 60 days after date of audit report.
 - (c) Audit documentation has to be prepared when information is required by regulator.
 - (d) Audit documentation has to be prepared 60 days after completion of audit work.
- (2) Audit documentation is owned by: -
 - (a) Client
 - (b) Auditor
 - (c) Team member responsible for documentation
 - (d) Regulator
- (3) Which of the following is least likely to be included in audit documentation of a company engaged in manufacturing and export of goods?
 - (a) Previous years audited financial statements.
 - (b) Projected cash flow statement for next twelve months provided by management in support of going concern assumption.

- (c) *Statements showing dispatch of overseas consignments in accordance with delivery schedules of overseas buyers.*
 - (d) *Statement showing verification of ageing of trade receivables as on date of balance sheet.*
- (4) *Which of the following is false in relation to audit documentation when an external auditor relies upon work of internal auditor?*
- (a) *Evaluation of objectivity and competence of internal auditor has to be documented.*
 - (b) *Nature of work used and reason for relying upon work used forms part of documentation.*
 - (c) *Documentation on whether quality control is exercised in internal audit work forms part of audit documentation.*
 - (d) *Documentation on what specific recommendations were given by internal auditor for risk assessment to external auditor forms part of audit documentation.*

Theoretical Questions

1. *The form, content and extent of audit documentation depends upon number of factors. List out any four such factors.*
2. *Discuss any two purposes of audit documentation.*
3. *Define audit documentation. Also give some examples.*
4. *"Audit documentation summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits". Explain.*
5. *CA N, statutory auditor of QST Limited, appointed for a term of 5 years has completed audit for the first financial year ending on 31st March 2026. In compliance with requirements of professional standards, an audit file has been assembled. After about a period of six months from date of issue of audit report, he gets a call from CFO of the company to share complete audit file so that financial reporting of company can be improved upon in coming periods. Is it mandatory for statutory auditors to share audit files with client? What are the requirements for making audit documentation available to clients?*

6. CA Shilpi, the engagement partner at MN Associates, is assigned the audit of following two companies:
- Zed Ltd., a small family-run business with straightforward operations, minimal internal controls, and low transaction volume.
 - Ted Ltd., a large multinational corporation with complex operations, multiple subsidiaries, high transaction volumes.

During the audit planning stage, CA Shilpi highlights that the form, content, and extent of audit documentation must be customised for each client based on specific factors. Discuss those factors on which form, content, and extent of audit documentation depends.

7. CA Piku has prepared audit documentation of an entity describing nature, timing and extent of audit procedures performed during the course of audit. In documenting nature, time and extent of audit procedures performed, which matters shall be recorded? He is also of the view that such documentation alone as described above meets requirements of Standards on Auditing. Comment upon validity of his views.
8. CA Ripun completed the audit of a listed company, and the audit report was issued on July 17th, 2026. However, he had not properly organized the audit working papers, including records of discussions with management, audit procedures performed, and conclusions reached. More than six months after issuing the report, he received a letter from the regulator in connection with audit of the company requesting him to share copy of audit file. In a hurry, CA Ripun quickly assembled the audit file, adding some papers he thought were necessary, but he used the current date on these newly added documents. He then sent the audit file to the regulator. Discuss the issues involved related to "audit documentation" and assembling of the final audit file in this case.
9. M/s BPA & Associates, Chartered Accountants, was appointed as the auditors of Nissan Ltd., a company with PAN-India presence, for the financial year 2025-26. The audit report was issued on August 20, 2026. Following the issuance of audit report, CA P instructed junior team member Mr. Y to assemble the final audit file and prepare the Completion Memorandum.
- (i) Explain the meaning and significance of a Completion Memorandum.

(ii) *Team Member Y completed the assembly of the final audit file in March 2026 and handed it over to CA P. Was team member Y correct in his approach?*

10. *Takur and Co, Chartered Accountants were conducting an audit of an LLP. They have verified the Receivables and concluded that all the Receivables are genuine and recoverable. However, before the final completion of the audit, the auditors came to know of severe financial crisis of one of the Receivables, M/s. Raj Enterprises, whose outstanding account balance was material to the overall Receivables figure as on the date of financial statements. CA Takur had discussions with the appropriate level of management to address the issue, and the management finally agreed to make provision for the same, as suggested by the auditor.*

You are required to -

- (i) *Ensure how the auditor can fulfil the "Documentation" part of this matter.*
(ii) *Mention any four different examples of "Audit Documentation".*

11. *Mr. Uttam, an articled clerk at RQP & Associates, is auditing AB Pharma Ltd. and has collected various papers and documents during the course of the audit. However, he is unsure about which of these papers and documents should be maintained as part of audit documentation and which should not be included. Later, AB Pharma Ltd. has also requested certain audit documentation from RQP & Associates. Advise him –*

Which items need not to be included in the audit documentation?

Whether RQP & Associates is obliged to provide their audit documentation to the client?

12. *During the audit of a manufacturing company, the engagement team encountered several complex areas requiring careful evaluation. The audit senior reminded the team that matters involving higher judgement must be documented more thoroughly.*

An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgement exercised in performing the work and evaluating the results. Explain, stating clearly the examples of significant matters (referring SA 230).

13. *FSY & Co., Chartered Accountants, completed the statutory audit of HIMMAT Ltd. for the year ended 31st March 2026. The audit partner instructed the audit team to finalize and assemble the audit documentation immediately after signing the auditor's report on 15th September 2026. However, audit team took this instruction lightly and forgot to assemble the audit documentation. After six months, audit team started assembling the file and completed its documentation. When audit partner became aware of this, he called a meeting of staff and discussed policies and procedures for timely completion of audit files, changes to audit documentation and period of retention of engagement documentation.*

Explain various points discussed by audit partner with reference to relevant standard on auditing.

14. *ABC & Co., Chartered Accountants is conducting the statutory audit of a listed company having multiple locations and a large engagement team. The audit involves extensive planning, supervision, review of work performed by assistants and is also subject to quality control review by the firm as well as possible inspection by regulatory authorities.*

During the audit, the engagement partner emphasises the need for proper and comprehensive audit documentation.

With reference to above, explain the purpose served by audit documentation for the auditor and the engagement team.

15. *Bee Ltd. is a listed manufacturing company. The statutory auditor, CA P, conducted the audit of the financial statements for the year ended 31st March 2026*

During the course of audit, CA P and his audit team performed various audit procedures relating to revenue recognition, inventory valuation and verification of fixed assets. However, while reviewing the audit files, it was observed that the working papers prepared by the audit team were incomplete and lacked clear documentation explaining the basis for certain conclusions reached by the auditor.

A junior member of the audit team questioned CA P regarding the purpose and objective of maintaining proper audit documentation and how such documentation supports the auditor's report and compliance with auditing standards.

In context of the above, explain the objective of the auditor in preparing audit documentation and describe the nature of audit documentation as per the relevant Standards on Auditing.

16. *CA B, an auditor, after the completion of busy audit season, was occupied in assembling of final audit files of one of his client. First of all, he started preparing various documents of that client and then kept those documents in various folders. He was preparing documents as well as audit file in paper form because he believed that it is mandatory. He could complete documentation as well as assembling of final audit file of that client after three months from the date of audit report. Generally, he retains audit file of the clients for 4 years from the date of audit report. Check the validity of the action of CA B.*

ANSWERS/ SOLUTIONS

Answers to the MCQs based Questions

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

Answers to Theoretical Questions

1. Refer to heading "Form, content and extent of audit documentation" described in Para 1.5
2. Refer to heading "Purpose of audit documentation" described in Para 1.4
3. Audit Documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. (terms such as "working papers" or "work papers" are also sometimes used.)
Refer Heading – Examples of Audit Documentation described in Para 1.6.
4. Refer Heading – Completion Memorandum or Audit Documentation Summary described in Para 1.11.

5. Standard on Quality Control 1 (SQC 1), "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. Therefore, it is not mandatory for CA N to share audit file with client.

He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

6. Refer to heading Form, Content and Extent of Audit Documentation in Para 1.5
7. In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:
- (a) The identifying characteristics of the specific items or matters tested.
 - (b) Who performed the audit work and the date such work was completed; and
 - (c) Who reviewed the audit work performed and the date and extent of such review.

The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

- (a) The nature, timing and extent of the audit procedures performed.
- (b) The results of the audit procedures performed, and the audit evidence obtained; and
- (c) Significant matters arising during the audit and the conclusions reached thereon and significant professional judgements made in reaching those conclusions.

Thus, all above matters shall be recorded to meet requirements of SA 230. Documenting nature, time and extent of audit procedures performed alone does not meet the requirements of SA 230. Therefore, CA Piku's views are not valid.

8. The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

SQC 1, "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files.

An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.

Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.

Further, preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

In the given case, even after passage of more than six months, CA Ripun has not assembled an audit file. Besides, he has put in some papers with the current date which is not permissible at all. It shows that part of the audit documentation has been prepared afterwards putting a question mark on the quality of audit.

9. (i) **Meaning and Significance of Completion Memorandum:** Refer Heading – Completion Memorandum or Audit Documentation Summary described in Para 1.11.
- (ii) **Assembly of the Final Audit File:** As per SQC 1, "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", the auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. An appropriate time limit

within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.

In the given case, the audit report was issued on August 20, 2026 and CA P instructed team member Mr. Y to assemble the final audit file and to prepare completion memorandum. However, Mr. Y completed the assembly of the final audit file in the month of March 2026, i.e. more than 60 days, is non-compliance of SQC 1. Thus, the approach of team member Y is not correct.

- 10.** The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place.

If the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency.

Considering the above, the auditor shall document the minutes of the discussions with the management, regarding the financial crisis of M/s Raj enterprises, the matters discussed, the persons representing the management and the auditor, the amount recommended for provision by the auditor and the amount of provision finally accepted and provided by the management and any other relevant data in support of the same.

- 11.** Items which need not be included in audit documentation: As per SA 230, "Audit Documentation", the auditor need not include in audit documentation -
1. Superseded drafts of working papers and financial statements
 2. Notes that reflect incomplete or preliminary thinking.
 3. Previous copies of documents corrected for typographical or other errors
 4. Duplicates of documents.

Whether RQP & Associates is obliged to provide audit documentation to the client: As per Standard on Quality Control (SQC) 1, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. The auditor is not obliged to provide audit documentation to the client. However, he may, at his discretion, make portions of, or extracts from, audit

documentation available to clients, provided such disclosure does not undermine the validity of the work performed or, in the case of assurance engagements, the independence of the auditor or of his personnel.

Thus, RQP & Associates is not obliged to provide audit documentation to AB Pharma Ltd., since such documentation is the property of the auditor; however, at its discretion, limited extracts may be shared provided such disclosure does not impair audit validity or auditor independence.

12. Examples of significant matters described in Para 1.10
13. As per SA 230, "Audit Documentation", the auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

SQC 1, "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files.

An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.

Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.

Examples of such changes include:

- Deleting or discarding superseded documentation.
- Sorting, collating and cross-referencing working papers.
- Signing off on completion checklists relating to the file assembly process.
- Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.

SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements 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.

- 14.** Refer to heading "Purpose of audit documentation" described in Para 1.4

Thus, in the given case, audit documentation supports effective audit planning, supervision, accountability, and compliance with quality control and regulatory inspection requirements.

- 15.** Refer Objective of the Auditor described in Para 1.2 and Nature of Audit Documentation described in Para 1.3.

Therefore, in the given case, CA P is required to ensure that the audit working papers properly document the procedures performed, evidence obtained and conclusions reached. Proper audit documentation enables the auditor to support the auditor's report and demonstrate that the audit was conducted in accordance with the Standards on Auditing and applicable legal and regulatory requirements.

- 16. Assembly of the Final Audit File:** Audit documentation may be recorded on paper or on electronic or other media. Audit file may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement. Hence the views of CA B that audit documentation should be maintained mandatorily in paper form is not correct.

The auditor shall prepare audit documentation on timely basis. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed. Completing the audit Documentation by CA B not on timely basis is not proper.

An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's

report. In the given situation, CA. B, after completion of audit season, is completing the audit file as well as assembling of final audit files of his client after three months of the date of audit report which is not valid as per SQC 1.

SQC 1 "Quality Control for Firms that perform Audits and Reviews of Historical Financial Information, and other Assurance and Related Services Engagements", requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements 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. He retains audit file of the client for 4 years from the date of audit report is also non-compliance of SQC 1.

Answers to Questions involving Test your Understanding

- (1) The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place.

In the instant case, an important matter regarding treatment of interest costs of company on its restructured loans taken from a bank directly impacting profits of the company was discussed. Although issue was resolved, it is necessary to document the same by including detail of the person with whom discussions took place along with date.

- (2) An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.

Further, preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

In the given case, even after passage of more than six months, she has not assembled audit file. Besides, she has put in some papers with current date which is not permissible at all. It shows that part of audit documentation has been prepared afterwards putting a question mark on quality of audit.

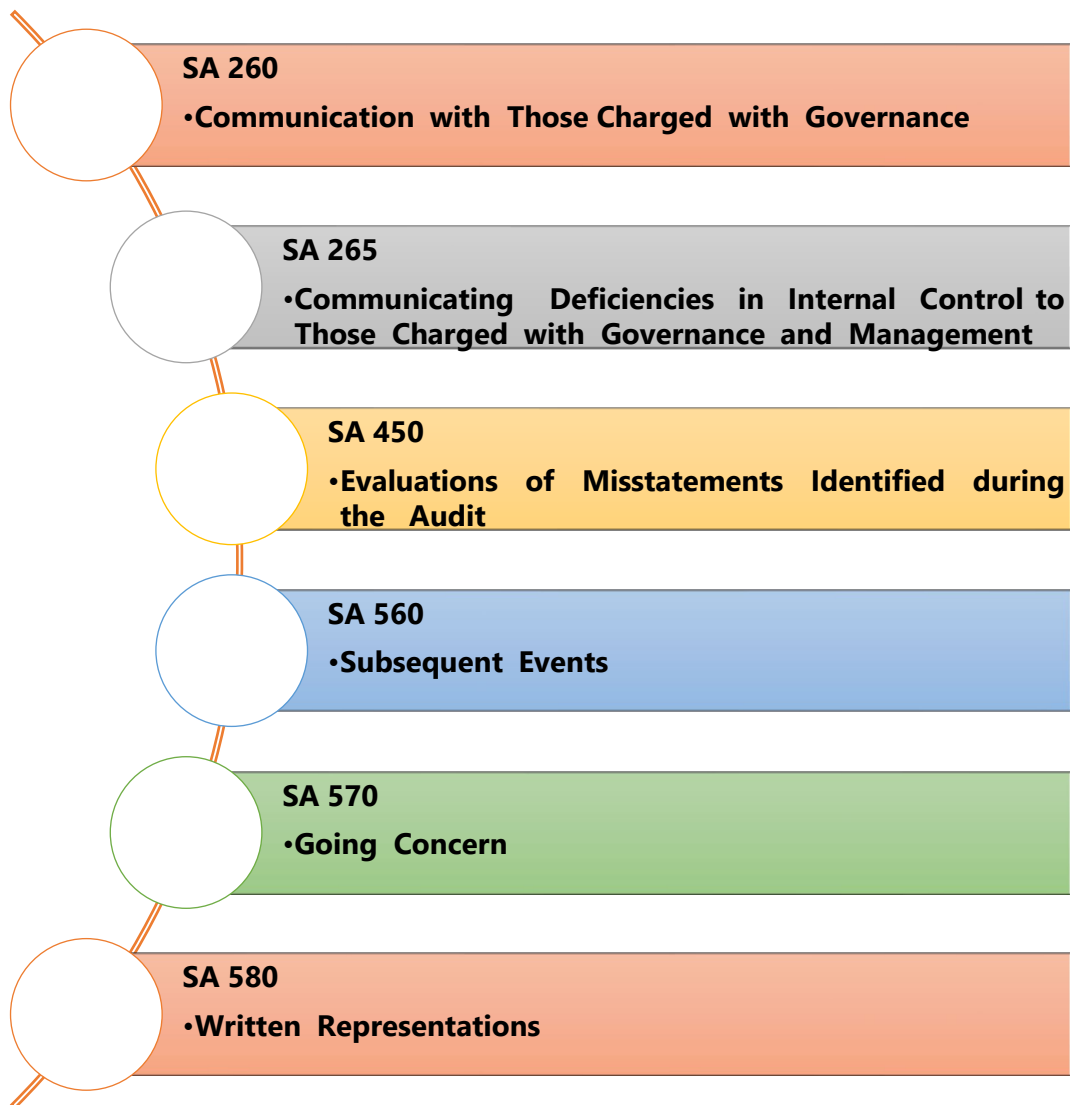
COMPLETION AND REVIEW



LEARNING OUTCOMES

After studying this chapter, you would be able to understand-

- ◆ Meaning of “Subsequent Events”
- ◆ SA 560- Subsequent Events
- ◆ Meaning of “Going Concern” and its significance
- ◆ SA 570- Going Concern
- ◆ SA 450- Evaluation of misstatements identified during the audit
- ◆ Meaning of Written representations
- ◆ SA 580-Written representations
- ◆ Significance of Communication with Those charged with governance
- ◆ Overview of SA 260 -concerning Communication with Those charged with governance
- ◆ Necessity of communication of significant deficiencies in internal control
- ◆ Overview of SA 265- Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
- ◆ Practicality of above concepts using examples and case studies.

CHAPTER OVERVIEW

Excited as he was, to know outcome of audit his friend Shekhar was part of, Sameer called him up one day. He came to know that substantive procedures have already been performed and audit is in its last leg of completion. A question arose in his mind. Is something more to be done? Are there still some procedures left to be performed?

It is in this context, he came to know about "Subsequent events". He was under the impression that audit is concerned only with events occurring up to date of financial statements. However, he rued his elementary understanding. Not only auditor is concerned with events occurring up to date of financial statements, he has also to deal with effects of events occurring up to date of auditor's report. Even after signing audit report, if auditor becomes aware of certain facts, he has to take necessary steps in certain situations. What are those steps and situations?

Apart from this, auditor has to assess whether use of *going concern assumption* by management in preparation of financial statements is appropriate. Applying his accountancy knowledge of AS 1, he remembered that it is one of the three fundamental accounting assumptions. It means that an enterprise will continue to be in business in foreseeable future. It is the basic assumption which affects how financial statements of an enterprise are prepared. Wow! That is why it is so important for auditors.

He was also considering whether misstatements found during audit have to be informed to the management first. Why it is necessary to do so? The reason behind it must be to provide an opportunity to management to correct those misstatements. Another reason could be of judging response of management to such misstatements. Something new may come to knowledge of auditors before he forms opinion and signs on dotted lines.

Remembering that audit suffers from inherent limitations, he knew that audit procedures are not completely fool-proof. An auditor may falter due to limitations of procedures themselves or due to their faulty selection. In such a case, how can auditor be sure of everything, of completeness of information, of recording of all transactions? That is where written representations come in the picture.

He has understood now reason for lull period in the audit and why an auditor takes time to sign report.

There are still procedures to be performed by auditor after completion of substantive procedures involving detailed checking. An auditor has to deal with effect of subsequent events. He has to obtain sufficient appropriate evidence regarding appropriateness of use by management of going concern assumption in preparation of financial statements. Misstatements identified during audit have to be evaluated and communicated. Communication regarding significant audit findings and other matters is made to those charged with governance. Written representations are obtained. All such procedures are performed before signing of audit report.

1. 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 are known as subsequent events.

Consider case of a company which may have planned an agreement to merge between the date of the financial statements and the date of the auditor's report. Or a fire claim amount of an entity receivable from insurance company as on date of financial statements may have been settled at a reduced amount before date of auditor's report. These are some of the examples of subsequent events.

Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Such financial reporting frameworks ordinarily identify two types of events: -

- (a) Those that provide evidence of conditions that existed at the date of the financial statements and
- (b) Those that provide evidence of conditions that arose after the date of the financial statements.

Examples of events providing evidence of conditions that existed at the date of the financial statements

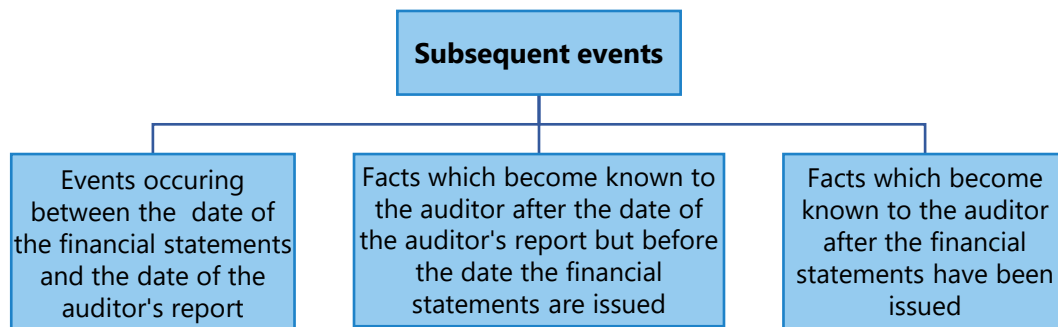
- Declaration of insolvency of a major debtor of the entity between the date of financial statements and the date of auditor's report providing evidence on

the recoverability of the money due from debtor as on date of the financial statements.

- Settling a legal claim outside the court at a reduced amount between the date of financial statements and the date of auditor's report for which provision has already been made in financial statements. It provides evidence on adjustment in provision amount already made in financial statements, if any.

Examples of events providing evidence of conditions that arose after the date of the financial statements

- Issue of new share capital.
- Planned merger of the company.
- Destruction of substantial inventories due to fire between the date of the financial statements and the date of auditor's report.



1.1 SA 560 Subsequent Events

SA 560 deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements.

1.2 Objectives of auditor in accordance with SA 560

The objectives of the auditor are to: -

- (a) 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 and

- (b) Respond appropriately to 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.

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

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. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following: -

- (a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
- (b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.
- (c) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.
- (d) Reading the entity's latest subsequent interim financial statements, if any.

Such information may also be obtained by auditor from accounting records pertaining to period after date of financial statements, reading entity's latest available budgets etc.

When, as a result of the procedures performed, the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements.

The auditor shall request management and, where appropriate, those charged with governance, to provide a written representation in accordance with SA 580, "Written Representations" that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

Meaning of "Date the financial statements are issued"

It reflects the date that *the auditor's report and audited financial statements are made available to third parties*. The date the financial statements are issued generally depends on the regulatory environment of the entity. In some circumstances, the date the financial statements are issued may be the date that they are filed with a regulatory authority. Since audited financial statements cannot be issued without an auditor's report, the date that the audited financial statements are issued must not only be at or later than the date of the auditor's report, but must also be at or later than the date the auditor's report is provided to the entity.

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

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:

- (a) Discuss the matter with management and, where appropriate, those charged with governance.
- (b) Determine whether the financial statements need amendment and, if so,
- (c) Inquire how management intends to address the matter in the financial statements.

If management amends the financial statements, the auditor shall:

- (a) Carry out the audit procedures necessary in the circumstances on the amendment.
- (b) Unless the circumstances in succeeding para apply: -
 - (i) Extend the audit procedures, already referred, to the date of the new auditor's report and
 - (ii) Provide a new auditor's report on the amended financial statements.

The new auditor's report shall not be dated earlier than the date of approval of the amended financial statements.

When law, regulation or the financial reporting framework does not prohibit management from restricting the amendment of the financial statements to the effects of the subsequent events or events causing that amendments and those responsible for approving the financial statements are not prohibited from restricting their approval to that amendment, the auditor is permitted to restrict the audit procedures on subsequent events to that amendment. In such cases, the auditor shall either: -

- (a) Amend the auditor's report to include an additional date restricted to that amendment that thereby indicates that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements described in the relevant note to the financial statements or
- (b) Provide a new or amended auditor's report that includes a statement in an Emphasis of Matter paragraph or Other Matter(s) paragraph that conveys that auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.

In some entities, management may not be required by the applicable law, regulation or the financial reporting framework to issue amended financial statements and, accordingly, the auditor need not provide an amended or new auditor's report. However, when management does not amend the financial statements in circumstances where the auditor believes they need to be amended, then: -

- (a) If the auditor's report has not yet been provided to the entity, the auditor shall modify the opinion as required by SA 705 and then provide the auditor's report or
- (b) If the auditor's report has already been provided to the entity, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity, those charged with governance, not to issue the financial statements to third parties before the necessary amendments have been made. If the financial statements are nevertheless subsequently issued without the necessary amendments, the auditor shall take appropriate action, to seek to prevent reliance on the auditor's report.

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

After the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements. However, when, after the financial statements have been 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: -

- (a) Discuss the matter with management and, where appropriate, those charged with governance.
- (b) Determine whether the financial statements need amendment and, if so,
- (c) Inquire how management intends to address the matter in the financial statements.

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

- (a) Carry out the audit procedures necessary in the circumstances on the amendment.
- (b) Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation.
- (c) Unless such circumstances when law, regulation or the financial reporting framework does not prohibit management from restricting the amendment

of the financial statements to the effects of the subsequent events or events causing that amendments and those responsible for approving the financial statements are not prohibited from restricting their approval to that amendment apply: -

- (i) Extend the audit procedures, already referred, to the date of the new auditor's report, and the date the new auditor's report no earlier than the date of approval of the amended financial statements and
 - (ii) Provide a new auditor's report on the amended financial statements.
- (d) When the circumstances are such that law, regulation or the financial reporting framework does not prohibit management from restricting the amendment of the financial statements to the effects of the subsequent events or events causing that amendments and those responsible for approving the financial statements are not prohibited from restricting their approval to that amendment, amend the auditor's report, or provide a new auditor's report as already discussed.

The auditor shall include in the new or amended auditor's report an Emphasis of Matter paragraph or Other Matter(s) paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided by the auditor.

If management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation and does not amend the financial statements in circumstances where the auditor believes they need to be amended, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity, those charged with governance, that the auditor will seek to prevent future reliance on the auditor's report.

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

(A) Overview of auditor's responsibilities regarding subsequent events between the date of the financial statements and the date of the auditor's report

Checkbox	Auditor's responsibilities regarding subsequent events
✓	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.
✓	If such subsequent events that require adjustment of, or disclosure in, the financial statements have been identified, it shall be determined whether each such event is appropriately reflected in those financial statements.
✓	Obtain a written representation from management or those charged with governance that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

(B) Overview of auditor's responsibilities after the date of the auditor's report but before the date the financial statements are issued

Checkbox	Auditor's responsibilities after the date of the auditor's report but before the date the financial statements are issued
✓	No obligation for auditor 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, determine if financial statements need amendment.

✓	If management amends financial statements, carry out audit procedures on amendment and extend the procedures to date of new audit report and provide new auditor's report on amended financial statements.
✓	When management does not amend the financial statements in circumstances where the auditor believes they need to be amended and auditor's report has not been provided to the entity, the auditor shall modify the opinion as required by SA 705 and then provide the auditor's report.
✓	If the auditor's report has already been provided to the entity, the auditor shall notify management not to issue the financial statements to third parties before the necessary amendments have been made. If the financial statements are nevertheless subsequently issued without the necessary amendments, the auditor shall take appropriate action, to seek to prevent reliance on the auditor's report.

(C) Overview of auditor's responsibilities after the financial statements have been issued

Checkbox	Auditor's responsibilities after the financial statements have been issued
✓	No obligation to perform any audit procedures regarding financial statements after the financial statements have been issued. However, after financial statements have been 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, determine if financial statements need amendment.
✓	If the management amends the financial statements, the auditor shall carry out the audit procedures necessary in the circumstances on the amendment.
✓	Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation. Extend the audit procedures, already referred, to the date of the new auditor's report and provide a new auditor's report on the amended financial statements.

✓	Include in the new auditor's report an Emphasis of Matter paragraph or Other Matter(s) paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided by the auditor.
✓	If management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation and does not amend the financial statements in circumstances where the auditor believes they need to be amended, the auditor shall notify management that the auditor will seek to prevent future reliance on the auditor's report. If, despite such notification, management or those charged with governance do not take these necessary steps, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report.

Test Your Understanding 1

CA PK Jacob is conducting audit of a company for year 2025-26. The company is engaged in export of ethnic rugs to buyers in Europe. The audit is nearing completion in month of July 2026. However, it becomes known to the auditor that one of overseas buyers has made a legal claim against the company on 1st June 2026 for injury caused to a customer of one European buyer due to sub-standard dyes used in rugs of one lot of order shipped in August, 2026. The management of company has decided to agree to an out of court settlement of ₹ 5 crore to protect its reputation. The financial statements of the company are silent on this issue.

Discuss, how, CA PK Jacob should proceed to deal with above issue.

Test Your Understanding 2

CA Chandni Khanna is going to complete audit of a company within next few days. She has performed necessary audit procedures like inquiry of management personnel, reading minutes of meetings held after date of financial statements, going through books of accounts after date of financial statements to make sure that all subsequent events before signing audit report have been considered by her. Still, she wants to be certain that no such events have been left out. What she should do in such a situation? Also, discuss the rationale of doing so.



2. MEANING OF GOING CONCERN AND ITS SIGNIFICANCE

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.

Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. General purpose financial statements are prepared 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.

The significance of **Going Concern** is due to its effect on preparation of financial statements. Ability or otherwise of an enterprise to be viewed as going concern affects its preparation of financial statements.

When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

When an enterprise is not viewed as a going concern, the financial statements are prepared on liquidation basis. For example, inventories may need to be written down as these may be sold for a lower price. Assets may have to be recorded at the likely prices they will fetch.

2.1 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.

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

The preparation of the financial statements requires management to assess the entity's ability to continue as a going concern even if the financial reporting framework does not include an explicit requirement to do so. Management's

assessment of the entity's ability to continue as a going concern involves making a judgment, at a particular point in time, about inherently uncertain future outcomes of events or conditions. The following factors are relevant to that judgment: -

- The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs.
- The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors affect the judgment regarding the outcome of events or conditions.
- Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made.

2.3 Responsibilities of the auditor

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. These responsibilities exist even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.

However, as described in SA 200, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. The auditor cannot predict such future events or conditions. Accordingly, the absence of any reference to a material uncertainty about the entity's ability to continue as a going concern in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

2.4 Objectives of auditor in accordance with SA 570

The objectives of the auditor are: -

- (a) 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;
- (b) To conclude, 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; and
- (c) To report in accordance with this SA.

OBJECTIVES

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;

To conclude, 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; and

To report in accordance with this SA.

2.5 Risk assessment procedures and related activities

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 as a going concern. In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern and: -

- (a) If such an assessment has been performed, the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern and, if so, management's plans to address them or

- (b) If such an assessment has not yet been performed, the auditor shall discuss with management the basis for the intended use of the going concern basis of accounting, and inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

The auditor shall remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

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

The following are examples of events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern

Financial events or conditions

- Net liability or net current liability position
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets
- Indications of withdrawal of financial support by creditors
- Negative operating cash flows indicated by historical or prospective financial statements
- Adverse key financial ratios
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows
- Arrears or discontinuance of dividends
- Inability to pay creditors on due dates
- Inability to comply with the terms of loan agreements
- Change from credit to cash-on-delivery transactions with suppliers
- Inability to obtain financing for essential new product development or other essential investments

Operating events or conditions

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

Other events or conditions

- Non-compliance with capital or other statutory or regulatory requirements, such as solvency or liquidity requirements for financial institutions
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy
- Changes in law or regulation or government policy expected to adversely affect the entity
- Uninsured or underinsured catastrophes when they occur

2.6 Evaluating management's assessment

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.

It is not the auditor's responsibility to rectify the lack of analysis by management. In some circumstances, however, the lack of detailed analysis by management to support its assessment may not prevent the auditor from concluding whether management's use of the going concern basis of accounting is appropriate in the circumstances.

For example, when there is a history of profitable operations and a ready access to financial resources, management may make its assessment without detailed

analysis. In this case, the auditor's evaluation of the appropriateness of management's assessment may be made without performing detailed evaluation procedures if the auditor's other audit procedures are sufficient to enable the auditor to conclude whether management's use of the going concern basis of accounting in the preparation of the financial statements is appropriate in the circumstances.

In other circumstances, evaluating management's assessment of the entity's ability to continue as a going concern, may include an evaluation of the process management followed to make its assessment, the assumptions on which the assessment is based and management's plans for future action and whether management's plans are feasible in the circumstances.

In evaluating management's assessment of the entity's ability to continue as a going concern, the auditor shall cover the same period as that used by management to make its assessment as required by the applicable financial reporting framework, or by law or regulation if it specifies a longer period. If management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the date of the financial statements, the auditor shall request management to extend its assessment period to at least twelve months from that date.

2.7 Additional audit procedures when events or conditions are identified

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. These procedures shall include: -

- (a) 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.

- (b) Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.
- (c) Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future actions:
 - (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.
- (d) Considering whether any additional facts or information have become available since the date on which management made its assessment.
- (e) Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans.

Examples of audit procedures when events or conditions have been identified that may cast significant doubt on the entity's ability to continue as going concern

- Analysing and discussing cash flow, profit and other relevant forecasts with management
- Analysing and discussing the entity's latest available interim financial statements
- Reading the terms of debentures and loan agreements and determining whether any have been breached
- Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties
- Inquiring of the entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications

- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds
- Evaluating the entity's plans to deal with unfilled customer orders
- Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern
- Confirming the existence, terms and adequacy of borrowing facilities
- Obtaining and reviewing reports of regulatory actions
- Determining the adequacy of support for any planned disposals of assets

2.8 Auditor's conclusions

The auditor shall evaluate whether sufficient appropriate audit evidence has been obtained regarding, and shall conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements. Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor's judgment, a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary.

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

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: -

- (a) 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

- (b) 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.

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

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern but, based on the audit evidence obtained the auditor concludes that no material uncertainty exists, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosures about these events or conditions.

2.11 Implications for the auditor's report

(I) If use of Going concern basis of accounting is inappropriate

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

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

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: -

- (a) Draw attention to the note in the financial statements that discloses such matters.
- (b) 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.

(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:

- (a) Express a ***qualified opinion or adverse opinion***, as appropriate, in accordance with SA 705.
- (b) 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.

(III) 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. In such a situation, ***a qualified opinion or a disclaimer of opinion*** in the auditor's report may be appropriate, because it may not be possible for the auditor to obtain sufficient appropriate audit evidence regarding management's use of the going concern basis of accounting in the preparation of the financial statements.

Overview of auditor's responsibilities regarding Going Concern

Checkbox	Auditor's responsibilities regarding going concern
✓	Obtain sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements.
✓	Conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.
✓	Report in accordance with SA 570.

Test Your Understanding 3

During course of audit of a company, CA. Varun Aggarwal notices that company is facing significant skilled labour shortages resulting in hampering of operations of company. The company's manufacturing is dependent upon skilled labour coming from villages in certain districts of Eastern UP. However, due to job opportunities available near villages now, many are not interested in going out from their native villages.

Such a situation has led to company not being able to keep its commitments, losing out on orders and fall in its revenues. Fixed costs of the company remain at a high level. As a result, company is facing a liquidity crunch and is not able to pay its creditors on time. The bankers of company are also not willing to help the company to tide over liquidity crisis. The auditor is having doubts over going concern status of the company.

How should management of the company try to address auditor's concerns? What audit procedures may be performed by auditor in such a situation?



3. EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT

Before forming an opinion on the financial statements, the auditor evaluates effects of identified misstatements on the audit and of uncorrected misstatements on financial statements after consideration of materiality. Uncorrected misstatements refer to those misstatements that the auditor has accumulated during the audit and that have not been corrected.

3.1 SA 450 Evaluation of Misstatements Identified during the Audit

SA 450 deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

3.2 Objectives of auditor in accordance with SA 450

The objective of the auditor is to evaluate: -

- (a) The effect of identified misstatements on the audit and
- (b) The effect of uncorrected misstatements, if any, on the financial statements.

3.3 Accumulation of misstatements identified during the audit

The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial. A misstatement may arise from a variety of factors. **For example**, an inaccuracy in gathering or processing data from which financial statements are prepared or an omission of an amount or disclosure can result into a misstatement.

An entity has wrongly capitalized machinery repair expenses amounting to Rs.5 lacs resulting in overstatement of profits. It is an example of misstatement.

3.4 Consideration of identified misstatements as the audit progresses

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

- (a) The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material or
- (b) The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320.

The auditor may request management to examine a class of transactions, account balance or disclosure in order for management to understand the cause of a misstatement identified by the auditor, perform procedures to determine the amount of the actual misstatement in the class of transactions, account balance or disclosure, and to make appropriate adjustments to the financial statements. Such a request may be made, for example, based on the auditor's projection of misstatements.

If, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected, the auditor shall perform additional audit procedures to determine whether misstatements remain.

3.5 Communication and correction of misstatements

The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation. The auditor shall request management to correct those misstatements. Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the items are misstatements, inform the auditor if it disagrees and take action as necessary.

The correction by management of all misstatements, including those communicated by the auditor, enables management to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.

If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

3.6 Evaluating the effect of uncorrected misstatements

Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with SA 320 to confirm whether it remains appropriate in the context of the entity's actual financial results.

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

- (a) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence and

- (b) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

3.7 Communication with those charged with governance

The auditor shall communicate with those charged with governance regarding uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected.

The auditor shall also communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

3.8 Written Representation from management regarding effects of uncorrected statements

The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation.

3.9 Documentation regarding misstatements identified during audit

The audit documentation shall include: -

- (a) The amount below which misstatements would be regarded as clearly trivial;
- (b) All misstatements accumulated during the audit and whether they have been corrected; and
- (c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion.

Overview of auditor's responsibilities regarding evaluation of misstatements identified during the audit

Checkbox	Auditor's responsibilities regarding evaluation of misstatements identified during the audit
✓	Accumulate misstatements identified during the audit other than those that are clearly trivial.
✓	Consider if the above process indicates that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material or the aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320.
✓	If so, consider if revision is necessary in audit strategy and plan.
✓	Communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management and request for correction of all misstatements.
✓	Upon management refusal to correct some or all of the misstatements communicated, obtain an understanding of management's reasons for not making the corrections and consider the same at time of evaluating whether the financial statements as a whole are free from material misstatement.
✓	In case of failure of management to correct all of the misstatements, reassess materiality to confirm whether it remains appropriate in the context of the entity's actual financial results.
✓	Determine whether uncorrected misstatements are material, individually or in aggregate.
✓	Communicate with those charged with governance regarding uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report.
✓	Request written representation from management that they believe that effects of uncorrected statements are immaterial.
✓	Maintain documentation.

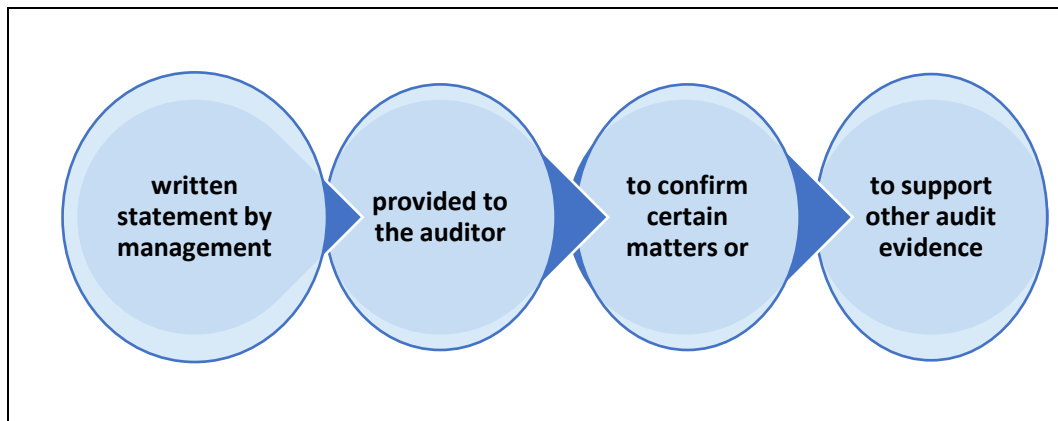
Test Your Understanding 4

You are nearing completion of audit of a company. On going through your working papers, it is noticed that finished goods inventory was overvalued by ₹ 2 crore. It has also been noticed that freight of ₹10 lacs paid on import of machinery was charged to statement of profit and loss.

Discuss, how you should, proceed and communicate in above situation before signing audit report.

4. WRITTEN REPRESENTATIONS

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.



4.1 Written Representations as Audit Evidence

Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence.

Written representations are an important source of audit evidence. If management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more significant issues may exist. Further, a request for written, rather than oral, representations in many cases may prompt management to consider such matters more rigorously, thereby enhancing the quality of the representations.

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.

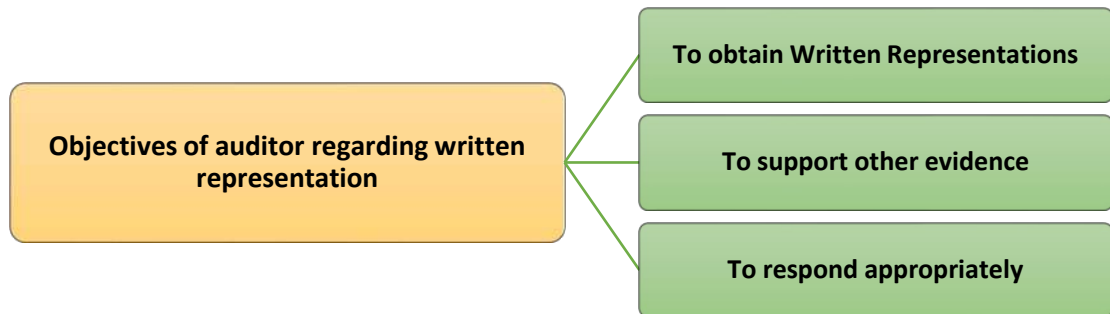
4.2 SA 580- Written Representations

SA 580- Written representations deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance.

4.3 Objectives of Auditor in accordance with SA 580

The objectives of the auditor are: -

- (a) To obtain written representations from management and, where appropriate, those charged with governance 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;
- (b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations, if determined necessary by the auditor or required by other SAs; and
- (c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.



4.4 From whom Written representations are requested by auditor?

The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned. Written representations relate to fulfilment of management's responsibilities or to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements.

4.5 Written representations about management's responsibilities

Written representation about management's responsibilities involves confirmation of fulfilment of management's responsibilities in following areas: -

(I) Preparation of the financial statements

The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation, as set out in the terms of the audit engagement.

Due to its responsibility for the preparation and presentation of the financial statements and its responsibilities for the conduct of the entity's business, management would be expected to have sufficient knowledge of the process followed by the entity in preparing and presenting the financial statements and the assertions therein on which to base the written representations.

In some cases, however, management may decide to make inquiries of others who participate in preparing and presenting the financial statements and assertions therein, including individuals who have specialized knowledge relating to the matters about which written representations are requested. Such individuals may include:

- An actuary responsible for actuarially determined accounting measurements.
- Staff engineers who may have responsibility for and specialized knowledge about environmental liability measurements.
- Internal counsel who may provide information essential to provisions for legal claims.

In some cases, management may include in the written representations qualifying language to the effect that representations are made to the best of its knowledge and belief. It is reasonable for the auditor to accept such wording if the auditor is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations. To reinforce the need for management to make informed representations, the auditor may request that management include in the written representations, confirmation that it has made such inquiries as it considered appropriate to place it in the position to be able to make the requested written representations.

(II) Information provided and completeness of transactions

The auditor shall request management to provide a written representation that: -

- (a) It has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement and
- (b) All transactions have been recorded and are reflected in the financial statements.

4.6 Why Written representations about management responsibilities are necessary?

Audit evidence obtained during the audit that management has fulfilled its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions is not sufficient without obtaining confirmation from management that it believes that it has fulfilled those responsibilities. This is because the auditor is not able to judge solely on other audit evidence whether management has prepared and presented the financial statements and provided information to the auditor on the basis of the agreed acknowledgement and understanding of its responsibilities.

For example, the auditor could not conclude that management has provided the auditor with all relevant information agreed in the terms of the audit engagement without asking it whether, and receiving confirmation that, such information has been provided.

The written representations requiring fulfilment of management responsibilities in relation to above draw on the agreed acknowledgement and understanding of management of its responsibilities in the terms of the audit engagement by requesting confirmation that it has fulfilled them. The auditor may also ask management to reconfirm its acknowledgement and understanding of those responsibilities in written representations.

This is particularly appropriate when: -

- Those who signed the terms of the audit engagement on behalf of the entity no longer have the relevant responsibilities;
- The terms of the audit engagement were prepared in a previous year;
- There is any indication that management misunderstands those responsibilities; or
- Changes in circumstances make it appropriate to do so.

4.7 Description of management's responsibilities in the Written representations

Management's responsibilities shall be described in the "Written representations required about management responsibilities" in the manner in which these responsibilities are described in the terms of the audit engagement.

4.8 Other Written representations

Other SAs require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations.

In addition to the written representation about management's responsibilities regarding preparation of financial statements, the auditor may consider it necessary to request other written representations about the financial statements. Such written representations may supplement, but do not form part of, the written representation relating to management's responsibilities regarding preparation of financial statements. They may include representations about the following: -

- Whether the selection and application of accounting policies are appropriate; and
- Whether matters such as the following, where relevant under the applicable financial reporting framework, have been recognized, measured, presented or disclosed in accordance with that framework: -
 - Plans or intentions that may affect the carrying value or classification of assets and liabilities;
 - Liabilities, both actual and contingent;
 - Title to, or control over, assets, the liens or encumbrances on assets, and assets pledged as collateral; and
 - Aspects of laws, regulations and contractual agreements that may affect the financial statements, including non-compliance.

4.9 Additional Written representations about information provided to the auditor

In addition to the written representation required by auditor regarding management responsibility about information provided to auditor, the auditor may consider it necessary to request management to provide a written representation that it has communicated to the auditor all deficiencies in internal control of which management is aware.

4.10 Written representations about specific assertions

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

- The entity's past history in carrying out its stated intentions.
- The entity's reasons for choosing a particular course of action.
- The entity's ability to pursue a specific course of action.
- The existence or lack of any other information that might have been obtained during the course of the audit that may be inconsistent with management's judgment or intent.

In addition, the auditor may consider it necessary to request management to provide written representations about specific assertions in the financial statements, in particular, to support an understanding that the auditor has obtained from other audit evidence of management's judgment or intent in relation to, or the completeness of, a specific assertion.

For example, if the intent of management is important to the valuation basis for investments, it may not be possible to obtain sufficient appropriate audit evidence without a written representation from management about its intentions. Although such written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own for that assertion.

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

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. The written representations shall be for all financial statements and period(s) referred to in the auditor's report.

Because 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.

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.

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.

4.12 Form of Written Representations

The written representations shall be in the form of a representation letter addressed to the auditor. If law or regulation requires management to make written public statements about its responsibilities, and the auditor determines that such statements provide some or all of the representations required regarding management responsibilities, the relevant matters covered by such statements need not be included in the representation letter.

Illustrative Written representation letter**On the letterhead of the entity**

To

PJ Shrimali & Co.

15th July, 2026

Chartered Accountants

Dear Sir,

This representation letter is provided in connection with your audit of the financial statements of XXXX Limited for the year ended March 31, 2026 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 2025, 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 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

4.13 Doubt as to the reliability of Written Representations

If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations and audit evidence in general.

In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations and audit evidence in general.

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

4.14 Requested Written representations not provided

If management does not provide one or more of the requested written representations, the auditor shall: -

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

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

The auditor shall disclaim an opinion on the financial statements in accordance with SA 705 if:

- (a) The auditor concludes that there is sufficient doubt about the integrity of management such that the written representations about management fulfilling its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions are not reliable; or
- (b) Management does not provide the written representations relating to fulfilling its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions.

Overview of auditor's responsibilities regarding Written representations

Checkbox	Auditor's responsibilities regarding Written representations
✓	Obtain Written representations from management and, where appropriate, those charged with governance 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.
✓	Obtain Written representations to support other audit evidence relevant to the financial statements or specific assertions in the financial statements, if determined necessary by the auditor or required by other SAs.
✓	Respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if the written representations requested by the auditor are not provided, then discuss the matter with management, re-evaluate the integrity of the management and evaluate effect on auditor's opinion.
✓	Disclaim opinion on financial statements in accordance with SA 705 in case of non-reliability of Written representations about management responsibilities or non-providing of Written representations about management responsibilities.

Test Your Understanding 5

CA R Gurumurthy is about to complete audit of a company. Before completion, he asks management to provide him a written representation confirming that management has fulfilled its responsibilities regarding preparation of financial statements. He also wants management to confirm in writing about providing of all the necessary information and completeness of transactions to him. The management feels that auditor is seeking irrelevant documents near the completion of audit. Why view of management is not proper? What possible implications it may lead to?

5. 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.

5.1 Who are “Those charged with governance”?

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

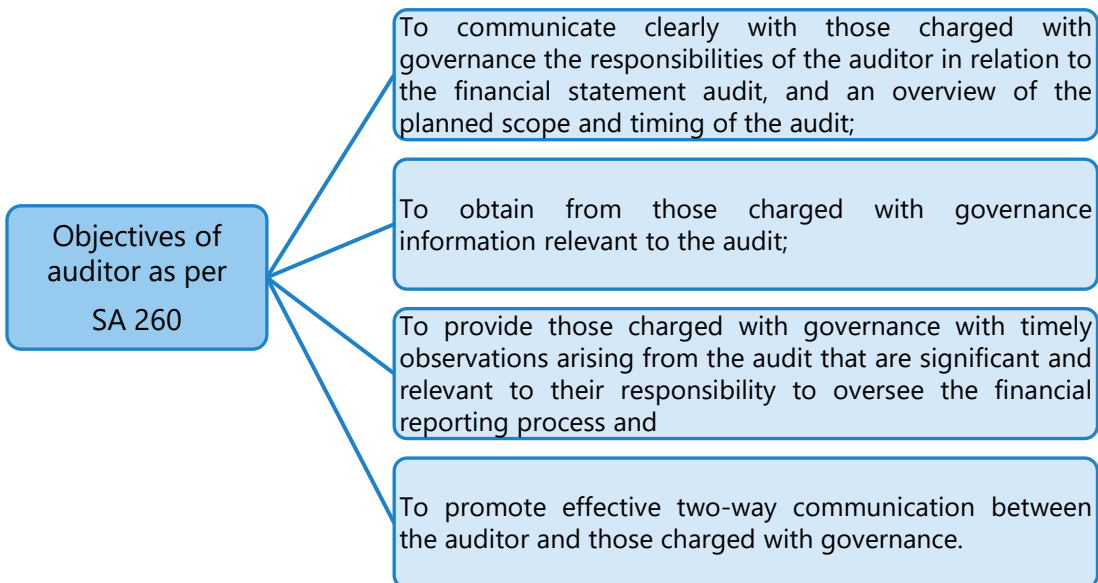
5.2 Scope of SA 260- Communication with Those Charged with Governance

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

5.3 Objectives of auditor in accordance with SA 260

The objectives of the auditor are: -

- (a) To communicate clearly with those charged with governance the 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.



5.4 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.

5.5 Matters to be communicated by 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.

(b) 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.

(c) 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;
 - (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.

5.6 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.

5.7 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.

5.8 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.

5.9 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.

Overview of auditor's responsibilities regarding communicating with those charged with governance

Checkbox	Auditor's responsibilities regarding communicating with those charged with governance
✓	Determine the appropriate person(s) within the entity's governance structure with whom to communicate.

✓	Communicate matters relating to auditor's responsibilities in relation to the financial statement audit, planned scope and timing of audit and significant findings from the audit.
✓	In case of listed entities, communicate about auditor's independence.
✓	Retain copy of communication of matters communicated in writing as part of audit documentation. In case of matters communicated orally, include them in the audit documentation stating when and to whom they were communicated.



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

Communicating significant deficiencies in internal control in writing to those charged with governance reflects the importance of these matters and assists those charged with governance in fulfilling their oversight responsibilities.

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

SA 265 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.

The auditor is required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement. In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. The auditor may identify deficiencies in internal control not only during this risk assessment process but also at any other stage of the audit. SA 265 specifies which identified deficiencies the auditor is required to communicate to those charged with governance and management.

6.2 Objective of auditor in accordance with SA 265

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.

6.3 Meaning of “Deficiency in internal control” and “significant deficiency in internal control”

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

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

(b) Significant deficiency in internal control – A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.

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.

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

- The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
- The susceptibility to loss or fraud of the related asset or liability.
- The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.

- The financial statement amounts exposed to the deficiencies.
- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- The importance of the controls to the financial reporting process, for example:
 - General monitoring controls (such as oversight of management).
 - Controls over the prevention and detection of fraud.
 - Controls over the selection and application of significant accounting policies.
 - Controls over significant transactions with related parties.
 - Controls over significant transactions outside the entity's normal course of business.
 - Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).
- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
- The interaction of the deficiency with other deficiencies in internal control.

Examples of indicators of significant deficiencies in internal control

- Evidence of ineffective aspects of the control environment, such as: -
 - Indications that significant transactions in which management is financially interested are not being appropriately scrutinised by those charged with governance.
 - Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.
 - Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.
- Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.

- Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.
- Evidence of an ineffective response to identified significant risks (e.g., absence of controls over such a risk).
- Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.
- Disclosure of a material misstatement due to error or fraud as prior period items in the current year's Statement of Profit and Loss.
- Evidence of management's inability to oversee the preparation of the financial statements.

6.4 Determination of significant deficiencies in internal control

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.

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

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 management's attention.

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.

Overview of auditor's responsibilities regarding communicating deficiencies in internal control to those charged with governance and management

Checkbox	Auditor's responsibilities regarding communicating deficiencies in internal control to those charged with governance and management
✓	Determine whether, on the basis of the audit work performed, one or more deficiencies in internal control have been identified.
✓	If one or more deficiencies in internal control have been identified, determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies.

✓	Communication in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis giving their description, explanation of potential effects and sufficient information to those charged with governance and management to understand context of communication.

Test Your Understanding 6

On reviewing internal control over inventories as part of statutory audit of a company, auditor finds that physical verification is not being conducted at regular intervals as stipulated by the management. The auditor finds it to be significant deficiency in internal control over inventories.

He points it out to the management in a one-liner as under: -

"Physical verification of inventories is not being conducted at regular intervals as stipulated by management."

Is above communication by auditor proper? Ignore statutory reporting requirements, if any in this regard.

CASE STUDY

CA. Gaurav Gogoi is about to conclude audit of a company. It has been noticed during the course of audit that there is shortage of important raw material supplies being imported from China due to prevailing geo-political situation. The company has shared with him its plan to deal with the situation. He is satisfied with assessment of the company for dealing with the matter. The issue is disclosed in financial statements and considering management's assessment, it is felt that use of going concern assumption by company in preparation of financial statements is appropriate.

Besides, he also wants to be sure that all subsequent events till now have been considered and accounted for, where ever necessary, in financial statements.

Before concluding audit, he requests written representations from management regarding its responsibilities. However, it is noticed that such written representations provided by management use qualifying language.

He has also communicated significant findings from audit in writing with those charged with governance in the company and has retained copy of relevant mails. Besides, there are certain matters which were communicated by him orally from time to time during the course of audit to those charged with governance.

Based on above, answer the following questions: -

- (1) *As regards description of matter above concerning issue of going concern, which of the following statements is most appropriate for auditor's report?*
 - (a) *The auditor should express an unmodified opinion.*
 - (b) *The auditor should express a qualified opinion as material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.*
 - (c) *Besides expressing an unmodified opinion, the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" drawing attention to the note in which such disclosure is made in financial statements along with related matters.*
 - (d) *Such an issue does not affect auditor's opinion.*
- (2) *As regards going concern basis of accounting is concerned, which of the following statements is true?*
 - (a) *A company showing net loss in its financial statements is essentially not a going concern.*
 - (b) *Following going concern assumption of accounting is primary duty of auditor.*
 - (c) *In case, a company is not a going concern, its financial statements must be prepared on liquidation basis.*
 - (d) *Audit procedure seeking confirmation from banker regarding outstanding balance relates to verification of going concern assumption.*

- (3) Which of the following statements is true in respect of auditor's responsibilities in respect of subsequent events?
- (a) There is no obligation for an auditor to perform audit procedures for events occurring between date of financial statements and date of auditor's report.
 - (b) There is no obligation for an auditor to perform audit procedures after signing of auditor's report, even if he comes to know of an event, which if known to him earlier would have caused him to amend the audit report.
 - (c) The auditor has only to rely upon written representation of management regarding subsequent events. He has no other means to know about such events.
 - (d) The auditor should perform necessary audit procedures to know about events occurring between the date of financial statements and date of auditor's report.
- (4) As regards use of qualifying language in written representations, which of the following statement is most appropriate?
- (a) It is reasonable for the auditor to accept such wording if the auditor is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.
 - (b) Written representations should be unconditional. Such a wording is not acceptable.
 - (c) Such a wording dilutes intent of written representations. However, it can be accepted by auditor only in exceptional circumstances.
 - (d) Qualifying language in written representations is compulsory.
- (5) As regards auditor's responsibility regarding matters communicated orally with those charged with governance, which of following is most appropriate?
- (a) Matters communicated orally have to be documented by the auditor stating when and to whom these were communicated.
 - (b) Matters communicated orally need not be put into writing. It is sufficient for auditor to have communicated orally.

- (c) *Matters communicated orally need not be put into writing. It is not practically feasible.*
- (d) *Matters communicated orally have to be documented by the auditor stating to whom these were communicated.*

Answers to MCQs involving case study

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

SUMMARY

- ◆ 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.
- ◆ 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.
- ◆ Before forming an opinion on the financial statements, the auditor evaluates effects of identified misstatements on the audit and of uncorrected misstatements on financial statements after consideration of materiality.
- ◆ Uncorrected misstatements refer to those misstatements that the auditor has accumulated during the audit and that have not been corrected.
- ◆ SA 450- Evaluation of misstatements identified during the audit deals with the auditor's responsibility to evaluate the effect of identified misstatements

on the audit and of uncorrected misstatements, if any, on the financial statements.

- ◆ 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.
- ◆ Communication from auditor is important with those charged with governance.
- ◆ "Those Charged with Governance" refer to the person(s) or organization(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process.
- ◆ SA 260- Communication with Those Charged with Governance deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements.
- ◆ Communicating significant deficiencies in internal control in writing to those charged with governance reflects the importance of these matters and assists those charged with governance in fulfilling their oversight responsibilities.
- ◆ SA 265 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management 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.

For a concise revision of the key concepts covered in this chapter, students may refer to the **Saransh Booklet for Paper 5: Auditing and Ethics**, which serves as a useful last-mile revision resource for examination preparation. Saransh Booklet can be accessed at <https://resource.cdn.icai.org/85998bos-aps751-int-p5.pdf>

TEST YOUR KNOWLEDGE

MCQs based Questions

- (1) *An auditor of a company communicates significant findings from audit with those charged with governance in the company. Which of the statements is false in regard to communication made?*
- (a) *Evaluation of adequacy of communication process is required on part of the auditor.*
 - (b) *Planned scope and timing of audit has also to be communicated.*
 - (c) *Communication of rationale behind audit procedures is necessary.*
 - (d) *Significant difficulties encountered during audit, if any, have to be communicated.*
- (2) *Written representations are: -*
- (a) *Necessary audit evidence*
 - (b) *Sufficient appropriate audit evidence*
 - (c) *Not audit evidence*
 - (d) *Audit evidence depending upon auditor's professional judgment*
- (3) *Which of the following is false regarding communication of misstatements identified during course of an audit?*
- (a) *The auditor should request those charged with governance for correction of identified misstatements.*
 - (b) *The auditor should obtain written representation acknowledging management belief that effect of uncorrected misstatements is material.*
 - (c) *The auditor should obtain written representation acknowledging management belief that effect of uncorrected misstatements is immaterial.*
 - (d) *The auditor should communicate effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.*

- (4) Which of the following is not an example of subsequent event?
- (a) Event occurring between date of financial statements and date of auditor's report.
 - (b) Event occurring on date of financial statements.
 - (c) Event occurring after filing audit report with tax authorities. Had such an event been known earlier, auditor would have amended report.
 - (d) Event occurring during course of performing audit procedures after date of financial statements.
- (5) Which of the following is not an example of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern?
- (a) Adverse key financial ratios.
 - (b) Inability to invest in modernisation of plant.
 - (c) Inability to pay creditors on time.
 - (d) Inability to pay salary of staff.

Descriptive Questions

1. CA Sumit has been appointed as statutory auditor of Core Limited. List out some matters that he may consider in determining whether a deficiency or combination of deficiencies in internal control constitute a "significant deficiency".
2. In what ways an effective two-way communication between auditor and those charged with governance is important?
3. The auditor of a company is having concerns about following of going concern basis of accounting followed by management for preparation of financial statements. He asks the management to justify preparation of financial statements. However, management is not willing to make its assessment and share with auditor. What are implications for auditor's report in such a scenario?
4. Discuss documentation requirements for an auditor regarding misstatements identified during audit under SA 450.

5. Discuss meaning of "Date the financial statements are issued" under SA 560.
6. ABC Pvt. Ltd., a manufacturing company, is facing significant financial difficulties due to downfall in market and increase in cost of production. CA Ram, the auditor of ABC Pvt. Ltd. has identified the following conditions:

- The company has defaulted on a major loan repayment.
- Current liabilities exceed current assets by 50%.
- Sales revenue has declined by 30% compared to the previous year.

Management has not yet performed an assessment of the company's ability to continue as a going concern, but they provided assurance for implementing corrective measures, including cost-cutting initiatives and discussions with creditors for restructuring the loan.

Which additional audit procedures need to be performed by CA Ram in accordance with SA 570 when such events or conditions are identified?

7. During the audit of a company, CA Jack obtained written representations from management regarding all known instances of non-compliance with laws and regulations that should be considered in the preparation of the financial statements. However, during the audit, he observed that the information provided in this regard was incomplete, and the audit evidence indicating such non-compliance contradicted the written representations, casting doubt on their reliability.

How should CA Jack proceed in this situation?

8. As per SA 560, 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, it may have caused the auditor to amend the auditor's report. In this context, what is meant by "Date the financial statements are issued"? Can it be later than the date of providing auditor's report to the entity?
9. Stay fit Private Limited is a start-up that has been in business for about two years. It runs an application which provides valuable information pertaining to nutrition and helps its clients to access customized healthy food. The company's revenues are expected to grow in the coming period. Although company has

reflected net losses in its financial statements for the last two years, it has managed to meet its financial commitments. The financial statements for last two years were prepared on going concern basis of accounting. The management of company wants to follow the same basis of accounting for the current year. Is the view of management appropriate? How does the "going concern" affect the preparation of financial statements?

10. *During the audit of Cryst Ltd. for the financial year ended 31st March 2026, the auditor, CA Z was in the process of finalising the audit report dated 30th May 2026. The engagement partner emphasised that CA Z shall perform audit procedure 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 requires adjustment of, or disclosure in, the financial statements have been identified. What audit procedures, in accordance with SA 560, should the auditor CA. Z perform based on risk assessment to identify events occurring between the date of the financial statements and the date of the auditor's report that require adjustment or disclosure?*
11. *The Management of Sun Shine Ltd. has provided the auditor with a written representation regarding its responsibilities for the preparation of the financial statements. In addition to this, the auditor may request other written representations about the financial statements.*

Mention such other representations which may supplement but do not form part of the written representation relating to management's responsibilities regarding preparation of financial statements.

12. *Projects India Limited (PIL) is engaged in manufacturing and trading of disposable glasses and plates used in social gatherings/functions. XYZ & Co., Chartered Accountants, is the statutory auditor of PIL for the F.Y 2025-26. Analytical procedures carried out by the audit team, headed by CA Z, indicate that company's business is going downward and PIL could achieve only 50% of total revenue of F.Y 2025-26. Management has not taken any steps to increase the revenue or add new products or customers to stabilize the revenue and profitability. Also the suppliers are demanding cash payment at the time of purchase of raw material. Before finalizing the audit report, audit in charge asked for a cash flow forecast from management for the next 12 months from*

the end date of financial statements. Keeping in view the above facts, answer the following:

- (i) What can be the likely purpose of CA Z in the above situation?*
 - (ii) State any two audit procedures in relation to the cash flow forecast likely to be performed by CA Z.*
13. *SRP Limited appointed M/s JK & Co. as its statutory auditors. Auditors while carrying out the audit observed that company has entered into a complex transaction having material effect on the financial statements. In order to have realistic information on the said transaction (relevant to the audit), audit team decided to take assistance from those charged with governance. Two of the team members were discussing as to who can be "Those charged with governance" but could not get a fair idea of the same. Can you guide them by explaining the same?*
14. *CA Rashmi is the auditor of ABC Ltd. for the financial year ending 31/03/2026. The audit report for the year was signed by her on 19/04/2026.*
- On 25/4/2026, the company received a communication from the Central Government that an incentive amount of ` 5 crores pertaining to financial year 2025-26 was approved. It was paid to the company before the end of April 2026. The financial statements of the company were not yet issued to the shareholders.*
- The Board of Directors wished to include the incentive amount in the financial statements and requested the auditor to issue a fresh audit report for the year ended 31/03/2026.*
- Analyze the issue involved and give an overview of the auditor's responsibility in such a situation.*
15. *CA Vasu was appointed as the statutory auditor of M/s. Pizza Limited for the financial year 2023-24. While reviewing the internal controls, he observed that the company has entered into many transactions with firms in which the directors are interested. The company's specified procedure was by-passed in such transactions. CA Vasu considered it as a significant deficiency in internal control over related party transactions. He communicated this deficiency to*

Those Charged With Governance (TCWG) as under, "Controls over significant transactions with related parties are weak." In view of the above, please explain:

- (i) What is meant by deficiency in internal control?*
- (ii) As per SA 265, whether the significant deficiency communicated by CA Vasu to TCWG is appropriate? Explain.*

16. *You are the auditor of LMN Ltd. The company's financial statements for the year ended 31st March, 2026, along with your audit report, were issued on 30th June, 2026. Two months after the issue of auditor's report, you become aware of a fact that existed as on the date of your audit report but was not known to you at that time. Had this fact been known earlier, it would have required a modification of your audit opinion.*

Give the Overview of the Auditor's responsibilities in the given facts and situation in line with SA 560 "Subsequent Events".

17. *ABC Ltd. is a listed company with an annual turnover of ` 1,000 crores. The company has appointed three joint auditors, ST and Associates, TR and Associates and PQ and Associates, to conduct the statutory audit for the financial year 2025-26.*

Since ABC Ltd. is a listed entity, the joint auditors are required to comply with ethical requirements relating to independence. Before commencing the audit, the audit firms held a meeting with the Audit Committee and submitted written communications regarding their independence. During the meeting, the Audit Committee asked the auditors to clarify the specific matters that must be included in such communication to ensure compliance with professional requirements.

With reference to SA 260, explain the matters that should be included in the communication regarding auditor's independence to those charged with governance in case of listed entities.

18. *GEM Ltd has appointed GSP & Co., Chartered Accountants as its Statutory Auditors. While conducting its audit, the audit partner requested the management to provide a written representation that it has fulfilled its responsibility for the preparation of financial statements in accordance with the applicable financial reporting framework. The Manager (Finance) is of the view that since all records and evidence have already been given, a separate written representation is not required. Explain.*

19. CA Sandeep has identified certain misstatements during course of audit of an entity. Except two misstatements, all were corrected by management. He wants to obtain written representation from management regarding effects of these uncorrected misstatements. Describe matter contained in such written representations.

Also discuss documentation requirements regarding misstatements identified during the course of audit in accordance with relevant SA.

20. XYZ Ltd. finalized its financial statements for the year ended 31st March 2026. Audit is in progress and the auditor is expected to issue the report in July, 2026. On 10th April 2026, a major debtor of the company was declared insolvent and the company realised that the amount due from this debtor as on 31st March 2026 was not recoverable. In the month of May, 2026, the management also initiated discussions for a possible merger with another company. Auditors understand that financial statements may be affected by certain events that occur after the date of the financial statements. Auditors of XYZ Ltd. consider that financial reporting frameworks ordinarily identify two types of events. Explain how you would classify and deal with these subsequent events.

21. Mindset Appliances Limited, a listed company engaged in manufacturing electrical equipment, closed its books of account for the year ended 31st March 2026. The statutory audit is in progress and the auditor proposes to sign the audit report on 30th June 2026.

During the period between 31st March 2026 and 30th June 2026, the following events occurred:

1. A major debtor owing ₹ 8 crores as on 31st March 2026 was declared insolvent on 15th April 2026. No specific provision had been made against this debtor as at year-end.
2. A legal case for product liability, for which a provision of ₹ 3 crores was created as on 31st March 2026, was settled out of court on 10th May 2026 for ₹ 1.80 crores.
3. On 20th May 2026, the company issued fresh equity shares through a qualified institutional placement.

4. On 25th May 2026, the Board approved a plan to merge with another listed entity, subject to regulatory approvals.
5. On 5th June 2026, a major fire destroyed finished goods inventory worth ₹6 crores stored in a warehouse. The loss is expected to be fully covered by insurance.

The management has not made any adjustments in the financial statements but has disclosed all the above events in the Notes to Accounts.

- (a) *Classify the above events into appropriate categories of subsequent events.*
 - (b) *State the auditor's considerations and implications on the financial statements in each case with reasons.*
 - (c) *Conclude whether the management's treatment is appropriate.*
22. *OPQ Infrastructure Ltd. is engaged in the construction of large industrial projects. The company has significant estimates in its financial statements such as actuarial valuation of employee benefits, environmental restoration liabilities, and provisions relating to ongoing legal disputes.*

CA R has been appointed as the statutory auditor of the company for the year ended 31 March 2026. During the course of the audit, the auditor noted that the preparation of the financial statements involved inputs from several specialists, including an actuary for employee benefit obligations, staff engineers for estimating environmental liabilities, and the company's internal legal counsel for assessing provisions relating to pending litigations.

While completing the audit, the auditor requested the management to provide written representations confirming that it has fulfilled its responsibilities for the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework. Management agreed to provide such representations but proposed to include qualifying language stating that the representations are made "to the best of its knowledge and belief."

In the above circumstances, explain the written representation that the auditor may obtain from management regarding its responsibilities for the preparation of financial statements. Also comment on whether the auditor can accept representations containing such qualifying language.

23. YZ & Co., Chartered Accountants, were appointed as auditors of Shree Ltd. for the financial year 2025–26. The auditor proposed to sign the audit report on 30th June 2026.

Management provided written representations dated 10th June 2026 and refused to update them closer to the date of the auditor's report, stating that no material changes had occurred.

Further, the present management took charge from 1st October 2025 and declined to give written representations for the period April to September 2025 on the ground that they were not in position during that period.

In the above context, explain the requirements relating to the date of written representations in relation to the auditor's report and the period(s) to be covered by such representations. Also, comment on the validity of management's stand.

ANSWERS/SOLUTIONS

Answers to the MCQs based Questions

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

Answers to Questions involving Descriptive Questions

1. Refer to topic on "Examples of some matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitute a significant deficiency".
2. Refer to topic on "Significance of Communication with Those charged with governance."
3. Refer to topic on "Implication for auditor's report" under heading SA 570 Going Concern
4. Refer to topic on "Documentation regarding misstatements identified during audit"
5. Refer to topic on Meaning of "Date the financial statements are issued" under SA 560.

6. 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.

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. These procedures shall include:

- (i) 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.
- (ii) Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.
- (iii) Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future actions:
 - (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.
- (iv) Considering whether any additional facts or information have become available since the date on which management made its assessment.
- (v) Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans.

7. In the given situation, company's management has not provided complete information regarding instances of non-compliance with laws & regulations. If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations and audit evidence in general.

The above situation highlights that auditor has obtained audit evidence relating to non-compliance with laws which is inconsistent with written representations in this respect casting a doubt about reliability of written representations.

As per SA 580, "Written Representation", if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations and audit evidence in general.

If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705, "Modifications to the Opinion in the Independent Auditor's Report" having regard to the requirement of disclaimer of opinion.

8. "Date the financial statements are issued" reflects the date on which the auditor's report and audited financial statements are made available to the third parties. The date the financial statements are issued generally depends on the regulatory environment of the entity.

In some circumstances, the date the financial statements are issued may be the date that they are filed with a regulatory authority. Since audited financial statements cannot be issued without an auditor's report, the date that the audited financial statements are issued must not only be at or later than the date of the auditor's report but must also be at or later than the date the auditor's report is provided to the entity.

Therefore, "date the financial statements are issued" can be later than date of providing auditor's report to the entity.

9. As per SA 570, "Going Concern", 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.

Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. General purpose financial statements are prepared 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.

In the given situation, company has reflected net losses in financial statements of last two years but is able to meet its financial commitments signifying its ability to carry on business/trade. The revenue of company is also expected to grow in the coming period. It shows that management has neither the intention nor the necessity of liquidation or of curtailing materially the scale of operations. Therefore, view of the management for following going concern basis of accounting in current year is appropriate.

Further, the significance of going concern is due to its effect on the preparation of financial statements. Ability or otherwise of an enterprise to be viewed as going concern affects its preparation of financial statements. When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business. When an enterprise is not viewed as a going concern, the financial statements are prepared on liquidation basis. For example, inventories may need to be written down as these may be sold for a lower price. Assets may have to be recorded at the likely prices they will fetch.

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

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. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following: -

- (i) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
- (ii) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.
- (iii) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.
- (iv) Reading the entity's latest subsequent interim financial statements, if any.

11. As per SA 580, "Written Representations", in addition to the written representation about management's responsibilities regarding preparation of financial statements, the auditor may consider it necessary to request other written representations about the financial statements.

Other representations which may supplement, but do not form part of the written representation relating to management's responsibilities regarding preparation of financial statements are the following:

- (i) Whether the selection and application of accounting policies are appropriate; and
 - (ii) Whether matters such as the following, where relevant under the applicable financial reporting framework, have been recognized, measured, presented or disclosed in accordance with that framework:
 - 1. Plans or intentions that may affect the carrying value or classification of assets and liabilities;
 - 2. Liabilities, both actual and contingent;
 - 3. Title to, or control over, assets, the liens or encumbrances on assets, and assets pledged as collateral; and
 - 4. Aspects of laws, regulations and contractual agreements that may affect the financial statements, including non-compliance.
- 12.** (i) In the given situation, CA. Z indicated that the company's business is going downward and 50% of total revenue is also being achieved, further, no steps are being taken by the management to stabilize the revenue and profitability. Accordingly, auditor in-charge asked for a cash flow forecast from management for the next 12 months to analyse as it is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future actions. Thus, likely purpose of CA Z in the given situation are:
- (1) 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;
 - (2) to conclude, 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; and
 - (3) to report in accordance with SA 570.
- (ii) Audit procedures in relation to the cash flow forecast, and analysis likely to be performed by CA. Z are:
- (1) Evaluating the reliability of the underlying data generated to prepare the forecast; and

- (2) Determining whether there is adequate support for the assumptions underlying the forecast.

- 13.** Refer Para Refer Para 5.1 for Who are “Those Charged with Governance”:
- 14.** 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, ABC Ltd. received an amount of ₹ 5 crore on account of incentives pertaining to year 2025-26 in the month of April 2026 i.e. after finalisation of financial statements and signing of audit report but before the issuance of Financial Statements to stakeholders. The Board of Directors of ABC Ltd. wished to amend the financial statements and requested the CA. Rashmi (auditor) to consider this event and issue a fresh audit report on the financial statements for the year ended on 31.03.2026.

After applying the conditions given in SA 560, CA. Rashmi 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.

15. (i) Refer para 6.3 for **Meaning of Deficiency in internal control**
- (ii) As per SA 265, While pointing out significant deficiencies in internal control, auditor has not only to communicate significant deficiencies giving their description but also explain the potential effects and sufficient information to those charged with governance and management to understand context of communication.

Therefore, the above communication is not proper. Not only significant deficiency has to be communicated, it should also be explained to management the potential effects of transactions with firm in which the directors are interested. It should explain that such a significant deficiency can lead to misstatement of transactions with related party. Highlighting importance of such a control, it should be stated that responsibility be fixed for concerned persons for adhering to such an important control.

16. SA 560 "Subsequent Events" - The auditor has no obligation to perform any audit procedures regarding such financial statements after the financial statements have been issued.

However, when, after the financial statements have been 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.
- (iv) If the management amends the financial statements, the auditor shall carry out the audit procedures necessary in the circumstances on the amendment.

- (v) Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation.
- (vi) Extend the audit procedures, already referred, to the date of the new auditor's report and provide a new auditor's report on the amended financial statements.
- (vii) Include in the new auditor's report Modified opinion as applicable/ an Emphasis of Matter paragraph or Other Matter(s) paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided by the auditor.
- (viii) If management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation and does not amend the financial statements in circumstances where the auditor believes they need to be amended, the auditor shall notify management that the auditor will seek to prevent future reliance on the auditor's report.
- (ix) If, despite such notification, management or those charged with governance do not take these necessary steps, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report.

17. Refer Para 5.6

18. In the given case, GSP & Co., auditor of GEM Ltd. requested the management to provide written representation that it has fulfilled its responsibility for the preparation of financial statements in accordance with the applicable financial reporting framework. The Manager (Finance) is of the view that since all records and evidence have already been given, a separate written representation is not required. View of Manager (Finance) is not correct because written representations about management responsibilities are necessary due to the following reasons:

Audit evidence obtained during the audit that management has fulfilled its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions is not sufficient without obtaining confirmation from management that it believes that it has fulfilled those responsibilities. This is because the auditor is not able to judge

solely on other audit evidence whether management has prepared and presented the financial statements and provided information to the auditor on the basis of the agreed acknowledgement and understanding of its responsibilities.

For example, the auditor could not conclude that management has provided the auditor with all relevant information agreed in terms of the audit engagement without asking it whether, and receiving confirmation that, such information has been provided.

The written representations requiring fulfilment of management responsibilities in relation to above draw on the agreed acknowledgement and understanding of management of its responsibilities in the terms of the audit engagement by requesting confirmation that it has fulfilled them. The auditor may also ask management to reconfirm its acknowledgement and understanding of those responsibilities in written representations.

This is particularly appropriate when: -

- Those who signed the terms of the audit engagement on behalf of the entity no longer have the relevant responsibilities;
- The terms of the audit engagement were prepared in a previous year;
- There is any indication that management misunderstands those responsibilities; or
- Changes in circumstances make it appropriate to do so.

- 19.** In the given case, all except two misstatements have been corrected by management.

The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation.

The documentation requirements regarding misstatements identified during the course of audit in accordance with SA 450 are as under: -

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

- (b) All misstatements accumulated during the audit and whether they have been corrected and
 - (c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion.
- 20.** As per SA 560 on "Subsequent Events", financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Such financial reporting frameworks ordinarily identify two types of events:
- (a) Those that provide evidence of conditions that existed at the date of the financial statements and
 - (b) Those that provide evidence of conditions that arose after the date of the 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. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The insolvency of the major debtor declared after 31st March 2026 provides evidence of conditions that existed at the date of the financial statements. This event affects the recoverability of the amount due as on 31st March 2026, therefore, it requires adjustment in the financial statements to reflect the correct realisable value.

On the other hand, the planned merger of the company provides evidence of conditions that arose after the date of the financial statements. Such an event does not require adjustment in the financial statements but should be disclosed if it is of such importance that non-disclosure would affect the ability of users to make proper evaluations or decisions.

Hence, the auditor should ensure that appropriate adjustments or disclosures are made in accordance with the nature of each subsequent event.

21. Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Such financial reporting frameworks ordinarily identify two types of events:

- 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.

Classification and Application to the Case

1. Events providing evidence of conditions that existed at the date of the financial statements: Examples of events providing evidence of conditions that existed at the date of the financial statements -

- Declaration of insolvency of a major debtor of the entity between the date of financial statements and the date of auditor's report providing evidence on the recoverability of the money due from debtor as on date of the financial statements.

In the present case, insolvency of the debtor owing ₹ 8 crores indicates that the financial difficulty existed as at 31st March 2026. Therefore, this is an adjusting event. The financial statements require adjustment by creating appropriate provision / writing off the debtor. Mere disclosure is not sufficient.

- Settling a legal claim outside the court at a reduced amount between the date of financial statements and the date of auditor's report for which provision has already been made in financial statements. It provides evidence on adjustment in provision amount already made in financial statements, if any.

In the present case, settlement at ₹ 1.80 crores provides evidence regarding the best estimate of liability as at 31st March 2026. Therefore, the excess provision of ₹ 1.20 crores should be reversed. This is also an adjusting event.

2. Events providing evidence of conditions that arose after the date of the financial statements: Examples of events providing evidence of conditions that arose after the date of the financial statements

- Issue of new share capital.
- Planned merger of the company.
- Destruction of substantial inventories due to fire between the date of the financial statements and the date of auditor's report.

In the present case:

- Issue of fresh equity shares is a non-adjusting event. It does not affect financial position as at 31st March 2026 but requires disclosure if material.
- Approval of merger plan is also a non-adjusting event requiring disclosure.
- Destruction of inventory due to fire occurred after the reporting date and relates to a new condition. Hence, it is a non-adjusting event. Only disclosure is required, unless it affects going concern assumption.

In the given case, management has merely disclosed all events without making adjustments.

- Non-provision for insolvent debtor and
- Non-reversal of excess legal provision

constitute material misstatements since they are adjusting events requiring modification of figures in the financial statements.

Therefore, unless management makes necessary adjustments, the auditor should modify the audit opinion in accordance with SA 705.

Disclosure alone is sufficient for issue of share capital, planned merger, and destruction of inventory due to fire, as they are non-adjusting events.

Accordingly, management's treatment is partially incorrect, and necessary adjustment is required.

22. Refer “Preparation of the financial statements” described under para 4.5

In the given case, the auditor may obtain written representations from management confirming that it has fulfilled its responsibility for the preparation and fair presentation of the financial statements. The inclusion of the phrase “to the best of its knowledge and belief” in the written representation may be accepted by the auditor, provided the auditor is satisfied that the representation is being made by management having appropriate responsibility and adequate knowledge of the matters concerned.

23. Refer para 4.11.

The management is required to provide written representations dated as near as practicable to the date of the auditor’s report and covering the entire period under audit. In case of refusal, the auditor should consider appropriate modification in the audit report.

Answers to Questions involving Test Your Understanding

1. In the given case, the auditor has come to know of legal claim against the company before issue of audit report. It has also come to his knowledge that management of company has agreed to an out of court settlement of Rs.5 crore. It is an example of subsequent event between the date of the financial statements and the date of the auditor’s report. It provides evidence of conditions that existed at the date of the financial statements and requires adjustment in financial statements.

He should ask company management to make necessary adjustment to the financial statements. If adjustment is not made by management, he should consider impact on auditor’s report.

2. She has already performed necessary audit procedures like inquiry of management personnel, reading minutes of meetings after date of financial statements and going through books after date of financial statements.

Now, she should request management and, where appropriate, those charged with governance, to provide a written representation in accordance with SA 580, “Written Representations” that all events occurring subsequent to the date of the financial statements and for which the applicable financial

reporting framework requires adjustment or disclosure have been adjusted or disclosed.

The rationale of obtaining written representations is that even after performing abovesaid procedures, she may not come to know all subsequent events. Therefore, it is necessary from an auditor's point of view to obtain acknowledgment from management in the form of Written representations that all such events for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

3. Significant shortage of skilled labour, inability to pay creditors on time and overall liquidity crisis faced by the company are examples of events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

In such a situation, management should try to address auditor's concerns by preparing its future plan of action including preparation of cash flow forecast showing inflow and outflow of cash. Such a cash flow forecast should address auditor's concerns regarding liquidity crisis being faced by the company.

The auditor should perform audit procedures to evaluate the reliability of the underlying data to prepare the forecast and determining whether there is adequate support for the assumptions underlying the forecast. The auditor should also consider whether any additional facts or information have become available since the date on which management made its assessment.

4. The instances highlighted in above situation are examples of misstatements identified during the audit. Over valuation of inventory of finished goods by ₹ 2 crore and wrongly charging freight of ₹ 10 lacs paid on machinery to statement of profit and loss instead of capitalizing are examples of misstatements.

The auditor should communicate above identified misstatements to those charged with governance and request for correction of these misstatements. In case, these are not corrected, understand the reasons for not making the corrections and reassess materiality. It should also be considered whether uncorrected statements are material individually or in aggregate. Effect of uncorrected misstatements on the opinion in auditor's report should be communicated to those charged with governance.

5. The view of management is not proper. Audit evidence obtained during the audit that management has fulfilled its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions is not sufficient without obtaining confirmation from management that it believes that it has fulfilled those responsibilities. This is because the auditor is not able to judge solely on other audit evidence whether management has prepared and presented the financial statements and provided information to the auditor on the basis of the agreed acknowledgement and understanding of its responsibilities.

In case of refusal of management to provide such a confirmation, it may lead to disclaimer of opinion by the auditor.

6. While pointing out significant deficiencies in internal control, auditor has not only to communicate significant deficiencies giving their description but also explain the potential effects and sufficient information to those charged with governance and management to understand context of communication.

Therefore, the above communication is not proper. Not only significant deficiency has to be communicated, it should also be explained to management the potential effects of not carrying out physical verification of inventories at regular intervals as stipulated by management. It should explain that such a significant deficiency can lead to misstatement of inventories impacting profits of the company. Highlighting importance of such a control, it should be stated that responsibility be fixed for concerned persons for adhering to such an important control.

AUDIT REPORT

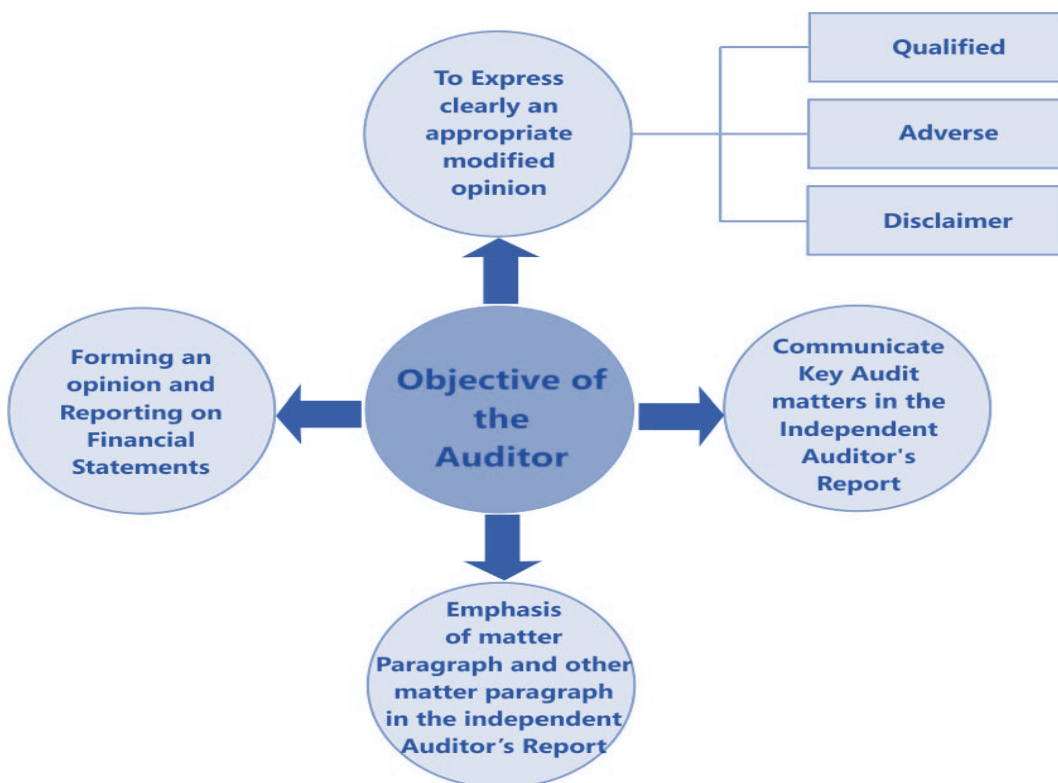


LEARNING OUTCOMES

After studying this chapter, you would be able to understand:

- ◆ The objectives of the auditor as per SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements." Also, whether the auditor has obtained reasonable assurance. Understand the evaluation by the auditor and Qualitative Aspects of the Entity's Accounting Practices. Elements of Auditor's report.
- ◆ The basics of SA 705, "Modifications to the Opinion in the Independent Auditor's Report".
- ◆ The basics of SA 701, "Communicating Key Audit Matters in the Independent Auditor's Report".
- ◆ The Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report as per SA 706.
- ◆ SA 710, "Comparative Information- Corresponding figures and Comparative financial statements".
- ◆ The basics of SA 600, "Using the work of Another Auditor".
- ◆ SA 299, "Joint Audit of Financial Statements".
- ◆ Reporting requirements under the Companies Act, 2013
- ◆ Companies (Auditor's Report) Order, 2020.
- ◆ Practicality of above concepts by studying through examples and case studies.

CHAPTER OVERVIEW



Audit process culminates in formation of opinion by an auditor and expression of the same by means of audit report. Audit report, therefore, is the final outcome of an audit exercise. It is the document on which reliance is placed by users of financial statements as it contains auditor's opinion. Audit evidence obtained by performing various audit procedures, ultimately, leads to crystallization of opinion by auditor contained in audit report.

Understanding enormous significance of audit report, Sameer was unequivocal in his mind regarding some kind of consistency and comparability in reporting. It logically led him to next question- What are basic elements of an audit report? How does it look like? Is it necessary for an auditor to prepare audit report using these elements?

A counter question struck his mind in no time. If there is consistency and comparability in reporting, how does an auditor report in specific situations?

Shouldn't there be flexibility in reporting in particular situations? How do auditors do that? If an auditor wants to highlight some matters which are necessary to understanding of users of financial statements, how the same can be ensured?

And what about those issues which were identified as significant issues during the audit? Can such issues and manner of addressing such issues be reported? What kind of audit procedures were performed on those significant matters? There must be some sort of reporting mechanism for these issues. In absence of such type of flexibility in reporting, audit report can become too mechanical. He was mulling deeply.

What if auditor wants to express a modified opinion? What are different types of it and under what circumstances different types of modified opinion can be given by auditor? Does auditor have to state basis for such an opinion compulsorily? These were probing thoughts criss-crossing his mind.

He was also considering about reporting requirements if some matters are specifically required to be reported in accordance with law. Particularly, in case of companies, are there some specific matters? How reporting is to be made by auditor in respect of such matters?

Amidst this maze of thoughts, Shekhar called him to inform that, audit of company his team was doing, is now over and audit report has been issued. Wanting to know about outcome, he was asked by Shekhar to go to website of the company and go through audit report himself.

INTRODUCTION

Management is responsible for the preparation of the financial statements. Management also accepts responsibility for necessary internal controls to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

The purpose of an audit is to enhance the degree of confidence of intended users of the financial statements. The aforesaid purpose is achieved by the expression of an independent reporting by the auditor as to whether the financial statements exhibit a true and fair view of the affairs of the entity.

Thus, an audit report is an opinion drawn on the entity's financial statements to make sure that the records are true and fair representation of the transactions they claim to represent. This 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. The main users of audit report are shareholders, members and all other stakeholders of the company.

1. FORMING AN OPINION AND REPORTING ON FINANCIAL STATEMENTS

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

1.1 Objective of the Auditor

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

1.2 To Form Opinion – Auditor to Obtain Reasonable Assurance

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 conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

That conclusion shall take into account:

- (a) Whether sufficient appropriate audit evidence has been obtained;
- (b) Whether uncorrected misstatements are material, individually or in aggregate;
- (c) The evaluations.

1.3 Evaluations by the Auditor

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

This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgements.

1.3.1 Qualitative Aspects of the Entity's Accounting Practices

1. Management makes a number of judgements about the amounts and disclosures in the financial statements.
2. SA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices.
3. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgements. The auditor may conclude that the cumulative effect of lack of neutrality, together with the effect of uncorrected misstatements, causes the financial statements as a whole to be materially misstated. Indicators of a lack of neutrality include the following:

- (i) The selective correction of misstatements brought to management's attention during the audit.

Example

- ◆ Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.

- (ii) Possible management bias in the making of accounting estimates.
4. SA 540 addresses possible management bias in making accounting estimates. Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement.

1.4 Specific Evaluations by the Auditor

In particular, the auditor shall evaluate whether:

- (a) The financial statements adequately disclose the significant accounting policies selected and applied;
- (b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
- (c) The accounting estimates made by management are reasonable;
- (d) The information presented in the financial statements is relevant, reliable, comparable, and understandable;
- (e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
- (f) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

Further, when the financial statements are prepared in accordance with a fair presentation framework, the evaluation mentioned above (Paragraph 1.3 & 1.4) shall also include an evaluation by the auditor as to whether the financial statements achieve fair presentation which shall include consideration of:

- (a) The overall presentation, structure and content of the financial statements; and
- (b) Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

The auditor shall evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework.

An overview of specific evaluations by the auditor

Checkbox	<i>Specific evaluations by the auditor</i>
✓	Selected and applied significant accounting policies are adequately disclosed.
✓	Accounting policies are consistent with applicable financial reporting framework.
✓	Accounting estimates by management are reasonable.
✓	Information in financial statement is relevant, reliable, comparable and understandable.
✓	Disclosures in financial statements are adequate to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements.
✓	Terminology used in financial statements is appropriate.

1.5 Definitions

For making the understanding better, the following terms have been defined below:

- (a) **General purpose financial statements** – Financial statements prepared in accordance with a general purpose framework.

- (b) **General purpose framework** – A financial reporting framework designed to meet the common financial information needs of a wide range of users. The financial reporting framework may be a fair presentation framework or a compliance framework.

The term “**fair presentation framework**” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

- (i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
- (ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term “**compliance framework**” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.

- (c) **Unmodified opinion** – The opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.



2. FORM OF OPINION

Unmodified Opinion: 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.

Modified Opinion: If the auditor:

(a) Concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

(b) 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 the auditor's report in accordance with SA 705.

3. AUDITOR'S REPORT

The auditor's report shall be in writing. This SA 700 requires the use of specific headings, which are intended to assist in making auditor's report more recognizable, where audit is conducted in accordance with the relevant Standards on Auditing.

3.1 Auditor's Report for Audits Conducted in Accordance with Standards on Auditing

•Title
•Addressee
•Auditor's Opinion
•Basis for Opinion
•Going Concern
•Key Audit Matters
•Other Information
•Responsibilities for the Financial Statements
•Auditor's Responsibilities for the Audit of the Financial Statements
•Location of the description of the auditor's responsibilities
•Other Reporting Responsibilities
•Signature of the Auditor
•Place of Signature
•Date of the Auditor's Report

Basic Elements of an Audit Report are given below:

1. Title: The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor.

For example

"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 appropriate, based on the circumstances of the engagement. Law, regulation or the terms of the engagement may specify to whom the auditor's report is to be addressed.

The auditor's report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited. In case of a company, the report is addressed to the shareholders of the company.

ILLUSTRATION 1

M/s Smart & Associates are the statutory auditors of Hotmeals Ltd. for the FY 2025-26. How will the auditor address the audit report issued on the financial statements for the FY 2025-26? Also give a title to the report.

SOLUTION**INDEPENDENT AUDITOR'S REPORT**

To the Members of Hotmeals Ltd.

ILLUSTRATION 2

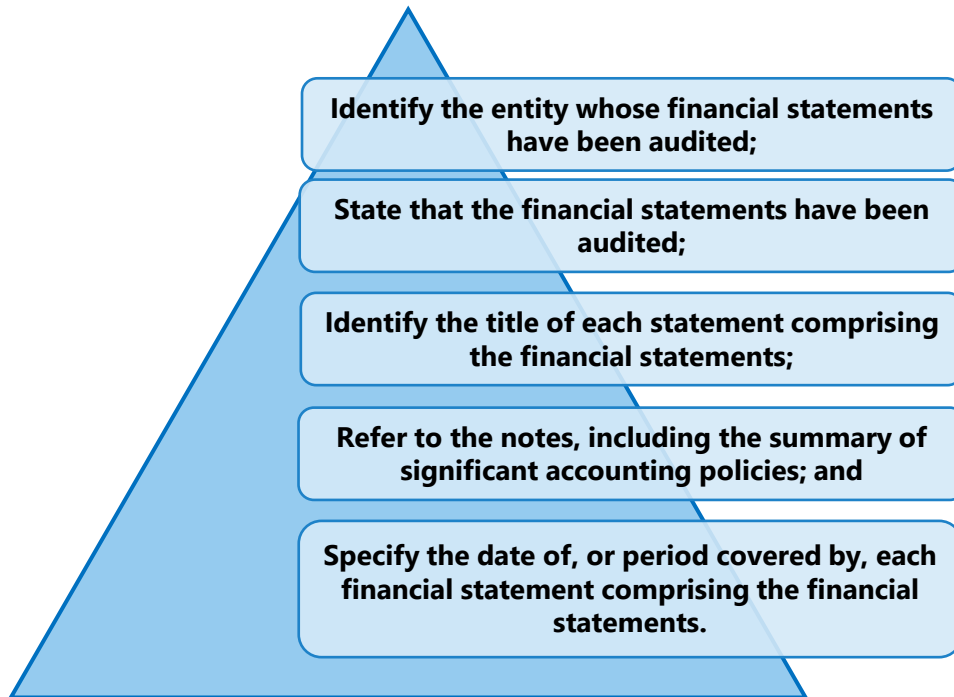
Richa International is a partnership firm dealing in export of blankets. The partners of the firm are Richa and Ashish. To whom the statutory auditor of the firm will address the auditor's report?

SOLUTION**INDEPENDENT AUDITOR'S REPORT**

To the Partners of Richa International

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:



Unmodified Opinion:

When expressing an unmodified opinion on financial statements, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases, which are regarded as being equivalent:

- (a) In our opinion, the accompanying financial statements **present fairly, in all material respects**, [...] in accordance with [the applicable financial reporting framework]; or
- (b) In our opinion, the accompanying financial statements **give a true and fair view of** [...] in accordance with [the applicable financial reporting framework].

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

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

ILLUSTRATION 3

M/s Amitabh & Associates are the statutory auditors of Ringston Ltd. which is a company engaged in the business of manufacture of pen drives. The auditor has started drafting the audit report for the FY 2025-26. CA Amitabh, the engagement partner is of the view that the financial statements of Ringston Ltd. represent a true and fair view. Give the draft of the opinion paragraph of the audit report.

SOLUTION**Opinion**

We have audited the financial statements of Ringston Limited which comprise the Balance Sheet as at 31.03.2026 and the statement of Profit and Loss Account and the 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 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 the company as at 31.03.2026 and the Profit & Loss for the year ending 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:

1. States that the audit was conducted in accordance with Standards on Auditing;
2. Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;
3. 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.
4. 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.

Thus, the Basis for opinion section provides important context about the auditor's opinion.

ILLUSTRATION 4

M/s Kite Rite & Associates are the statutory auditors of Prime Deluxe Limited, for the FY 2025-26. At the time of finalising the audit report, one of the engagement team members, Mr. Robin, asked the engagement partner, CA Kite as to what all should be included in the Basis of Opinion Paragraph. The engagement partner CA Kite, explained the team in detail and asked Mr. Robin to draft such section for the auditor's report of Prime Deluxe Limited. Help Mr. Robin to draft the Basis for opinion section.

SOLUTION**Basis for Opinion**

We conducted our audit in accordance with the 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 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 (Revised).

- ◆ Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. General purpose financial statements are prepared 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.
- ◆ When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.
- ◆ The auditor shall evaluate whether sufficient appropriate audit evidence has been obtained regarding, and shall conclude on, the appropriateness of

management's use of the going concern basis of accounting in the preparation of the financial statements.

- ◆ Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor's judgement, a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.
- ◆ A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgement, appropriate disclosure of the nature and implications of the uncertainty is necessary for:
 - (a) In the case of a fair presentation financial reporting framework, the fair presentation of the financial statements, or
 - (b) In the case of a compliance framework, the financial statements not to be misleading.

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.

Law or regulation may require communication of key audit matters for audits of entities other than listed entities.

Example

Entities characterized in such law or regulation as public interest entities.

The auditor may also decide to communicate key audit matters for other entities, including those that may be of significant public interest, for example because they have a large number and wide range of stakeholders and considering the nature and size of the business.

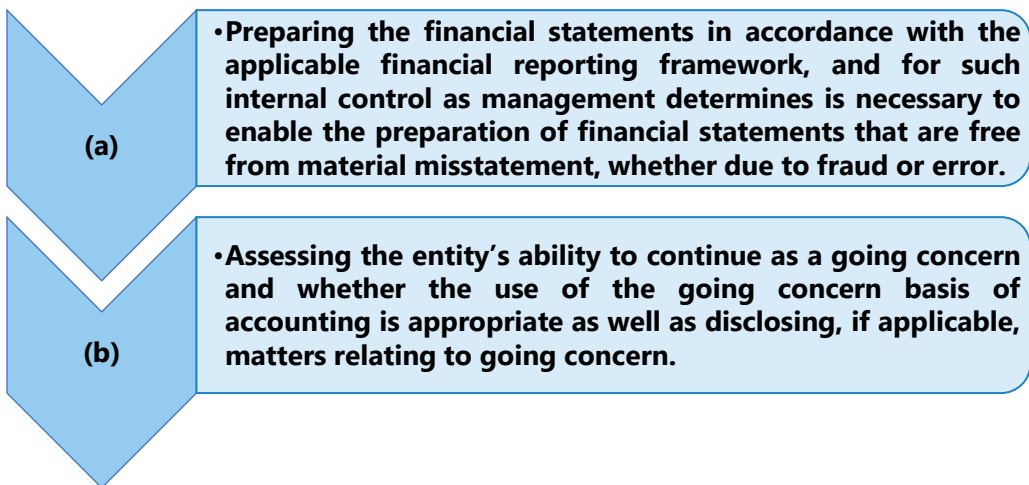
Examples

of such entities may include financial institutions (such as banks, insurance companies, and pension funds), and other entities such as charitable institutions.

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."

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;[because of the possible effects of fraud on other aspects of the audit, materiality does not apply to management's acknowledgement regarding its responsibility for the design, implementation, and maintenance of internal control (or for establishing and maintaining effective internal control over financial reporting) to prevent and detect fraud.] 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.

SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Management and, where appropriate, those charged with governance accept responsibility for the preparation of the financial statements. Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted.

SA 210 requires the auditor to agree management's responsibilities in an engagement letter or other suitable form of written agreement.

Oversight of the financial reporting process: 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 Management. 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 the entity.**

ILLUSTRATION 5

Diamond Shine Ltd. is a company engaged in the manufacture of detergent. M/s Bright & Associates are the statutory auditors of the company. Explain how the paragraph related to the management's responsibility will come in the auditor's report.

SOLUTION

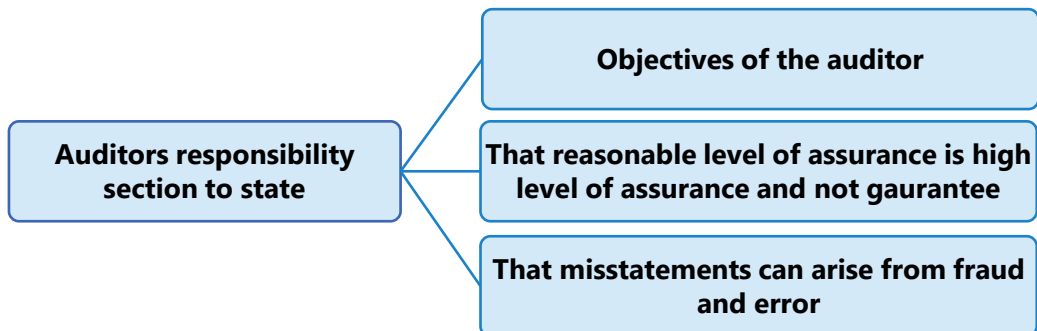
Management's Responsibility for the Standalone Financial Statements

The Company's Board of Directors is responsible for the matters stated in section 134(5) of the Companies Act, 2013 ("the Act") with respect to the preparation of these standalone financial statements that give a true and fair view of the financial position, financial performance, (changes in equity) and cash flows of the Company in accordance with the accounting principles generally accepted in India, including the accounting Standards specified under section 133 of the Act. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the Company and for

preventing and detecting frauds and other irregularities; selection and application of appropriate accounting policies; making judgements and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statement that give a true and fair view and are free from material misstatement, whether due to fraud or error. In preparing the financial statements, management is responsible for assessing the Company'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 Company or to cease operations, or has no realistic alternative but to do so. Those Board of Directors are also responsible for overseeing the Company's financial reporting process.

9. Auditor's Responsibilities for the Audit of the Financial Statements: The auditor's 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 state:



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

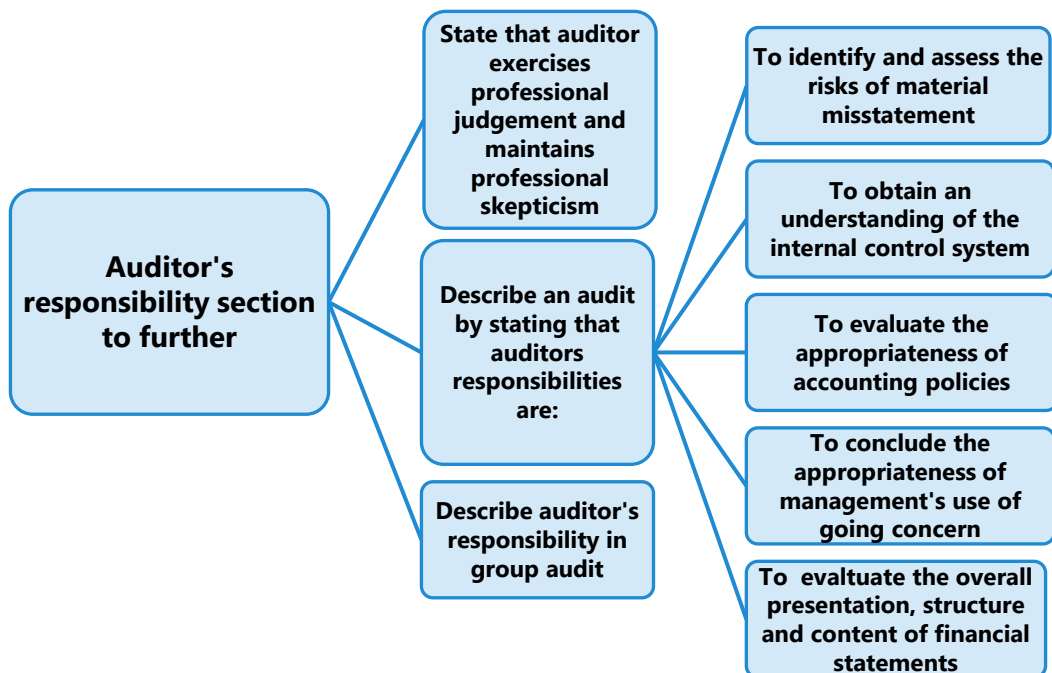
- (i) Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and
- (ii) Issue an auditor's report that includes the auditor's opinion.

(b) 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) 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 judgement 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.
 - (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.
 - (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 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)** For audits of financial statements of listed entities, 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 listed entities and any other 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. The auditor describes these matters in the auditor's report unless law or regulation precludes public disclosure.

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 shall be included:

Within the body of the auditor's report

Within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix or

By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority, where law, regulation or national auditing standards expressly permit the auditor to do so.

ILLUSTRATION 6

M/s Ajay Vijay & Associates are the statutory auditors of Sarovar Ltd. for the FY 2025-26. The company is engaged in the business of manufacture of water bottles. At the time of finalising the auditor's report, one of the audit team members asked CA Ajay, the engagement partner to advise as to how the auditor's responsibilities can be shown in an appendix to the auditor's report. Draft the auditor's responsibility paragraph so as to advise the audit team member.

SOLUTION**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 aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is included in appendix X of this auditor's report. This description, which is located at *[indicate page number or other specific reference to the location of the description]*, forms part of our auditor's report.

11. Other Reporting Responsibilities:

- 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.

- 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.
- If the auditor's report contains a separate section that addresses other reporting responsibilities, the requirements stated above 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.

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:

All the statements that comprise the financial statements, including the related notes, have been prepared; and

Those with the recognized authority have asserted that they have taken responsibility for those financial statements

The date of the auditor's report informs the user of the auditor's report that the auditor has considered the effect of events and transactions of which the auditor became aware and that occurred up to that date. The auditor's responsibility for events and transactions after the date of the auditor's report is addressed in SA 560.

UDIN

It was noticed that financial documents/ certificates attested by third person misrepresenting themselves as CA Members were misleading the Authorities and Stakeholders. ICAI also received number of complaints of signatures of CAs being forged by non CAs. To curb the malpractices, the Professional Development Committee of ICAI implemented in phased manner an innovative concept of UDIN i.e. Unique Document Identification Number. All Certificates were made mandatory with effect from 1st February, 2019 as per the Council decision taken at its 379th Meeting held on 17th – 18th December, 2018.

Chartered Accountants having full-time Certificate of Practice can register on UDIN Portal and generate UDIN by registering the certificates attested/certified by them.

Accordingly, an auditor is required to mention the UDIN with respect to each audit report being signed by him, along with his membership number while signing an audit report. The same is shown in the below illustration.

ILLUSTRATION 7

M/s TUV & Associates are the statutory auditors of Venus Ltd. for the FY 2025-26.

At the time of finalising the auditor's report, one of the audit team members asked the engagement partner, CA Tarun, to explain as to how the auditor's report will be signed. Help CA Tarun in explaining the same.

SOLUTION

The following is the correct way of signing an audit report.

M/s TUV & Associates
Chartered Accountants
(Firm's Registration No.)
Signature
(Name of the Member Signing the Audit Report)
(Designation)
(Membership No. XXXXX)

Place of Signature:

UDIN: 20037320AAAAAH1111

Date:

Test Your Understanding 1

Maithili Thakur, a CA student, was perusing audit report of a company. Her eyes fell on an 18-digit alpha numeric number stated at end of audit report below the signatures of auditor and membership number. Make her understand objective and significance of such a randomly generated number. Is it required to be stated in case of audit reports only?

Test Your Understanding 2

CA. Maya Memani has conducted audit of a company. She has asked Sana, a CA student undergoing training in her office, to prepare draft audit report. Sana was part of engagement team conducting the audit. She has been further told to prepare draft report expressing unmodified opinion. After drafting para comprising unmodified opinion, Sana feels no need to provide basis for opinion. Discuss why her thinking is not proper.



4. AUDITOR'S REPORT PRESCRIBED BY LAW OR REGULATION

SA 200 explains that the auditor may be required to comply with legal or regulatory requirements in addition to SAs. When the differences between the legal or regulatory requirements and SAs relate only to the layout and wording of the auditor's report, the requirements stated below in points (a)–(m) set out the minimum elements to be included in the auditor's report to enable a reference to the Standards on Auditing. In those circumstances, the requirements stated in paragraph 3.1 above that are not included in points (a)–(m) need not be applied.

For example, the required ordering of the Opinion and the Basis of Opinion sections need not be applied.

Where specific requirements in a particular law or regulation do not conflict with SAs, the layout and wording required by this SA assist users of the auditor's report in more readily recognizing the auditor's report as a report of an audit conducted in accordance with SAs.

If the auditor is required by law or regulation 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:

- (a) A title.
- (b) An addressee, as required by the circumstances of the engagement.
- (c) 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.
- (d) An identification of the entity's financial statements that have been audited.
- (e) 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.
- (f) Where applicable, a section that addresses, and is not inconsistent with, the reporting requirements relating to going concern as per SA 570 (Revised).
- (g) Where applicable, a Basis for Qualified (or Adverse) Opinion section that addresses, and is not inconsistent with, the reporting requirements relating to going concern as per SA 570 (Revised).
- (h) 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.
- (i) 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 as contained in this SA 700.
- (j) 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 as contained in this SA 700.
- (k) The auditor's signature.
- (l) The Place of signature.
- (m) The date of the auditor's report.

ILLUSTRATION 8*Auditor's Report on Financial Statements of a Listed Entity Prepared in Accordance with a Fair Presentation Framework*

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 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 prescribed under section 133 of the Companies Act, 2013.*
- ◆ *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 comprise the Code of Ethics issued by ICAI together with the other relevant ethical requirements relating to the audit and the auditor refers to both.*
- ◆ *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.*

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Standalone Financial Statements¹

Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at 31st March 20XX, and the statement of Profit and Loss, (*statement of changes in equity*)² and 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)]³.

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 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 March 31, 20XX, and profit/loss, (*changes in equity*)⁴ and its cash flows for the year ended on that date.

Basis for Opinion

We conducted our audit in accordance with the 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 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

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.

² Where applicable

³ Where applicable

Key Audit Matters

Key audit matters are those matters that, in our professional judgement, 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.]

Management's Responsibility for the Standalone Financial Statements

The Company's Board of Directors is responsible for the matters stated in section 134(5) of the Companies Act, 2013 ("the Act")⁴ with respect to the preparation of these standalone financial statements that give a true and fair view of the financial position, financial performance, (changes in equity)⁵ and cash flows of the Company in accordance with⁶ the accounting principles generally accepted in India, including the accounting Standards specified under section 133 of the Act. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the Company and for preventing and detecting frauds and other irregularities; selection and application of appropriate implementation and maintenance of accounting policies; making judgements and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statement that give a true and fair view and are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company'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

⁴ Where applicable

⁵ Where applicable

⁶ Where management's responsibility is to prepare financial statements that give a true and fair view, this may read: "Management is responsible for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards, and for such ..."

management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those Board of Directors are also responsible for overseeing the Company'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 applicable 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.

As part of an audit in accordance with SAs, we exercise professional judgement 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. Under section 143(3)(i) of the Companies Act, 2013, we are also responsible for expressing our opinion on whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

- ◆ 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 Company'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 Company to cease to continue as a going concern.
- ◆ 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.

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.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine 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. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Other Matter

We did not audit the financial statements/ information of (number) branches included in the stand alone financial statements of the Company whose financial statements/financial information reflect total assets of ₹ as at 31st March 20XX and the total revenue of ₹ for the year ended on that date, as considered in the standalone financial statements/information 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 branches, is based solely on the report of such branch auditors.

Our opinion is not modified in respect of these matters.

Report on Other Legal and Regulatory Requirements

As required by the Companies (Auditor's Report) Order, 2020 ("the Order"), issued by the Central Government of India in terms of sub-section (11) of section 143 of the Companies Act, 2013, we give in the Annexure a statement on the matters specified in paragraphs 3 and 4 of the Order, to the extent applicable.

As required by Section 143(3) of the Act, we report that:

- (a) We have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit.
- (b) In our opinion, proper books of account as required by law have been kept by the Company so far as it appears from our examination of those books [*and proper returns adequate for the purposes of our audit have been received from the branches not visited by us*⁷]
- (c) [*The reports on the accounts of the branch offices of the Company audited under Section 143(8) of the Act by branch auditors have been sent to us and have been properly dealt with by us in preparing this report*⁸.]
- (d) The Balance Sheet, the Statement of Profit and Loss, and the Cash Flow Statement dealt with by this Report are in agreement with the books of account [*and with the returns received from the branches not visited by us*⁹].

⁷ Where applicable

⁸ Where applicable

⁹ Where applicable

- (e) In our opinion, the aforesaid standalone financial statements comply with the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014.
- (f) We do not have any observation or comment on the financial statements or matters which have any adverse effect on the functioning of the company.
- (g) On the basis of the written representations received from the directors as on 31st March, 20XX taken on record by the Board of Directors, none of the directors is disqualified as on 31st March, 20XX from being appointed as a director in terms of Section 164 (2) of the Act.
- (h) We do not have any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected herewith.
- (i) With respect to the adequacy of the internal financial controls over financial reporting of the Company and the operating effectiveness of such controls, refer to our separate Report in "Annexure A".
- (j) With respect to the other matters to be included in the Auditor's Report in accordance with Rule 11 of the Companies (Audit and Auditors) Rules, 2014, in our opinion and to the best of our information and according to the explanations given to us:
 - (1) The Company has disclosed the impact of pending litigations on its financial position in its financial statements – Refer Note XX to the financial statements; *[or the Company does not have any pending litigations which would impact its financial position¹⁰]*
 - (2) The Company has made provision, as required under the applicable law or accounting standards, for material foreseeable losses, if any, on long-term contracts including derivative contracts – Refer Note XX to the financial statements; *[or the Company did not have any long-term contracts including derivative contracts for which there were any material foreseeable losses.¹¹]*
 - (3) There has been no delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company *{or, following are the instances of delay in transferring*

¹⁰ As may be applicable

¹¹ As may be applicable

amounts, required to be transferred, to the Investor Education and Protection Fund by the Company or there were no amounts which were required to be transferred to the Investor Education and Protection Fund by the Company¹²}.

- (4) (i) 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) 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 we have considered reasonable and appropriate in the circumstances, nothing has come to our notice that has caused us to believe that the representations under sub-clause (i) and (ii) contain any material mis-statement.
- (5) The dividend declared or paid during the year by the company is in compliance with section 123 of the Companies Act, 2013.

¹² As may be applicable

- (6) 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.

For XYZ & Co

Chartered Accountants
(Firm's Registration No.)

Signature

(Name of the Member Signing the Audit Report)

(Designation¹³)

(Membership No. XXXXX)

UDIN: 20037320AAAAAH1111

Place of Signature:

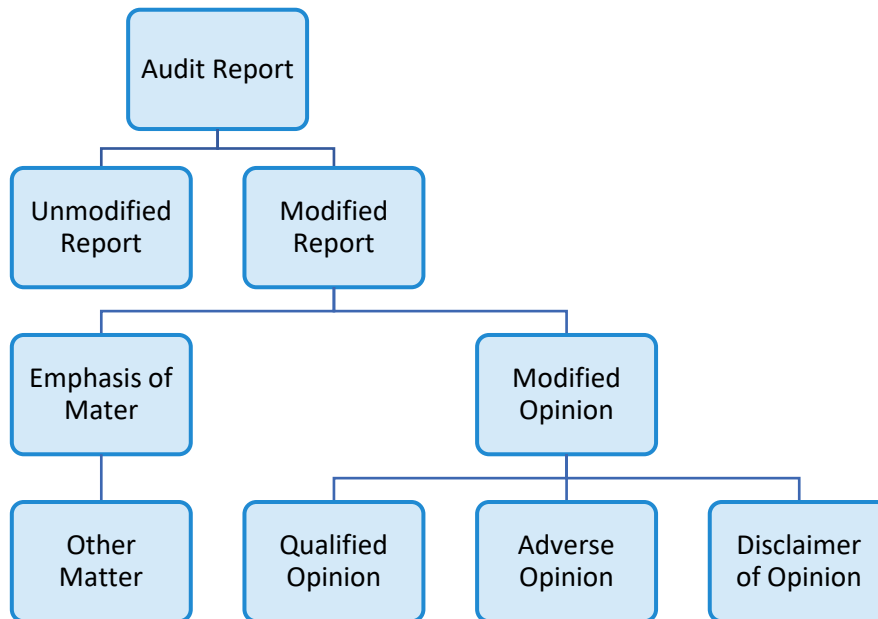
Date:



5. MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT

Standard on Auditing (SA) 705 "Modifications to the Opinion in the Independent Auditor's Report" deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700 (Revised) "Forming an Opinion and Reporting on Financial Statements", the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary.

¹³ Partner or Proprietor, as the case may be



This SA also deals with how the form and content of the auditor's report is affected when the auditor expresses a modified opinion.

5.1 Circumstances When a Modification to the Auditor's Opinion Is Required

The auditor shall modify the opinion in the auditor's report in the following circumstances:

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.

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

As per Standard on Auditing (SA) 705 "Modifications To The Opinion In The Independent Auditor's Report", 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 Types of Modified Opinions:

There are three types of modified opinions, namely-

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

Qualified Opinion

The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, are material, but not pervasive 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.

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.

Disclaimer of Opinion

The auditor shall disclaim an opinion when he is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and he concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

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.

ILLUSTRATION 9

Super Duper Ltd. is a company engaged in the manufacture of office furniture. M/s Young Old & Associates are the statutory auditors of the company for the FY 2025-26. During the year under audit, the engagement partner CA Young noticed that the company has not bifurcated its loans into long term and short term. CA Young understands that such misstatement is not pervasive though the same is material.

Explain the type of opinion that should be given by M/s Young Old & Associates in this case.

SOLUTION

M/s Young Old & Associates should give a qualified opinion as the effect of the misstatement on account of the non-bifurcation of loans into long term and short term loans, is material but not pervasive.

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.

Definition of Pervasive – 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 judgement:

- (i) Are not confined to specific elements, accounts or items of the financial statements;
- (ii) If so confined, represent or could represent a substantial proportion of the financial statements; or
- (iii) In relation to disclosures, are fundamental to users' understanding of the financial statements.

ILLUSTRATION 10

M/s Taj Raj & Associates are the statutory auditors of Porex Ltd. engaged in the manufacture of premium watches, for the FY 2025-26. During the course of audit, CA Taj, the engagement partner found that the stocks and debtors of the company constituting about 80% of the total assets of the company are not realisable. Further, the cashier of the company has committed a fraud during the year under audit. Both the facts are not reflected in the financial statements for the year ending 31.03.2026. Accordingly, CA Taj is of the view that the impact of both the situations on the financial statements is material and pervasive and thus, the financial statements represent a distorted view of the state of affairs of the company. Explain the reporting requirements of CA Taj.

SOLUTION

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.

In the case Porex Ltd., CA Taj found that the stocks and debtors of the company constituting about 80% of the total assets of the company are not realisable. Further, the cashier of the company has committed a fraud during the year under audit. Such situations are not reflected in the financial statements of the company despite having a material and pervasive impact on the financial statements. As such, CA Taj should give an adverse opinion.

Further, CA Taj should also consider the reporting responsibilities under CARO 2020 and section 143(12) of the Companies Act, 2013.

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.

ILLUSTRATION 11

Delightful Ltd. is a company engaged in the production of smiley balls. During the FY 2025-26 the company transferred its accounts to computerised system (SAP) from manual system of accounts. Since the employees of the company were not well versed with the SAP system, there were many errors in the accounting during the transition period. As such the statutory auditors of the company were not able to extract correct data and reports from the system. Such data was not available manually also. Further, the employees and the management of the company were not supportive in providing the requisite information to the audit team. Explain the kind of audit report that the statutory auditor of the company should issue in this case.

SOLUTION

When the statutory auditor of the company is unable to obtain sufficient and appropriate audit evidence, the auditor should give disclaimer of opinion as per SA 705.

In the present case, the statutory auditor of the company is unable to extract correct data and reports from the SAP system for conduct of audit. Also, such data and reports are not available manually. As such, the statutory auditor of Delightful Ltd. should give a disclaimer of opinion.

5.4 Which type of opinion is appropriate?

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 judgement about the pervasiveness of the effects or possible effects of the matter on the financial statements.

The table below illustrates how the auditor's judgement about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed.

Nature of Matter Giving Rise to the Modification	Auditor's Judgement 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

5.5 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 is 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 referred above, 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.
- If the auditor withdraws as contemplated by point (b)(i) above, 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.

Test Your Understanding 3

CA. Sarasbhai Patel, while conducting audit of an entity, feels that there is an atmosphere of non-cooperation all around. He has not been provided with necessary support for attending inventory count process of entity as at year end. Besides, CFO is not providing him present addresses of customers as well as suppliers for sending external confirmations. Even mail ids have not been provided on the pretext of business confidentiality.

He was not able to verify revenues of entity due to lack of complete details. For verifying expenses, he has been asking for bills on a sample basis, but staff has been making lame excuses. The matter was brought to knowledge of higher echelons of management, but of no avail. The auditor feels that there could be misstatements and their possible effects would be material and affecting many aspects of financial statements.

Assuming it is not possible to withdraw from engagement, what type of opinion should be expressed by auditor?

- The above matter is depicted in the following diagram:

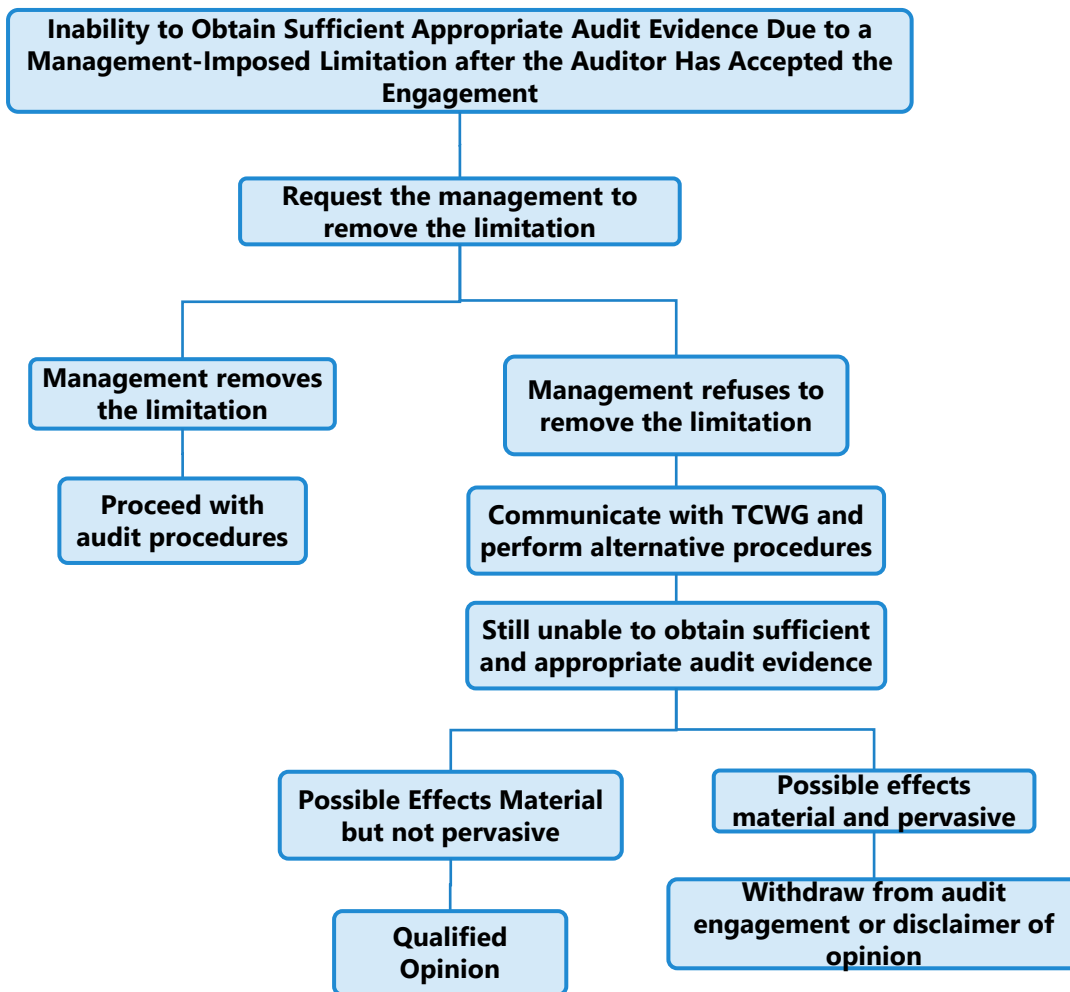


ILLUSTRATION 12

M/s Daisy & Associates are the statutory auditors of Zebra Ltd. for the FY 2025-26. CA Daisy, the engagement partner wants to verify the cash in hand as on 31.03.2026. The cash balance of the company as on 31.03.2026 is ₹ 1,00,000/- and the turnover of the company for the year is ₹ 6 crores. The management of the company informs CA Daisy that such cash verification is not possible as the cashier is on leave for his marriage and no other employee of the company is available as all are busy in year ending activities. Explain the relevant provisions to deal with such a situation.

SOLUTION

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 is 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.

In the present case CA Daisy, the statutory auditor is unable to verify the cash in hand of Zebra Ltd. as on 31.03.2026. The same is due to a limitation imposed by the management of Zebra Ltd. which is due to the non availability of the cashier. In such situation, CA Daisy should perform alternate procedures to verify the cash on hand of the company. Further, CA Daisy should consider the impact on the auditor's report and may consider issuing a qualified opinion in this case.

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

Auditor's Opinion

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

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.

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].

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 by SA 700 (Revised), which indicates that the financial statements have been audited, to state that the auditor was engaged to audit the financial statements.

5.7 Basis for Opinion

When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by SA 700 (Revised):

Amend the heading “Basis for Opinion” required by SA 700 (Revised) to “Basis for Qualified Opinion,” “Basis for Adverse Opinion,” or “Basis for Disclaimer of Opinion,” as appropriate; and

Within this section, include a description of the matter giving rise to the modification.

- ◆ If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements (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 required by SA 700 (Revised) 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 the following elements required by SA 700 (Revised).
 - (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.

5.8 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 by SA 700 (Revised).

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

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.

5.10 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.

ILLUSTRATION 13

M/s Sun Moon & Associates are the statutory auditors of Venus Ltd. for the FY 2025-26. Owing to the pervasive nature of material misstatements in the financial statements of the company, CA Moon, the engagement partner decided to give an adverse opinion. Explain the responsibility of CA Moon with respect to communication with those charged with governance.

SOLUTION

CA Moon, being the statutory auditor of Venus Ltd. should communicate with those charged with governance about the circumstances that led to the expected modification i.e. an adverse opinion. Further the wording of such modification also needs to be discussed.



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

SA 706 deals with additional communication in the auditor's report when the auditor considers it necessary to:

- (a) 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

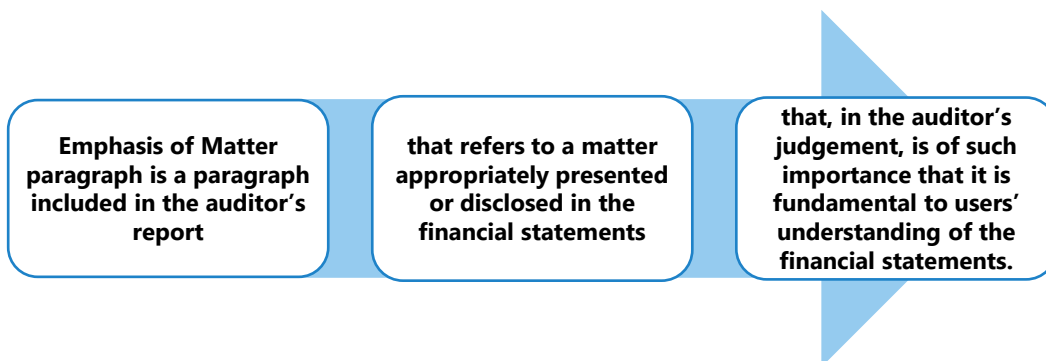
- (b) Draw users' attention to any matter or matters other than those presented or disclosed in the financial statements that are relevant to user's understanding of the audit, the auditor's responsibilities or the auditor's report.

6.1 Objective of the Auditor as per SA 706

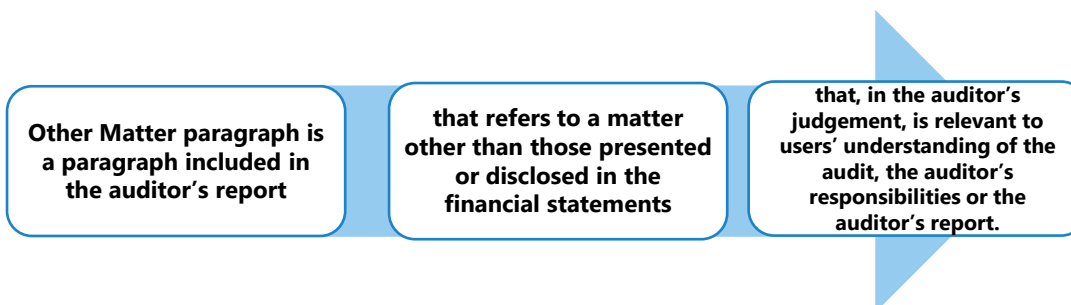
As per SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor's Report", the objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgement it is necessary to do so, by way 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.

Definition of Emphasis of Matter Paragraph



Definition of Other Matter paragraph



6.2 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 judgement, 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.

6.2.1 Separate section for Emphasis of Matter paragraph

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.

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

- An uncertainty relating to the future outcome 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.

6.3 The inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion

An Emphasis of Matter paragraph is not a substitute for:

- (a) A modified opinion in accordance with SA 705 (Revised) when required by the circumstances of a specific audit engagement;
- (b) Disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation; or
- (c) 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.

ILLUSTRATION 14

Lomaxe Ltd. is a company engaged in the business of manufacture of candles. CA Kamalnath is the statutory auditor of the company for the FY 2025-26. During the year under audit, there was a fire in the company's factory as a result of which, some of the company's plant and machinery was destroyed. The same was disclosed by the company in the notes to accounts annexed to the financial statements for the year ending 31.03.2026. CA Kamalnath decided to communicate this matter in the auditor's report as he is of the view that the matter is of such importance that it is fundamental to the user's understanding of the financial statements. Help CA Kamalnath to deal with this situation in the auditor's report.

SOLUTION

In the present case there is a need to add Emphasis on Matter Paragraph in the Auditor's Report. The draft of the same is as under:

Emphasis of Matter – Effects of Fire in Company's Factory

We draw attention to Note Y of the financial statements, which describes the effects of a fire in the Company's factory. Our opinion is not modified in respect of this matter.

6.4 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 judgement, 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.

6.4.1 Separate section for Other Matter paragraph

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.

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

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 judgement as to what to communicate in the auditor's report and the form and content of such communication.

Definition of Key Audit Matter

Key Audit Matters are those matters that, in the auditor's professional judgement

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.

7.1 Purpose of Communicating Key Audit Matters

As per SA 701, "Communicating Key Audit Matters in the Auditor's Report", 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 judgement, 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 judgement in the audited financial statements.

7.2 Objectives of the Auditor regarding Key Audit Matters

As per SA 701, "Communicating Key Audit Matters in The Independent Auditor's Report", the objectives of the auditor are to determine key audit matters and, having formed an opinion on the financial statements, communicate those matters by describing them in the auditor's report.

7.3 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:

Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315.

Significant auditor judgements relating to areas in the financial statements that involved significant management judgement, including accounting estimates that have been identified as having high estimation uncertainty.

The effect on the audit of significant events or transactions that occurred during the period.

The auditor shall determine which of the matters determined, as stated above, were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters.

7.4 Communicating Key Audit Matters

The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "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 judgement, 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.

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

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 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.

7.6 Communication with Those Charged with Governance

The auditor shall communicate with those charged with governance:

- (a) Those matters the auditor has determined to be the key audit matters; or
- (b) If applicable, depending on the facts and circumstances of the entity and the audit, the auditor's determination that there are no key audit matters to communicate in the auditor's report.

Example:

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.

SA 701 AT A GLANCE

APPLICABILITY OF SA 701	➤ 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 ➤ 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

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.

**COMMUNICATING
AUDIT MATTERS:**

KEY

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.

AUDITOR'S REPORT ON THE FINANCIAL STATEMENTS- A BIRD'S EYE VIEW

The following table gives a summary of the Standards on Auditing related to audit reporting:

Standard on Auditing	Name of SA	Matters dealt with (Scope)
SA 700 (Revised)	Forming an Opinion and Reporting on Financial Statements	- The auditor's responsibility to form an opinion on financial statements. - The form and content of the Auditor's Report.
SA 705 (Revised)	Modifications to the Opinion in the Independent Auditor's Report	Auditor's responsibility to issue an appropriate report in circumstances when auditor concludes that a modification to auditor's opinion is necessary.

		- Three types of modified opinion - A Qualified Opinion - An adverse opinion - A disclaimer of opinion
SA 701	Communicating Key Audit Matters in the Independent Auditor's Report	- The auditor's responsibility to communicate key audit matters in the auditor's report. - What to communicate and the form and content of such communication.
SA 706 (Revised)	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report	- Additional communication in the auditor's report when the auditor considers it necessary to draw users' attention to a matter: - Presented or disclosed in the financial statements and which is fundamental for the user's understanding. - Not presented or disclosed in the financial statements and which are relevant for the user's understanding.

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

This Standard on Auditing (SA) deals with the auditor's responsibilities regarding comparative information in an audit of financial statements. When the financial statements of the prior period have been audited by a predecessor auditor or were not audited, the requirements and guidance in SA 510 regarding opening balances also apply.

8.1 The Nature of the Comparative Information

The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework. There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements. The approach to be adopted is often specified by law or regulation but may also be specified in the terms of engagement.

The essential audit reporting differences between the approaches are:

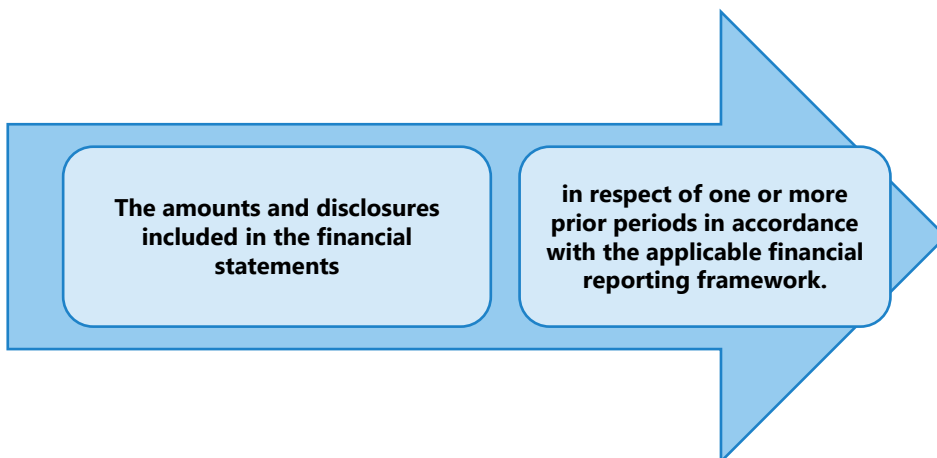
- (a) For corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas
- (b) For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

Objectives

As per SA 710, the objectives of the auditor are:

- (a) 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
- (b) To report in accordance with the auditor's reporting responsibilities.

Definition of Comparative Information:

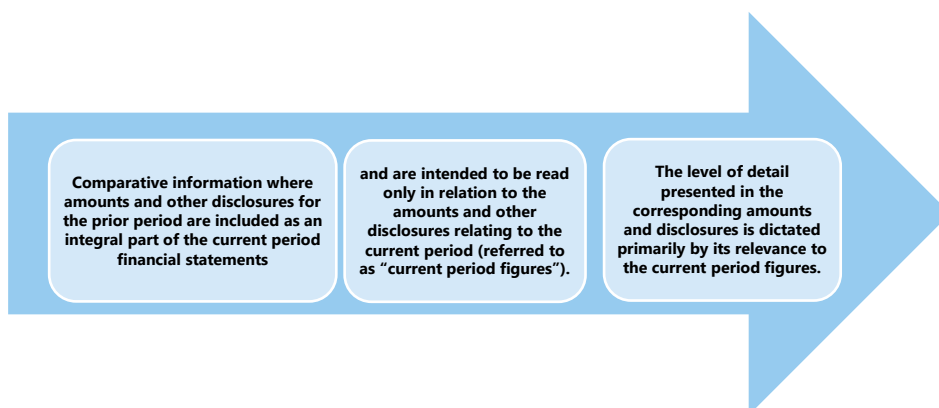


8.2 Audit Procedures regarding comparative information

- ◆ The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:
 - (a) The comparative information agrees with the amounts and other disclosures presented in the prior period; and
 - (b) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.
- ◆ If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period's financial statements, the auditor shall also follow the relevant requirements of SA 560.
- ◆ As required by SA 580, the auditor shall request written representations for all periods referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any prior period item that is separately disclosed in the current year's statement of profit and loss.

8.3 Audit Reporting regarding Corresponding Figures

Definition of Corresponding figures:



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

- 1. If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion** and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:
 - (a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
 - (b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.
- 2. If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements** on which an unmodified opinion has been previously issued, the auditor shall verify whether the misstatement has been dealt with as required under the applicable financial reporting framework and, if that is not the case, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements, modified with respect to the corresponding figures included therein.
- 3. Prior Period Financial Statements Not Audited-** If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

Prior Period Financial Statements Audited by a Predecessor Auditor

If the financial statements of the prior period were audited by a predecessor auditor and the auditor is permitted by law or regulation to refer to the

predecessor auditor's report on the corresponding figures and decides to do so, the auditor shall state in an Other Matter paragraph in the auditor's report:

- (a) That the financial statements of the prior period were audited by the predecessor auditor;
- (b) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and
- (c) The date of that report.

8.4 Comparative Financial Statements

Definition: Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

Auditor's opinion- to refer each period: When comparative financial statements are presented, the auditor's opinion shall refer to each period for which financial statements are presented and on which an audit opinion is expressed.

When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph in accordance with SA 706.

Prior Period Financial Statements Audited by a Predecessor Auditor

If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, the auditor shall state in an Other Matter paragraph:

- (a) That the financial statements of the prior period were audited by a predecessor auditor;
- (b) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefor; and
- (c) The date of that report,

unless the predecessor auditor's report on the prior period's financial statements is revised with the financial statements.

If the auditor concludes that a material misstatement exists that affects the prior period financial statements on which the predecessor auditor had previously reported without modification, the auditor shall communicate the misstatement with the appropriate level of management and those charged with governance and request that the predecessor auditor be informed. If the prior period financial statements are amended, and the predecessor auditor agrees to issue a new auditor's report on the amended financial statements of the prior period, the auditor shall report only on the current period.

Prior Period Financial Statements Not Audited

If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph that the comparative financial statements are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

9. AUDIT OF BRANCH OFFICE ACCOUNTS

As per **section 128(1)** of the Companies Act, 2013, every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting.

It may be noted that all or any of the books of account aforesaid and other relevant papers may be kept at such other place in India as the Board of Directors may decide and where such a decision is taken, the company shall, within 7 days thereof, file with the Registrar a notice in writing giving the full address of that other place.

Students may also note that the company may keep such books of account or other relevant papers in electronic mode in such manner as may be prescribed.

Sub-section (2) provides that where a company has a branch office in India or outside India, it shall be deemed to have complied with the provisions of sub-section (1), if proper books of account relating to the transactions effected at the branch office are kept at that office and proper summarised returns periodically are sent by the branch office to the company at its registered office or the other place referred in (1).

Further, sub-section (8) of section 143 of the Companies Act, 2013, prescribes the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor. Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed.

It may be noted that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

Further as per **rule 12 of the Companies (Audit and Auditors) Rules, 2014**, the branch auditor shall submit his report to the company's auditor and reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

For better understanding, let us now have a look at the following definitions:

- **Principal auditor** means the auditor with responsibility for reporting on the financial information of an entity when that financial information includes the financial information of one or more components audited by another auditor.
- **Other auditor** means an auditor, other than the principal auditor, with responsibility for reporting on the financial information of a component which is included in the financial information audited by the principal 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.

Using the Work of another Auditor: When the accounts of the branch are audited by a person other than the company's auditor (or principal auditor), there is need for a clear understanding of the role of such other auditor and the company's auditor in relation to the audit of the accounts of the branch and the audit of the company as a whole; also, there is great necessity for a proper rapport between these two auditors for the purpose of an effective audit. In recognition of these needs, the Council of the Institute of Chartered Accountants of India has dealt with these issues in **SA 600, "Using the Work of another Auditor"**. It makes clear that 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. Further, it requires that 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 following procedures:

- (a) advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as are as requiring special consideration, procedures for the identification of inter -component transactions that may require disclosure and the time-table for completion of audit; and
- (b) advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

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

Test Your Understanding 4

CA. Dicky Yadav is auditor of a company having four branches. The four branches are audited by another auditor CA. Yamini Jain. The reports in respect of accounts of branches examined by her have already been sent to company auditor. During the course of audit, CA Dicky Yadav asks the branch auditor to share with her summary of audit procedures and findings in respect of accounts of branches examined. CA. Yamini Jain feels it as encroachment of her domain. Discuss the issue.

10. JOINT AUDIT

The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work. This is by itself a great advantage.

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

- (i) Sharing of expertise.
- (ii) Advantage of mutual consultation.
- (iii) Lower workload.
- (iv) Better quality of performance.
- (v) Improved service to the client.
- (vi) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.
- (vii) Lower staff development costs.
- (viii) Lower costs to carry out the work.
- (ix) A sense of healthy competition towards a better performance.

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

- (i) The fees being shared.
- (ii) Psychological problem where firms of different standing are associated in the joint audit.

- (iii) General superiority complex of some auditors.
- (iv) Problems of co-ordination of the work.
- (v) Areas of work of common concern being neglected.
- (vi) Uncertainty about the liability for the work done.

The Institute of Chartered Accountants of India has issued Standard on Auditing (SA) 299 (Revised), "Joint Audit of Financial Statements" which lays down the principles for effective conduct of joint audit to achieve the overall objectives of the auditor as laid down in SA 200 "Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with Standards on Auditing". This Standard deals with the special considerations in carrying out audit by joint auditors. It requires that–

- (i) the engagement partner and other key members of the engagement team from each of the joint auditors should be involved in planning the audit.
- (ii) the joint auditors should jointly establish an overall audit strategy which sets the scope, timing and direction of the audit, and also guides the development of the audit plan.
- (iii) before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should:
 - (a) identify division of audit areas and common audit areas;
 - (b) ascertain the reporting objectives of the engagement;
 - (c) consider and communicate among all joint auditors the factors that are significant in directing the engagement team's efforts;
 - (d) consider the results of preliminary engagement activities, or similar engagements performed earlier.
 - (e) ascertain the nature, timing and extent of resources necessary to accomplish the engagement.
- (iv) each of the joint auditors should consider and assess the risks of material misstatement and communicate to other joint auditors.
- (v) the joint auditors should discuss and document the nature, timing, and the extent of the audit procedures for (I) common and (II) specific allotted areas of audit to be performed.
- (vi) the joint auditors should obtain common engagement letter and common management representation letter.

- (vii) the work allocation document should be signed by all the joint auditors and communicated to those charged with governance.

It further states that, 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. On the other hand, all the joint auditors shall be jointly and severally responsible for:

- (i) the audit work which is not divided among the joint auditors and is carried out by all joint auditors;
- (ii) decisions taken by all the joint auditors under audit planning in respect of common audit areas;
- (iii) matters which are brought to the notice of the joint auditors by any one of them and there is an agreement among the joint auditors on such matters;
- (iv) examining that the financial statements of the entity comply with the requirements of the relevant statutes;
- (v) presentation and disclosure of the financial statements as required by the applicable financial reporting framework;
- (vi) ensuring that the audit report complies with the requirements of the relevant statutes, applicable Standards on Auditing and other relevant pronouncements issued by ICAI.

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

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

[Note: Student may refer SA 299 (revised) "Joint Audit of Financial Statements" for comprehensive knowledge.]

11. REPORTING REQUIREMENTS UNDER THE COMPANIES ACT, 2013

Section 143 of the Companies Act, 2013 contains, inter alia, reporting requirements of auditor of a company in form of duties.

(1) Reporting requirement relating to matters stated in section 143(1)

Under section 143(1), auditor shall inquire into following matters given as under: -

- (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.

However, 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. 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) Reporting on accounts examined

Under provisions of Section 143(2), the auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made thereunder or under any order made under sub-section (11).

Further, auditor has to report whether to best of his information and knowledge, the said accounts, financial statements give a true and fair view of ***the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as prescribed under Rule 11 of the Companies (Audit and Auditors) Rules, 2014.***

Further, in terms of section 143(3), 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;

However, it may be noted that the reporting requirement on adequacy of internal financial controls (IFCs) with reference to financial statements shall **not** be applicable to a private company which is a–

- (i) One person company; or
 - (ii) Small company; or
 - (iii) Company having turnover less than ₹ 50 crore as per latest audited financial statement and having aggregate borrowings from banks or financial institutions or any body corporate at any point of time during the financial year less than ₹ 25 crore.
- (j) such other matters as are prescribed **in Rule 11 of the Companies (Audit and Auditors) Rules, 2014** which are as under:-
- (a) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;
 - (b) 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;
 - (c) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.
 - (d) (i) Whether the management has represented that, to the best of it's 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 it's 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 (1) and (2) contain any material misstatement.
- (e) Whether the dividend declared or paid during the year by the company is in compliance with section 123 of the Companies Act, 2013.
 - (f) 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.

While reporting, 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 therefor in terms of Section 143(4). Further, every auditor shall comply with the auditing standards as required under section 143(9).

- (3) **Reporting on any other matter specified by Central Government:** As per **section 143(11)**, the Central Government may, in consultation with the National Financial Reporting Authority, 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.

[Note: Students may note that Companies (Auditor's Report) Order, 2020 has been notified in this perspective which is discussed later in this chapter as Reporting under Companies (Auditor's Report) Order, 2020]

- (4) **Reporting on frauds:**

- A. Reporting to the Central Government-** As per **section 143(12)** of the Companies Act, 2013 read with **Rule 13** of the Companies (Audit and Auditors) Rules, 2014, 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, which involves or is expected to involve individually an amount of ₹ 1 crore or above, 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 prescribed.
- B. Reporting to the Audit Committee or Board-** 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 prescribed.

Besides, auditor has also to report matters pertaining to fraud at point (xi) of paragraph 3 of CARO,2020 which is discussed subsequently.



12. REPORTING UNDER COMPANIES AUDITOR'S REPORT ORDER, 2020 [CARO, 2020]

In exercise of the powers conferred by sub-section (11) of section 143 of the Companies Act, 2013 (18 of 2013) and in supersession of the Companies (Auditor's Report) Order, 2016, published in the Gazette of India, Extraordinary, Part II, Section 3, Sub-section (ii), vide number S.O. 1228 (E), dated the 29th March, 2016, except as respects things done or omitted to be done before such supersession, the Central Government, after consultation with the National Financial Reporting Authority constituted under section 132 of the Companies Act, 2013, hereby makes the following Order, namely:—

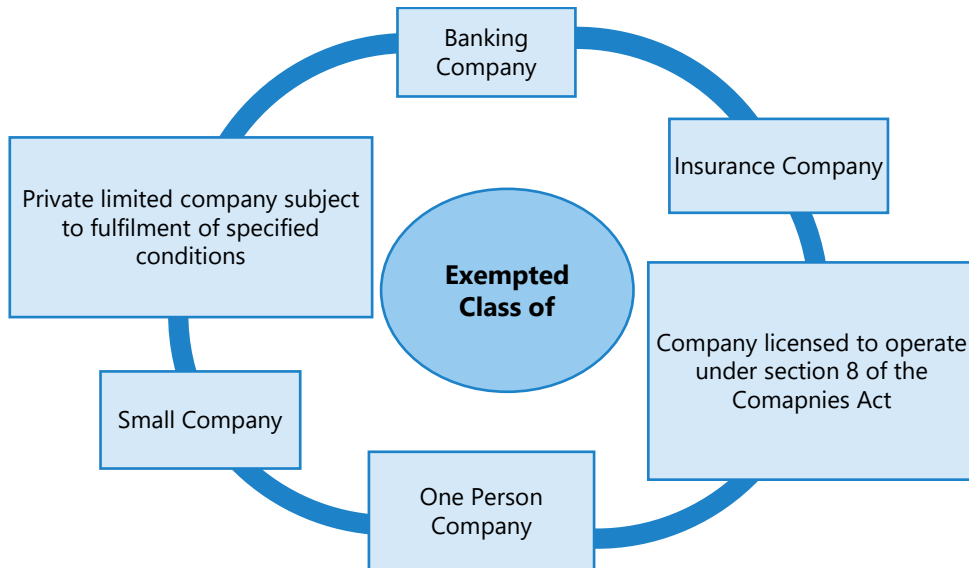
Short title, application and commencement –

Short title: This Order may be called the **Companies (Auditor's Report) Order, 2020.**

Application: It shall apply to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013 (18 of 2013) [hereinafter referred to as the Companies Act], except—

- (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, 2013;
- (iv) a One Person Company as defined in clause (62) of section 2 of the Companies Act, 2013 and a small company as defined in clause (85) of section 2 of the Companies Act, 2013; 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 one crore rupees as on the balance sheet date and which does not have total borrowings exceeding one crore rupees 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 (including revenue from discontinuing operations) exceeding ten crore rupees during the financial year as per the financial statements.

Commencement: It shall come into force on the date of its publication in the Official Gazette.



Example

'Educating Child' is a limited company registered under section 8 of the Companies Act, 2013.

In the given case, 'Educating Child' is licensed to operate under section 8 of the Companies Act, 2013. Therefore, CARO, 2020 shall not be applicable to 'Educating Child' accordingly.

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 years commencing on or after the 1st April, 2019, shall in addition, contain the matters specified in paragraphs 3 and 4, as may be applicable: Provided this Order shall not apply to the auditor's report on consolidated financial statements except clause (xxi) of paragraph 3.

Paragraph 3

Matters to be included in 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 noncompliance;
- (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 the Companies Act, 2013 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 the Companies Act, 2013 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, 2013 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 subsection (5) of section 135 of the Companies Act, 2013 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.

Paragraph 4. Reasons to be stated for unfavourable or qualified answers. –

- (1) 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.
- (2) 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.

Test Your Understanding 5

CA. Ravi Patnaik is conducting audit of a company for which reporting requirements under CARO, 2020 are applicable. He finds that cash credit facilities amounting to ₹ 4 crores were released to the company by branch of a bank for meeting its working capital requirements. He finds that out of above funds, ₹ 1 crore have been used by company for installing effluent treatment plant to meet State pollution control Board requirements.

Is there any reporting obligation upon him under CARO,2020?

Example *The company has dispensed with the practice of taking inventory of their inventories at the year-end as in their opinion the exercise is redundant, time consuming and intrusion to normal functioning of the operations. Explain reporting requirement under CARO, 2020.*

Reporting for Physical Verification of Inventory:

Clause (ii) of Para 3 of CARO, 2020, requires the auditor to report (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;

In the given case, the above requirement of physical verification of inventory by the management has not been taken place and therefore the auditor should point out the same under CARO, 2020. He may consider the impact on financial statement and report accordingly.

CASE STUDY

M/s AB & Company is a firm of Chartered Accountants based in Mumbai. Mr. A and Mr. B are the Partners of the Firm. The Firm is engaged in various assignments including Audits. The partners are taking a summary of their work in order to prepare themselves to finalize the Audit and issue the audit report to various clients. You are requested to go through the following and answer the questions that follow:

- During the audit of M/s Persistent & Co, Mr. A found that the firm has changed the method of Depreciation from WDV to SLM but has not given the retrospective effect. Mr. A has calculated the difference of depreciation but M/s Persistent & Co. has stated that they don't want to change the financial statements and if auditor persists they may give the effect in the next financial year.
- During the audit of M/s Dubious Brothers, Mr B observed that the firm had a very large amount of cash sales and there were no details of the customers to whom the sales were made. Further, cash generated was not even deposited into bank regularly. When Mr. B asked the firm to give him an opportunity to count cash, the manager of the firm said that the cash is with the owner and it cannot be made available to the auditor for the checking purpose. The manager also declined to give an opportunity for stock verification to Mr B.
- During the audit of M/s Honest & Associates, Mr. A came to know that the firm has changed its method of valuation of stock. This change has a material impact on the financial statement of the firm. The firm has made relevant disclosures in the financial statements and has given proper accounting treatment to this exercise.

Based on above, answer following questions:

1. *In case of M/s Persistent & Company, what would be an ideal Audit Opinion?*
 - (a) *Unmodified*
 - (b) *Qualified*
 - (c) *Mention the fact in Emphasis of Matter Paragraph*
 - (d) *Disclaimer*

2. *In case of M/s Dubious Brothers, what Audit Opinion should the Auditor give?*
 - (a) *Qualified*
 - (b) *Adverse*
 - (c) *Disclaimer*
 - (d) *Unmodified*
3. *According to you, what would be appropriate course to take in case of M/s Honest & Associates?*
 - (a) *Issue Qualified Opinion*
 - (b) *Issue Adverse Opinion*
 - (c) *Mention the fact of change in method in Emphasis of Matter Paragraph*
 - (d) *Issue Disclaimer of Opinion*
4. *When the Auditor, after conclusion of an Audit exercise, is of the opinion that there are material misstatements in the Financial Statements, but they are not pervasive, then what should an Auditor do?*
 - (a) *Issue Unmodified Opinion*
 - (b) *Issue Qualified Opinion*
 - (c) *Issue Disclaimer of Opinion*
 - (d) *Mention it in Emphasis of Matter Paragraph*
5. *When the Auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework, Auditor shall give:*
 - (a) *Modified Opinion*
 - (b) *Qualified Opinion*
 - (c) *Disclaimer of Opinion*
 - (d) *Unmodified Opinion*

Answers to Questions involving case study

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

SUMMARY

- ◆ Management is responsible for the preparation of the financial statements. The purpose of an audit is to enhance the degree of confidence of intended users of the financial statements. The aforesaid purpose is achieved by the expression of an independent reporting by the auditor.
- ◆ The objectives of the auditor as per SA 700 (Revised), "Forming An Opinion And Reporting On Financial Statements" 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.
- ◆ 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.
- ◆ There are three types of modified opinions, namely-a qualified opinion, an adverse opinion, and a disclaimer of opinion.
- ◆ As per SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor's Report", the objective of the auditor is to draw users' attention by way of clear additional communication in the auditor's report, to 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 as appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.
- ◆ As per SA 701, "Communicating Key Audit Matters in The Independent Auditor's Report", the objectives of the auditor are to determine key audit matters and, having formed an opinion on the financial statements, communicate those matters by describing them in the auditor's report.
- ◆ As per SA 710, there are two different broad approaches to the auditor's reporting responsibilities in respect of comparative information: corresponding figures and comparative financial statements. The approach to be adopted is often specified by law or regulation but may also be specified in the terms of engagement.

- ◆ As per SA 600, when the principal auditor uses the work of another auditor, the principal auditor should determine how the work of the other auditor will affect the audit.
- ◆ SA 299 "Joint Audit of Financial Statements" deals with the professional responsibilities which the auditors undertake in accepting appointments as joint auditors.
- ◆ CARO 2020, - Every report made by the auditor under section 143 of the Companies Act on the accounts of every company audited by him, to which CARO, 2020 applies, for the financial years commencing on or after the 1st April, 2019, shall in addition, contain the matters specified in paragraphs 3 and 4, as may be applicable.

For a concise revision of the key concepts covered in this chapter, students may refer to the **Saransh Booklet for Paper 5: Auditing and Ethics**, which serves as a useful last-mile revision resource for examination preparation. Saransh Booklet can be accessed at <https://resource.cdn.icai.org/85998bos-aps751-int-p5.pdf>

TEST YOUR KNOWLEDGE

MCQs based Questions

1. While expressing an unmodified opinion on financial statements, the auditor shall not use which of the following phrases?
 - (a) *present fairly in all material respects*
 - (b) *give a true and fair view*
 - (c) *with the foregoing explanation*
 - (d) *All of the above*
2. 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 judgement, is of such importance that it is fundamental to the user's understanding of the financial statements.
 - (a) *Emphasis of Matter Paragraph*

- (b) *Other Matter Paragraph*
 - (c) *Key Audit Matter*
 - (d) *Management Responsibility Paragraph.*
3. *Statement 1: Communicating key audit matter in the auditor's report constitutes a substitute for disclosure in the financial statements.*
- Statement 2: Instead of modifying an opinion in accordance with SA 705, the statutory auditor can use Key Audit Matter paragraph in the audit report with an unmodified opinion.*
- (a) *Only Statement 1 is correct*
 - (b) *Only Statement 2 is correct*
 - (c) *Both the statements are correct*
 - (d) *None of the statement is correct*
4. *Which of the following is not correct?*
- (a) *SA 700 - Forming an Opinion and Reporting on the Financial Statements*
 - (b) *SA 701- Key Audit Matters in the Independent Auditor's Report*
 - (c) *SA 705- Comparative Information- Corresponding figures and Comparative Financial Statements*
 - (d) *SA 706- Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*
5. *Responsibilities of Joint Auditors are governed by:*
- (a) *SA 200*
 - (b) *SA 229*
 - (c) *SA 299*
 - (d) *SA 230*

Correct/Incorrect

State with reasons (in short) whether the following statement is correct or incorrect:

- (i) *The auditor shall express a qualified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.*
- (ii) *There is no need of addressee in the Auditor's report.*
- (iii) *The auditor shall modify the opinion in the auditor's report only when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement.*
- (iv) *The auditor shall express a disclaimer of 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.*
- (v) *Communicating key audit matter in the auditor's report constitutes a substitute for disclosure in the financial statements.*
- (vi) *When the auditor has to express an adverse opinion, he need not communicate with those charged with governance as this may have an impact on payment of his audit fees.*
- (vii) *Instead of modifying an opinion in accordance with SA 705, the statutory auditor can use Key Audit Matter paragraph in the audit report with an unmodified opinion.*
- (viii) *The concept of "joint audit" has legal foothold under the Companies Act, 2013.*

Theoretical Questions

1. *"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." Explain*
2. *"The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators*

- of possible bias in management's judgements." Discuss stating clearly qualitative aspects of the entity's accounting practices*
3. *Discuss the factors affecting the decision of the auditor regarding which type of modified opinion is appropriate.*
 4. *Discuss the objective of the auditor as per Standard on Auditing (SA) 705 "Modifications to The Opinion in The Independent Auditor's Report".*
 5. *In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgements. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Explain and analyse the indicators of lack of neutrality with examples, wherever required.*
 6. *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 identify the entity whose financial statements have been audited. Apart from the above, explain the other relevant points to be included in opinion section.*
 7. *Define Emphasis of Matter Paragraph and how it should be disclosed in the Independent Auditor's Report?*
 8. *"An auditor is required to make specific evaluations while forming an opinion in an audit report." State those evaluations.*
 9. *The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Explain*
 10. *Communicating Key Audit Matter is not a substitute for disclosure in the Financial Statements rather 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. Analyse.*
 11. *The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion". Explain what is included in this "Basis for Opinion" section.*

12. *Distinguish between an adverse opinion and a qualified opinion. Also draft an opinion paragraph for both types of opinion.*
13. *ABC Ltd is a company incorporated in India. It has branches within and outside India. Explain who can be appointed as an auditor of these branches within and outside India. Also explain to whom branch auditor is required to report.*
14. *Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should identify division of audit areas and common audit areas. Explain stating the other relevant considerations in this regard.*
15. *The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Explain stating the advantages of the joint audit.*
16. *Discuss the reporting requirements under CARO 2020, with respect to the moneys raised by the company by way of initial public offer or further public offer and where the company has made any preferential allotment or private placement of shares.*
17. *Discuss which class of companies are specifically exempt from the applicability of CARO 2020?*
18. *The auditor is not required to report on the matters specified in sub-section (1) of Section 143 of the Companies Act, 2013 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. Explain clearly stating the matters for which the auditor has to perform his duty of inquiry under this section.*
19. *SKN Ltd. a biopharma company and global manufacturers of select critical care medical products has been sanctioned working capital limits of ` 5.99 crores from a nationalized bank on the basis of security of current assets. During the year under audit, the statutory auditor of SKN Ltd. considers that inventory is material to the financial statements and performs audit procedures over the company's final inventory records to determine whether they accurately reflect actual inventory count and without any major discrepancies for each class of inventory. What are the reporting requirements regarding physical verification of inventory under CARO 2020 in this case?*

20. *"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." Briefly explain when the auditor should express:*
- (i) *Qualified Opinion.*
 - (ii) *Adverse Opinion and*
 - (iii) *Disclaimer of Opinion.*
21. *During the audit of a limited company as a statutory auditor you discovered that a fraud amounting to ₹5 lakh has been committed by the company. What are the reporting requirements regarding fraud under the Companies Auditor's Report Order, 2020?*
22. *Pure Services Limited is into the litigation relating to some legal action initiated by the industry regulator. The matter has reached jurisdictional High Court. Keeping in view uncertainty related to future outcome of matter, statutory auditor of the company has decided to include Emphasis of Matter (EOM) Paragraph in auditor's report.*
- (i) *Briefly discuss the considerations to be taken care of by the statutory auditor when EOM paragraph is included in auditor's report.*
 - (ii) *State any two examples of circumstances where the auditor may consider it necessary to include an EOM paragraph.*
23. *As per SA 701, the objectives of the auditor are to determine key audit matters and having formed an opinion on the financial statements, communicate those matters by describing them in the auditor's report. Which factors are taken into account by auditor while determining Key Audit Matters? How Key Audit Matters are communicated in audit report?*
24. *The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework. There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements.*

Explain clearly the differences between the approaches stating the essential audit reporting. Also define comparative information and audit procedures regarding comparative information.

25. *The senior member of the firm Soni & Associates, Chartered Accountants, informed to its auditing staff that at the time of audit reporting regarding corresponding figures, when corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in specified circumstances. What are those exceptional circumstances?*
26. *TS Ltd. has raised funds by issuing fully convertible debentures. These funds were raised for the expansion and diversification of the business. The company had clearly outlined in its board resolution that these funds will be used for business expansion and diversification purposes only.*

However, the company utilised these funds for repayment of long-term loans and advances rather than for the intended purpose of business growth and expansion.

State the reporting responsibility of the auditor under paragraph 3, clause (x) of the Companies Auditor's Report Order, 2020 (CARO 2020).

27. *RJ Limited has expanded its operations from a single Indian state to multiple countries worldwide. Due to this significant growth, the management has decided to appoint joint auditors for the statutory audit and has engaged three chartered accountant firms. In this context, for which audit responsibilities will the joint auditors be jointly and severally liable?*
28. *Oval Enterprises Limited (OEL) is under legal obligation to represent its current year's financial statements along with the previous year's financial statements (comparative financial statements). Karan & Associates, Chartered Accountants, has been appointed as the statutory auditor for the year. CA Karan noticed that the last year's financial statements contain an adverse opinion for the financial statement as a whole due to a misstatement in the evaluation and disclosure of the debtors. Guide CA Karan for his duty regarding the treatment and addressing the issue while drafting his audit report. What disclosures he is required to make in this regard?*

29. CA Student Ravi is learning the concept of "Key Audit Matters". However, he is confused between modification of audit report and reporting of key audit matters.

You are required to guide him in explaining the following:

- (i) Purpose of communicating Key Audit Matters
 - (ii) Communicating Key Audit Matters is not a substitute for disclosure in financial statements.
30. During the audit of Alpha Components Ltd., the management informs the auditor that the company has implemented a sophisticated ERP system that tracks all movements of raw materials and finished goods in real time. Based on this system, they have stopped conducting any physical verification of inventories, claiming that the system itself ensures accuracy and control over stock levels.

As the auditor, explain reporting requirement under CARO, 2020.

ANSWERS/SOLUTIONS

Answers to the MCQs based Questions

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

Answers to Correct/Incorrect

- (i) **Incorrect:** 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.
- (ii) **Incorrect:** The auditor's report shall be addressed, as appropriate, based on the circumstances of the engagement. Law, regulation or the terms of the engagement may specify to whom the auditor's report is to be addressed. The auditor's report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited.

- (iii) **Incorrect:** The auditor shall modify the opinion in the auditor's report when:
- (a) The auditor concludes that, based on the audit evidence obtained, 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.
- (iv) **Incorrect:** 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.
- (v) **Incorrect:** 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 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.
- (vi) **Incorrect:** 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.
- (vii) **Incorrect:** Communicating key audit matters in the auditor's report is not 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).
- (viii) **Correct:** Under provisions of section 139(3), the members of a company may resolve to provide that audit shall be conducted by more than one auditor. Hence, the concept of "joint audit" has legal foothold also under Companies Act, 2013.

Answers to Theoretical Questions

1. Refer Para 1.2
2. Refer Para 1.3.

3. Refer Para 5.4
4. Refer Para 5.2
5. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgements. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Indicators of a lack of neutrality include the following:
 - (i) The selective correction of misstatements brought to management's attention during the audit.

Example

- Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.
 - The combination of several deficiencies affecting the same significant account or disclosure (or the same internal control component) could amount to a significant deficiency (or material weakness if required to be communicated in the jurisdiction). This evaluation requires judgement and involvement of audit executives.
- (ii) Possible management bias in the making of accounting estimates.
6. 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.

7. **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 judgement, is of such importance that it is fundamental to users' understanding of the financial statements.

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

- (i) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";
- (ii) 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
- (iii) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

8. **Specific Evaluations by the auditor:** In particular, the auditor shall evaluate whether :

- (i) The financial statements adequately disclose the significant accounting policies selected and applied;
- (ii) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
- (iii) The accounting estimates made by management are reasonable;
- (iv) The information presented in the financial statements is relevant, reliable, comparable, and understandable;
- (v) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
- (vi) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

9. **Responsibilities for the Financial Statements:** The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements."

SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Management and, where appropriate, those charged with governance accept responsibility for the preparation of the financial statements. Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted.

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; [because of the possible effects of fraud on other aspects of the audit, materiality does not apply to management's acknowledgement regarding its responsibility for the design, implementation, and maintenance of internal control (or for establishing and maintaining effective internal control over financial reporting) to prevent and detect fraud.] 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.

10. **Communicating key audit matters in the auditor's report is not:**

- (i) 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;

- (ii) 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);
- (iii) A substitute for reporting in accordance with SA 570 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
- (iv) A separate opinion on individual matters

11. 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.
- (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.

12. An auditor shall express an adverse opinion, when the auditor having obtained sufficient and appropriate audit evidence, concludes that misstatements, individually or in aggregate are both material and pervasive.

Whereas, when the auditor, having obtained sufficient and appropriate audit evidence, concludes that misstatements are material but not pervasive, shall express a qualified opinion.

SA705 – "Modifications To The Opinion In The Independent Auditor's Report" deals with the form and content of both types of report. The following are the draft of the opinion paragraphs of the reports.

- (a) **Adverse Opinion :** We have audited the accompanying consolidated financial statements of ABC Company Limited (hereinafter referred to as the "Holding Company") and its subsidiaries (the Holding Company and its subsidiaries together referred to as "the Group"), its associates and jointly controlled entities, which comprise the consolidated balance sheet as at March 31, 2026, the consolidated statement of profit and Loss, (consolidated statement of changes in equity) and the consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies (hereinafter referred to as the "consolidated financial statements"). In our opinion and to the best of our information and according to the explanations given to us, because of the significance of the matter discussed in the Basis for Adverse Opinion section of our report, the accompanying consolidated financial statements do not give a true and fair view in conformity with the accounting principles generally accepted in India, of their consolidated state of affairs of the Group, its associates and jointly controlled entities, as at March 31, 2026, of its consolidated profit/loss, (consolidated position of changes in equity) and the consolidated cash flows for the year then ended.
- (b) **Qualified Opinion:** We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 2026, 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)) . 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, 2026 and profit/loss, (changes in equity) and its cash flows for the year ended on that date.

13. Sub-section (8) of section 143 of the Companies Act, 2013, prescribes the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor. Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed:

It may be noted that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

Further as per rule 12 of the Companies (Audit and Auditors) Rules, 2014, the branch auditor shall submit his report to the company's auditor and reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

14. **Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan.** In developing the joint audit plan, the joint auditors should:

- (a) identify division of audit areas and common audit areas;
- (b) ascertain the reporting objectives of the engagement;
- (c) consider and communicate among all joint auditors the factors that are significant in directing the engagement team's efforts;
- (d) consider the results of preliminary engagement activities, or similar engagements performed earlier.
- (e) ascertain the nature, timing and extent of resources necessary to accomplish the engagement.

- 15. Joint Audit:** The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work. This is by itself a great advantage.

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

- (i) Sharing of expertise.
 - (ii) Advantage of mutual consultation.
 - (iii) Lower workload.
 - (iv) Better quality of performance.
 - (v) Improved service to the client.
 - (vi) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.
 - (vii) Lower staff development costs.
 - (viii) Lower costs to carry out the work.
 - (ix) A sense of healthy competition towards a better performance
- 16.** The following are the disclosure requirements as per CARO 2020, with respect to the moneys raised by the company by way of initial public offer or further public offer and where the company has made any preferential allotment or private placement of shares.
- (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 noncompliance;

17. CARO 2020 shall apply to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013, except—
Refer Para 12
18. Refer Para 11(1).
19. As per clause (ii) of Paragraph 3 of CARO, 2020 the auditor is required to report, in respect of physical verification of inventory and in respect of sanctioned working capital, that:
 - (i) 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.
 - (ii) 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.
20. Refer Para 5.3
- 21 **Reporting requirements of a fraud under the CARO 2020:** The auditor is required to report the fraud under clause (xi) of Paragraph 3 of CARO 2020:
 - (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;

22. Refer Para 6.2.1

23. 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:

- Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315.
- Significant auditor judgements relating to areas in the financial statements that involved significant management judgement, including accounting estimates that have been identified as having high estimation uncertainty.
- The effect on the audit of significant events or transactions that occurred during the period.

The auditor shall determine which of the matters determined, as stated above, were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters.

The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "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 judgement, 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.

24. Refer Para 8.1

25. Refer Para 8.3

26. The auditor is required to report under Clause (x) of Paragraph 3 of CARO 2020 that:

- (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 noncompliance.

27. 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. On the other hand, all the joint auditors shall be jointly and severally responsible for:

- (i) the audit work which is not divided among the joint auditors and is carried out by all joint auditors;
- (ii) decisions taken by all the joint auditors under audit planning in respect of common audit areas;
- (iii) matters which are brought to the notice of the joint auditors by any one of them and there is an agreement among the joint auditors on such matters;
- (iv) examining that the financial statements of the entity comply with the requirements of the relevant statutes;
- (v) presentation and disclosure of the financial statements as required by the applicable financial reporting framework;
- (vi) ensuring that the audit report complies with the requirements of the relevant statutes, applicable Standards on Auditing and other relevant pronouncements issued by ICAI.

28. In the given case, CA Karan noticed that the last year's financial statements contain an adverse opinion for the financial statement whole due to a misstatement in the evaluation and disclosure of the debtors. If the auditor's report on the prior period, as previously issued, included an adverse opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

- (i) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
- (ii) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

Further, when comparative financial statements are presented, the auditor's opinion shall refer to each period for which financial statements are presented and on which an audit opinion is expressed. If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, the auditor shall state in an Other Matter paragraph:

- (i) That the financial statements of the prior period were audited by a predecessor auditor;
- (ii) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and
- (iii) The date of that report.

29. (i) Purpose of Communicating Key Audit Matters: As per SA 701, "Communicating Key Audit Matters in the Auditor's Report", 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 judgement, 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 judgement in the audited financial statements.

(ii) Communicating Key Audit Matters- not a substitute for disclosure in the Financial Statements: 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:

- (1) 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.
- (2) 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);
- (3) A substitute for reporting in accordance with SA 570 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
- (4) A separate opinion on individual matters.

30 Reporting requirement under CARO 2020: As per Clause 3(ii)(a) of CARO, 2020, the auditor is required to report 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 procedures of such verification by the management is appropriate. The auditor is also required to report whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and, if so, whether the same have been properly dealt with in the books of account.

Auditor must Report on the non-conduct of physical verification

In the present case, the management of Alpha Components Ltd. has stated that it has discontinued physical verification of inventories on the ground that

a sophisticated ERP system tracks inventory movement in real time. However, the existence of an ERP system does not replace the requirement of physical verification, as CARO, 2020 specifically requires reporting on physical verification conducted by management.

Therefore, in compliance with Clause 3(ii)(a) of CARO, 2020, the auditor must report the non-conduct of physical verification of inventory, notwithstanding the use of an ERP system, and suitably reflect this matter in the CARO report.

Answers to Test your Understanding

1. The 18-digit alpha numeric number noticed by her at end of audit report is Unique Document Identification number (UDIN). It is a system generated unique number. Its basic objective is to curb the malpractices of non-CAs impersonating themselves as CAs. It helps in securing reports and documents issued by practising CAs.

It is required to be stated in case of audit reports and certificates.

2. "Basis for Opinion" is one of basic elements of an audit report in accordance with SA-700. Even in cases where unmodified opinion is expressed by auditor, "Basis for opinion" has to be provided by auditor. Basis for opinion section provides context about auditor's opinion.

Therefore, Sana's thinking is not proper.

3. In the given case, auditor has not been able to obtain sufficient appropriate audit evidence relating to inventories, debtors, creditors, revenues and expenses. The matter has brought to knowledge of management but no result has been achieved. Besides, auditor opines that there could be misstatements and their possible effects could be both material and pervasive.

In such circumstances, he should make disclaimer of opinion in accordance with SA 705.

4. As per SA 600 - "Using the Work of Another Auditor", 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. Such review of audit procedures and findings can be undertaken if principal auditor feels

that it is necessary to apply such procedures to obtain sufficient appropriate audit evidence. It is not an encroachment of another auditor's domain.

5. Clause (ix) (d) of CARO, 2020 whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated.

In the given situation, funds have been raised for meeting working capital requirements for ₹ 4 crores. Cash credit facilities for meeting working capital requirements are, by their very nature, short term borrowings. Out of above, ₹1 crore have been used by the company for investment in effluent treatment plant which is ostensibly for a long-term purpose.

Hence, the matter needs to be reported in accordance with requirements of Clause (ix) (d) of CARO, 2020.

SPECIAL FEATURES OF AUDIT OF DIFFERENT TYPES OF ENTITIES



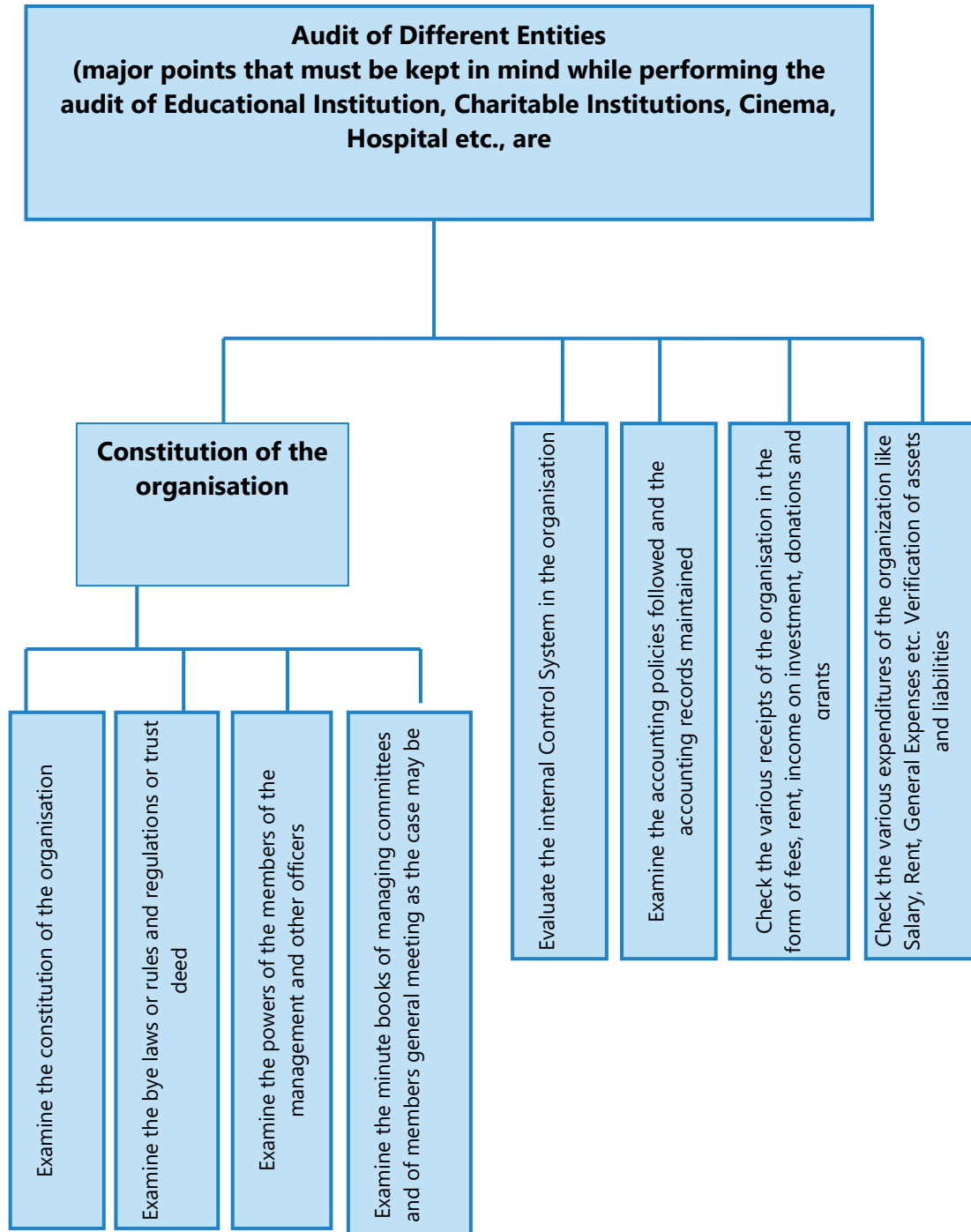
LEARNING OUTCOMES

After studying this chapter, you would be able to:

- ◆ Understand about Government audit, duties of the Comptroller and Auditor General of India
- ◆ Understand the procedures to be adopted for auditing of Not-for-profit Organizations (NGOs), Charitable Institutions.
- ◆ Gain knowledge of auditing procedure of sole trader, firm, educational institutions, hospitals, clubs, cinema, hotels, etc.
- ◆ Learn the audit procedure of hire purchase and leasing company accounts.
- ◆ Identify the audit procedures of Government, Local Bodies, Cooperative Societies, LLPs, Trusts & Societies.
- ◆ Understand practicality of above concepts using examples and case studies.

CHAPTER OVERVIEW





Scrambling for his television remote one day, Sameer accidentally pushed button of "Sansad TV". Although not fond of keenly watching Parliamentary debates, his attention was drawn to pandemonium being caused in one Houses of Parliament over a report of the Comptroller and Auditor General of India (CAG). Anxious to know about importance of reports of CAG, he wanted to first know about this constitutional office. What is nature of duties of Comptroller and Auditor General of India as envisaged in Constitution of India? What makes position of CAG unique?

Astonished to learn that Comptroller and Auditor General is known as "Supreme Audit Institution of India", he wanted to know more about scope of duties performed by such an important institution. Not only audits of receipts and expenditure of Union of India and States are performed by CAG of India, this institution is also responsible for audit of receipts and expenditure of bodies mainly financed by Union or State Revenues.

Besides above, it is responsible for ensuring that public funds are being collected and used effectively and efficiently. Does CAG have a role to play in audits of government companies? What are law provisions in this regard? He was also thinking that Constitution must have included provisions to ensure independence of such an institution. What are such provisions?

Knowing importance of local bodies governing cities, Sameer also wanted to know how control over expenditure of local bodies is exercised. Who exercises such control and what are main objectives of such an audit? How financial administration of such urban local bodies is run?

Are there some other sets of entities which merit special audit considerations by virtue of their nature or structure? For example, an NGO works in a totally different environment. It may work in social or environmental areas. What critical points are to be kept in mind by auditor of an NGO? Similarly, clubs, hotels and hospitals may involve audit considerations peculiar to their nature of working.

Sameer had also noticed sign boards of some organizations with LLP written at the end. What does it denote? How does it differ from a partnership firm? What are regulatory requirements in respect of LLP? As an auditor, what special considerations apply in case of audit of LLP?



1. GOVERNMENT AUDIT

1.1 Background

Government Audit is as old as organised governments and has fairly long pedigree even in developing countries. The concept, content and scope of government audit have developed in tune with the political, social and economic development of the countries. It has also responded to the needs of the administration. It aims to ensure accountability of the executive in respect of public revenue and expenditure. Primarily, the Parliament and in case of States, the State legislatures control all government expenditure through insistence upon demand for grants. The main idea underlying this control is that no expenditure can be incurred unless it has been voted upon by the **Parliament** or State Legislatures and funds for every such expenditure must be provided from out of the **Consolidated Fund of India or of the State**.

(As per Article 266, the Consolidated Fund of India consists of all the revenue received from direct and indirect taxes, all the loans taken by the Govt. of India and all the amount of repayment of loans received by the Govt. of India)

After the expenditure has been incurred and the accounts are closed, the Appropriation Accounts are prepared which are scrutinised by the **Public Accounts Committee** (The Public Accounts Committee (PAC) is a committee of selected members of parliament, constituted by the Parliament of India, for the purpose of auditing the revenue and the expenditure of the Government of India). Thus, Parliamentary or Legislative control is exercised before spending and after the expenditure is actually incurred.

Since independence there has been a tremendous spurt in governmental activities with the attendant increase in expenditure, revenue and capital, and in receipts and borrowings to match the expenditure. Government has entered the business field and government in business is not the same as government administering law and order and attending to regulatory functions. Independent India witnessed a steady growth of state commercial enterprise. The change in the character of government and the complex nature of its activities, including regulatory functions in an international environment called for a change in the nature and scope of audit. Audit has evolved from accountancy and regularity check to evaluation of the end results of the operations of government.

Initially, government auditing in India as elsewhere was primarily expenditure-oriented. Gradually, audit of receipts-tax and non-tax was taken up. With the rapid growth of public enterprises, another major area of specialisation, i.e., commercial audit, came into being. There are also a large number of non-commercial autonomous bodies financed by government in diverse fields of development and of academic study and scientific or social research which are also required to be audited from the viewpoint of public accountability.

Government audit has not only adopted the basic essentials of auditing as known and practised in the profession to suit the requirements of governmental transactions but has also added new concepts, techniques and procedures to the audit profession.

The U.N. Handbook on Government Auditing and Developing Countries defines government auditing in a comprehensive manner which is as follows:

Government auditing is

- ◆ the objective, systematic, professional and independent examination
- ◆ of financial, administrative and other operations
- ◆ of a public entity
- ◆ made subsequently to their execution
- ◆ for the purpose of evaluating and verifying them,
- ◆ presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future actions
- ◆ by the responsible officials
- ◆ and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

OBJECTIVES :-

- (a) **Accounting for Public Funds:-**Government audit serves as a mechanism or process for public accounting of government funds.
- (b) **Appraisal of Government policies:-**It also provides public accounting of the operational, management, programme and policy aspects of public administration as well as accountability of the officials administering them.

- (c) **Base for Corrective actions:**-Audit observations based on factual data collection also serve to highlight the lapses of the lower hierarchy, thus helping supervisory level officers to take corrective measures.

Administrative accountability:-Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanour to its logical end. The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration. In India, the function of Government Audit is discharged by the independent statutory authority of the **Comptroller and Auditor General** through the agency of the **Indian Audit and Accounts Department**. Audit is a necessary function to ensure accountability of the executive to Parliament, and within the executives of the spending agencies to the sanctioning or controlling authorities. The purpose or objectives of audit need to be tested at the touchstone of public accountability. The Comptroller and Auditor General (C&AG), in the discharge of his functions, watches that the various authorities act in regard to financial matters in accordance with the Constitution and the laws made by Parliament, and conform to the rules or orders made thereunder.

1.2 Legal Framework and Comptroller & Auditor General

The Constitution of India contains specific provisions regarding the appointment, salary and duties and powers of the C&AG.

1. APPOINTMENT & REMOVAL

The Constitution guarantees the independence of the C&AG of India by prescribing that he shall be **appointed by the President of India** and shall not be **removed** from office except on the ground of proven mis-behaviour or incapacity. As in the case of a Judge of the Supreme Court, he can be removed only when each House of Parliament decides to do so by a majority of not less than **2/3rd** of the members of the House present and voting. The Parliament is competent to make laws to determine salary and other conditions of service and they cannot be varied to his disadvantage after his appointment. The Constitution further provides that the conditions of service of person serving in the Indian Audit and Accounts Department and the administrative powers of the C&AG shall be determined by the President after consultation with him.

2. TENURE

The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 passed in pursuance of the provisions of the Constitution lays down a fixed tenure of the office prescribing that he shall be paid a salary which is equal to the salary of the Judge of the Supreme Court thereby further strengthening his independence.

3. VARIOUS CONSTITUTIONAL PROVISIONS

- i. **Article 149** states that the C&AG shall perform such duties and exercise such powers in relation to the accounts of the Union and of the States and of any other authority or body as may be prescribed by or under any law made by the Parliament. The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 defines these functions and powers in detail.
- ii. **Article 150** of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the President may on the advice of the C&AG prescribe.
- iii. **Article 151** requires that the reports of the C&AG relating to the accounts of the Union/State shall be submitted to the President/Governor who shall cause them to be laid before House of Parliament/State Legislature.

1.3 Comptroller and Auditor General's — Duties and Powers

The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 defines functions and powers in detail. The relevant provisions are discussed hereunder—

Duties of the C&AG:

- (i) **Compile and submit Accounts of Union and States** - The Comptroller and Auditor General shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account. The Comptroller

and Auditor General shall, from the accounts compiled by him or [by the Government or any other person responsible in that behalf] prepare in each accounts (including, in the case of accounts compiled by him, appropriation accounts) showing under the respective heads the annual receipts and disbursements for the purpose of the Union, of each State and of each Union Territory having a Legislative Assembly, and shall submit those accounts to the President or the Governor of a State or Administrator of the Union Territory having a Legislative Assembly, as the case may be, on or before such dates as he may, with the concurrence of the Government concerned, determine.

NOTE :- The C&AG Act of 1971 has provisions for relieving him of this responsibility to give information and render assistance to the Union and States: The Comptroller and Auditor General shall, in so far as the accounts, for the compilation or keeping of which he is responsible, enable him so to do, give to the Union Government, to the State Government or to the Governments of Union Territories having Legislative Assemblies, as the case may be, such information as they may, from time to time, require and render such assistance in the preparation of the annual financial statements as they may reasonably ask for.

(ii) General Provisions Relating to Audit - It shall be the duty of the Comptroller and Auditor General—

- (a) to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;
- (b) to audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;
- (c) to audit and report on all trading, manufacturing and profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.

- (iii) **Audit of Receipts and Expenditure** - Where anybody or authority is **substantially financed** by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.

Meaning of Substantially financed :- Where the grant or loan to a body or authority from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly in a financial year is not less than **₹ 25 lakhs** and the amount of such grant or loan is not less than 75% of the total expenditure of that body or authority, such body or authority shall be deemed, for this purpose to be substantially financed by such grants or loans as the case may be.

- (iv) **Audit of Grants or Loans** - Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the Comptroller and Auditor General shall scrutinise the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body.
- (v) **Audit of Receipts of Union or States** - It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make for this purpose such examination of the accounts as he thinks fit and report thereon.
- (vi) **Audit of Accounts of Stores and Inventory** - The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State.

(vii) Audit of Government Companies and Corporations - The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013. The Comptroller and Auditor-General of India shall appoint the auditor under section 139(5) or 139(7) (i.e. appointment of First Auditor or Subsequent Auditor) and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

Powers of C&AG

The C&AG Act gives the following powers to the C&AG in connection with the performance of his duties-

- (a) To inspect any office of accounts under the control of the Union or a State Government including office responsible for the creation of the initial or subsidiary accounts.
- (b) To require that any accounts, books, papers and other documents which deal with or are otherwise relevant to the transactions under audit, be sent to specified places.
- (c) To put such questions or make such observations as he may consider necessary to the person in charge of the office and to call for such information as he may require for the preparation of any account or report which is his duty to prepare.
- (d) In carrying out the audit, the C&AG has the power to dispense with any part of detailed audit of any accounts or class of transactions and to apply such limited checks in relation to such accounts or transactions as he may determine.

1.4 Expenditure Audit

The audit of government expenditure is one of the major components of government audit. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred. These standards are—

- (i) that the expenditure incurred conforms to the relevant provisions of the statutory enactment and in accordance with the Financial Rules and Regulations framed by the competent authority. Such an audit is called as the **audit against 'rules and orders'**.
- (ii) that there is sanction, either special or general, accorded by competent authority authorising the expenditure. Such an audit is called as the **audit of sanctions**.
- (iii) that there is a provision of funds out of which expenditure can be incurred and the same has been authorised by competent authority. Such an audit is called as **audit against provision of funds**.
- (iv) that the expenditure is incurred with due regard to broad and general principles of financial propriety. Such an audit is also called as **propriety audit**.
- (v) that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Such an audit is termed as the **performance audit**.

Each of the above audits is discussed in detail in the following paragraphs.

(1) Audit against Rules & Orders - Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. It also seeks to satisfy that the expenditure is in accordance with the financial rules, regulations and orders issued by a competent authority. Audit of expenditure against regularity is of a quasi-judicial type of work performed by the audit authorities. It involves interpretation of the Constitution, statutes, rules, regulations and orders. The final power of interpretation of these, however, does not vest with the C&AG.

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

- (i) Rules and orders regulating the powers to incur and sanction expenditure from the Consolidated Fund of India or of a State (and the Contingency Fund of India or of a State);
- (ii) Rules and orders dealing with the mode of presentation of claims against government, withdrawing moneys from the Consolidated Fund, Contingency Fund and Public Accounts of the Government of the India and of the States, and in general the financial rules prescribing the detailed procedure to be followed by government servants in dealing with government transactions; and
- (iii) Rules and orders regulating the conditions of service, pay and allowances, and pensions of government servants.

It is the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be.

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

- (a) they are not inconsistent with any provisions of the Constitution or any laws made thereunder;
- (b) they are consistent with the essential requirements of audit and accounts as determined by the C&AG;
- (c) they do not come in conflict with the orders of, or rules made by, any higher authority; and
- (d) in case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

(2) Audit of sanctions - The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, of the competent authority. The audit of sanctions is directed both in respect of ensuring that the expenditure is properly covered by a sanction, and also to satisfy that the authority sanctioning it is competent for the purpose by virtue of the powers vested in it by the provisions of the Constitution and of the law, rules or orders made thereunder, or by the rules of delegation of financial powers made by an authority competent to do so.

(3) Audit against provision of funds - Audit against provision of funds aims at ascertaining that the expenditure incurred has been on the purpose for which the grant and appropriation had been provided and that the amount of such expenditure does not exceed the appropriation made.

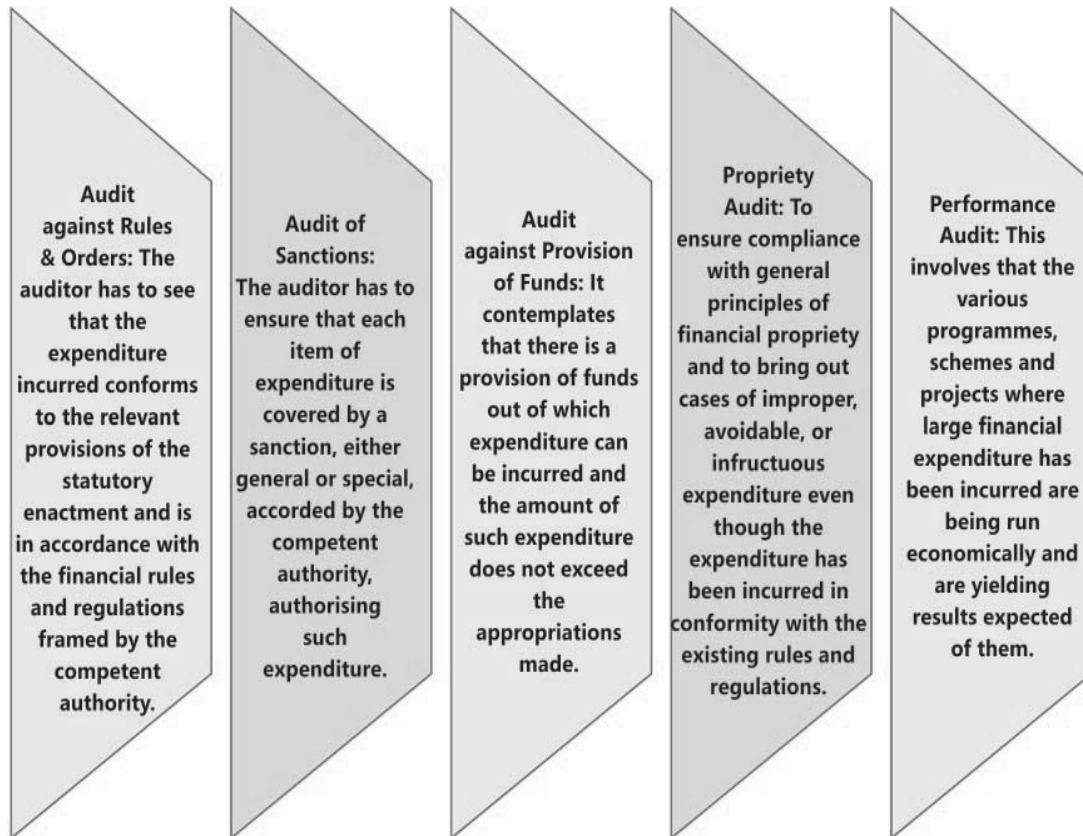
(4) Propriety audit - According to '**Propriety audit**', the auditors try to bring out cases of improper, avoidable, or ineffective expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. With the passage of time, it was felt that regularity audit alone was not sufficient to protect properly the public interest in the spending of money by the executive authorities. A transaction may satisfy all the requirements of regularity audit insofar as the various formalities regarding rules and regulations are concerned, but may still be highly wasteful. e.g.:- A building may be constructed for installing a telephone exchange but may not be used for the same purpose resulting in unproductive expenditure or a school building may be constructed but used after five years of its completion is a case of avoidable expenditure.

Audit should, therefore, try to secure a reasonably high standard of public financial morality by looking into the wisdom, faithfulness and economy of transactions. These considerations have led to the evolution of audit against propriety which is now being combined by the audit authorities with their routine function of regularity audit. It is hard to frame any precise rules for regulating the course of audit against propriety. Such an objective of audit depends for its acceptance on its appeal to the common sense and straight logic of the auditors and of those whose financial transactions are subjected to propriety audit.

However, some general principles have been laid down in the Audit Code, which have for long been recognised as standards of financial propriety. Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:

- (a) The expenditure should not be prima facie more than the occasion demands. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.
- (b) No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.
- (c) Public moneys should not be utilised for the benefit of a particular person or section of the community unless:
 - (i) the amount of expenditure involved is insignificant; or
 - (ii) a claim for the amount could be enforced in a Court of law; or
 - (iii) the expenditure is in pursuance of a recognised policy or custom; and
 - (iv) the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

Note :- It is the responsibility of the executive departments to enforce economy in public expenditure. The function of audit is to bring to the notice of the proper authorities of wastefulness in public administration and cases of improper, avoidable and ineffective/unproductive expenditure



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

Efficiency audit looks into whether the various schemes/projects are executed and their operations conducted economically and whether they are yielding the results expected of them, *i.e.*, the relationship between goods and services produced and resources used to produce them; and examination aimed to find out the extent to which operations are carried out in an economical and efficient manner.

Economy audit looks into whether government have acquired the financial, human and physical resources in an economical manner, and whether the sanctioning and spending authorities have observed economy.

Effectiveness audit is an appraisal of the performance of programmes, schemes, projects with reference to the overall targeted objectives as well as efficiency of the means adopted for the attainment of the objectives.

Efficiency- cum-performance audit, wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness.

The procedure for conducting performance audit covers

- ◆ identification of topic,
- ◆ preliminary study,
- ◆ planning ,
- ◆ execution of audit, and
- ◆ reporting.

1.5 Audit of Receipts

The audit of receipts is neither all pervasive or as old as audit of expenditure but has come to stay in some countries. Such an audit provides for checking;

- (i) whether all revenues or other debts due to government have been correctly assessed, realised and credited to government account by the designated authorities;
- (ii) whether adequate regulations and procedures have been framed by the department/agency concerned to secure an effective check on assessment, collection and proper allocation of cases;
- (iii) whether such regulations and procedures are actually being carried out;
- (iv) whether adequate checks are imposed to ensure the prompt detection and investigation of irregularities, double refunds, fraudulent or forged refund vouchers or other loss of revenue through fraud or willful omission or negligence to levy or collect taxes or to issue refunds; and
- (v) review of systems and procedures to see that the internal procedures adequately secure correct and regular accounting of demands collection and refunds and pursuant of dues up to final settlement and to suggest improvement. The basic principle of audit of receipts is that it is more important to look at the general than on the particular, though individual

cases of assessment, demand, collection, refund, etc. are important within the area of test check. A review of the judicial decisions taken by tax authorities is done to judge the effectiveness of the assessment procedure.

- (vi) The extent and quantum of audit required to be done under each category of audit are determined by the C&AG. These are neither negotiable nor questioned. The prescribed extent and quantum of audit are structured in accordance with the design of test check, random sampling, general review, in-depth study of specified areas, etc. as may be warranted by the nature of transactions, its importance in the scheme of activities of a department and the totality of its transactions, the frequency of check and total plan of audit to be executed during a period. **Institutional mechanism provides for primary check by the auditor, test check by the supervisor and control and direction by the group leader.** Planning, executing and reporting of work is directed and monitored at middle and top levels of the audit hierarchy. There are built-in arrangements within the C&AG to ensure that the work assigned to each employee is carried out as prescribed. The audit is conducted both centrally where accounts and original vouchers are kept and locally where the drawing and disbursing functions are performed depending on the organisational and institutional arrangements obtaining.

1.6 Audit of Stores and Inventories

Audit of the accounts of stores and inventories has been developed as a part of expenditure audit with reference to the duties and responsibilities entrusted to C&AG. Audit is conducted :-

- ◆ to ascertain whether the Regulations governing purchase, receipt and issue, custody, sale and inventory taking of stores are well devised and properly carried out.
- ◆ to bring to the notice of the government any deficiencies in quantities of stores held or any defects in the system of control.
- ◆ to verify that the purchases are properly sanctioned, made economical and in accordance with the Rules for purchase laid down by the competent authority.

- ◆ to ensure that the prices paid are reasonable and are in agreement with those shown in the contract for the supply of stores, and that the certificates of quality and quantity are furnished by the inspecting and receiving units. Cases of uneconomical purchase of stores and losses attributable to defective or inferior quality of stores are specifically brought by the audit.
- ◆ to check the accounts of receipts, issues and balances regarding accuracy, correctness and reasonableness of balances in inventories with particular reference to the specified norms for level of consumption of inventory holding. Any excess or idle inventory is specifically mentioned in the report and periodical verification of inventory is also conducted to ensure their existence. When priced accounts are maintained, the auditor should see that the prices charged are reasonable and have been reviewed from time to time. The valuation of the inventories is seen carefully so that the value accounts tally with the physical accounts and that adjustment of profits or losses due to revaluation, inventory taking or other causes is carried out.

1.7 Audit of Commercial Accounts

Public enterprises are required to maintain commercial accounts and are generally classified under three categories—

- (a) **departmental enterprises** engaged in commercial and trading operations, which are subject to the same laws, financial and other regulations as other government departments and agencies;
- (b) **statutory bodies, corporations**, created by specific statutes mostly financed by government in the form of loans, grants, etc.; and
- (c) **government companies** set up under the Companies Act, 2013.

The audit of :-

- **departmental concerns** is undertaken in the same manner as any department of government where commercial accounts are kept.
- **statutory bodies or corporations** depends on the nature and type of the statute governing the bodies or corporations. Financial / accounts audit is conducted by the C&AG, and where compilation of accounts is vested with the C&AG, functions, norms and standards of works usually followed by the professional auditors are adopted mutatis mutandis.

- **government companies** is conducted by their own auditors under the statute appointed by C&AG. In addition, the C&AG conducts a supplementary test audit of the accounts, as well as periodical financial audit and appraisal of performance. The C&AG also issues direction to the company auditors for reporting on specific aspects of their audit work. These are reviewed, and condensed in the audit reports to the government/legislatures. C&AG has adopted the mechanism of an **Audit Board**-comprising of representatives of the audit and nominees of government including functional specialists to process reviews or appraisals on performance.

Role of C&AG is prescribed under sub section (5), (6) and (7) of section 143 of the Companies Act, 2013.

(1) Power to appoint Government Company Auditor :- Section 143(5) of the Act states that, in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 i.e. appointment of First Auditor or Subsequent Auditor and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

(2) Power to conduct Supplementary Audit & comment thereupon :-The Comptroller and Auditor-General of India shall within **60 days** from the date of receipt of the audit report have a right to,

- (a)** conduct a **supplementary audit under section 143(6)(a)**, of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General of India may direct; and

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

Any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section of section 136 i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

(3) Test Audit: Further, without prejudice to the provisions relating to audit and auditor, the Comptroller and Auditor-General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.

As stated above, in the case of a government company, audit is conducted by professional auditors appointed on the advice of the C&AG and the later is authorised under section 143 of the Companies Act, 2013 to conduct supplementary or test audit.

The C&AG shall direct the manner in which the company's accounts shall be audited by the statutory auditors and give such auditors instructions in regard to any matter relating to the performance of his functions as such. The directions under section 143(6) broadly covers the system of book-keeping and accounts, internal control etc.

The C&AG has power to conduct a supplementary or test audit of the company's accounts by such person as he may authorise in this behalf and for the purposes of such audit require information or additional information to be furnished to any person or persons so authorised on such matters by such person or persons and in such form as the C&AG may by general or special order, direct.

The statutory auditors shall submit a copy of their audit report to the C&AG who shall have a right to comment upon or supplement the audit report submitted by the statutory auditors in such manner as he may think fit. Section 134(3) of the Companies Act, 2013 imposes a duty on the board of directors of a company to give an explanation or comments on every reservation, or adverse remarks or disclaimer contained in the auditors' report and secretarial audit report of the Company Secretary in practice. In the absence of similar provisions requiring the company to give reply on the reservation made by the C&AG, the board of directors of such a company is not bound to give information or explanation in respect of such comments.

The general standards, principles, techniques and procedures for audit adopted by the C&AG are a mixture of government audit and commercial audit as known and practiced by professional auditors. The concepts of autonomy and accountability of the institution / bodies / corporations / companies have influenced the nature and scope of audit in applying the conventional audit from the angle of economy, efficiency and effectiveness.

1.8 Reporting Procedures

The effectiveness of an audit depends on reporting results to the proper authority so that appropriate action may be taken to rectify the irregularities or impropriety where possible or to prevent re-occurrence. The right as also the obligation to report on the results of audit findings is inherent to the institution of the Auditor General and is usually safeguarded in the Constitution and related enactments. Article 151 of the Indian Constitution enjoins that the C&AG shall report on the accounts of the Union and of each of the States to the President or the Governor concern and the latter shall cause the report to be laid before the legislatures. The reports should not only be presented to the legislatures but thereafter also publicised adequately in order to create a proper climate of public opinion for taking remedial action where necessary, on the findings of the Auditor General. This may also constitute a more effective safeguard in the future.

In India, the reporting is factual and the conclusions are left to be drawn by the reader. This is presumably to ensure total objectivity. Nothing debars C&AG from making recommendations in the audit report but traditionally this has been left to be done by the Public Accounts Committee.

Test Your Understanding 1

It is the duty of Comptroller and Auditor General of India to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it. Discuss, in above context, what is understood by “Consolidated Fund of India”? What is its importance?

2. AUDIT OF LOCAL BODIES

2.1 Background

(1) A **Municipality** can be defined as a unit of local self-government in an urban area. By the term ‘local self-government’ is ordinarily understood the administration of a locality – a village, a town, a city or any other area smaller than a state – by a body representing the local inhabitants, possessing fairly large autonomy, raising at least a part of its revenue through local taxation and spending its income on services which are regarded as local and, therefore, distinct from state and central services.

The discussion in following paragraphs is based on an article “Audit of Municipal Administration” by R. Chandra Sekharan.

By 1947, the year of independence of India, most of the urban and semi-urban areas had been constituted into municipalities of one kind or another. Among them were the premier corporations of Mumbai, Chennai and Kolkata each with a special kind of constitutional structure, better financial resources and subject to less state control than other municipal bodies. The service which the local bodies had to render was restricted to education, public health, sanitation, medical relief, roads and a few public works. This was so because these bodies were considered to be inefficient and they lacked adequate financial resources. These bodies derived their revenues from a number of sources – taxes on property, taxes on trade, taxes on persons; fees and licences, non- tax resources such as rent of land, houses, income from commercial undertakings; government grants, etc.

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

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

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

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

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

- (a) general administration and revenue collection,
- (b) public health,
- (c) public safety,
- (d) education,
- (e) public works, and
- (f) others such as interest payments, etc.

(5) Property taxes and octroi are the major sources of revenue of the municipal authorities; other municipal taxes are profession tax, non-mechanised vehicles tax, taxes on advertisements, taxes on animals and boats, tolls, show-tax, etc. The taxation powers of the corporations are confined to a few items and are of a generally compulsive nature; on the other hand, the tax powers of other types of urban local authorities cover a wider range, optional in nature and subject to a procedure for their imposition requiring the final sanction of the state governments.

(6) Local bodies may receive different types of grants from the state administration as well. Broadly, the revenue grants are of three categories:

- (a) General purpose grants:** These are primarily intended to substantially bridge the gap between the needs and resources of the local bodies.
- (b) Specific purpose grants:** These grants which are tied to the provision of certain services or performance of certain tasks.
- (c) Statutory and compensatory grants:** These grants, under various enactments, are given to local bodies as compensation on account of loss of any revenue on taking over a tax by state government from local government.

2.2 Financial Administration

It would be imminent on the part of the auditor to understand financial administration of local bodies before embarking upon the audit. Some of the aspects are as under:

(a) Budgetary Procedure: This is geared to subserve the twin considerations of *financial accountability* and *control of expenditure*. The main objective is to ensure that funds are raised and moneys are spent by the executive departments in accordance with the rules and regulations and within the limits of sanction and authorisation by the legislature or council. Budget preparation is usually the occasion for determining the levels of taxation and rates and the ceilings on expenditure.

Municipal budget formats and heads of accounts vary from state to state. There are variations between the corporation and municipalities. One important feature of the municipal budgets is that there is no strict separation between revenue and capital items; usually there is a 'head' called *extraordinary items* which cover most of the capital transactions. There are, however, a number of special funds (e.g. roads) or in some cases separate budgets for specific municipal functions (e.g. education) or enterprise activities (e.g., water supply and sanitation, transport, electricity, etc.)

(b) Expenditure Control: The system of financial control existing in the state and central government level is conditioned by the fact that there is a clear demarcation between the legislature and executive. The integration of legislation and executive

powers in the municipal council makes it difficult for its executive to function as its inquisitorial body as well. Moreover the separation of executive powers and functions in municipal government cannot accommodate the existence of an independent finance officer responsible to the municipal council or its executive committee. This leaves the system of external audit by state government as the only instrument of controlling municipal expenditure.

(c) Accounting System: Municipal accounting and budget format have been criticised as neither simple nor comprehensible, sometimes providing inadequate information and at other times a surfeit of information. Both these situations are not conducive to a proper system of management information.

2.3 Objective of Audit of Local Bodies

The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. However, the municipal corporations of Delhi, Mumbai and a few others have powers to appoint their own auditors for regular external audit.

The important objectives of audit are:

- (a) reporting on the fairness of the content and presentation of financial statements;
- (b) reporting upon the strengths and weaknesses of systems of financial control;
- (c) reporting on the adherence to legal and/or administrative requirements;
- (d) reporting upon whether value is being fully received on money spent; and
- (e) detection and prevention of error, fraud and misuse of resources.

Audit is another method of financial control on local governments. This provision is coupled with the privilege of *ultra vires*. An action of the local authority if it is beyond legal authority can result in 'surcharge' by audit. This procedure is a legacy of colonial days and even in England it is being resorted to less and less. This may well be because of the increasing competence of the local government authorities.

In addition to the external audit, it is also opined by the learned author that there should be a system of internal audit in all municipal institutions. Internal audit should be provided by the institutions' own staff. It should be performed on a

continuous basis according to a well- defined programme. The external auditor should be able to rely upon the work of the internal audit as forming part of a complete system of internal financial control. Where there is no internal audit, as may happen in the case of small or poorly staffed municipalities, the external auditor himself has to do detailed checking. As described under government audit above, increasing attention is being given, to what is described as 'value for money' audit. This kind of audit focuses upon assessment of whether urban institutions are fulfilling their responsibilities with efficiency, economy and effectiveness (sometimes known as 'the three Es').

2.4 Audit Programme for Local Bodies

- (i) **APPOINTMENT:-**The Local Fund Audit Wing of the State Govt. is generally in-charge of the audit of municipal accounts. Sometimes bigger municipal corporations e.g. Delhi, Mumbai etc. have power to appoint their own auditors for regular external audit. So the auditor should ensure his appointment.
- (ii) **AUDITOR'S CONCERNS:-**The auditor while auditing the local bodies should report on the
- fairness of the contents and presentation of financial statements,
 - the strengths and weaknesses of system of financial control,
 - the adherence to legal and/or administrative requirements;
 - whether value is being fully received on money spent.
- His objective should be to detect errors and fraud and misuse of resources.
- (iii) **RULES & REGULATIONS:-** The auditor should ensure that the expenditure incurred conforms to the relevant provisions of the law and is in accordance with the financial rules and regulations framed by the competent authority.
- (iv) **AUTHORISATIONS:-** He should ensure that all types of sanctions, either special or general, accorded by the competent authority.

- (v) **PROVISIONING:-** He should ensure that there is a provision of funds and the expenditure is incurred from the provision and the same has been authorized by the competent authority.
- (vi) **PERFORMANCE:-** The auditor should check that the different schemes, programmes and projects, where large financial expenditure has been incurred, are running economically and getting the expected results.

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

3.1 Background

(1) NGOs can be defined as non-profit making organisations which raise funds from members, donors or contributors apart from receiving donation of time, energy and skills for achieving their social objectives like imparting education, providing medical facilities, economic assistance to poor, managing disasters and emergent situations.



Source of image: crossbarriers.org

(2) Therefore, this definition of NGO would include religious organisations, voluntary health and welfare agencies, **charitable organisations, hospitals, old age homes, research foundations etc.** The scope of services rendered by NGOs is extremely wide and as such cannot be covered in a small definition. Some examples of NGOs operating in India include **Child Relief and You (CRY), NORAD, UNICEF, Godhuli, Vidya, Concern India Foundation., etc.**



(3) Non-Governmental Organisations are generally incorporated as societies under the **Societies Registration Act, 1860** or as a trust under the **India Trust Act, 1882**, or under any other law corresponding to these Laws enforced in any part of India. NGOs can also be incorporated as a company under section 8 of the **Companies Act, 2013**. None of the above mentioned Act warrant a mandatory registration under them for an NGO. But if an NGO is created as a trust and trust relates to immovable property worth more than one hundred rupees, the provision of Section 17(1) of the Registration Act, 1908 read with Section 123 of the Transfer of Property Act, 1882 must be complied with and the registration of trust becomes mandatory. In some states, such as the states of Maharashtra and Gujarat, where Public Trusts Acts have been passed, such as the Bombay Public Trusts Act 1950, all charitable trusts have to be registered under these specific Public Trusts Acts. Registration under the Income Tax Act, 1961 and the Foreign Contribution (Regulation) Act, 2010 would also be invoked in many cases.

NGOs registered under the Companies Act, 2013 must maintain their books of account under the accrual basis as required by the provisions of section 128 of the said Act. If the accounts are not maintained on accrual basis, it would amount to non-compliance of the provision of the Companies Act, 2013. The NGOs which are not registered under the Companies Act, 2013 are allowed to maintain accounts either an accrual basis or cash basis.

3.2 Sources and Applications of Funds

- (1) The main sources of funds include grants and donations, fund raising programmes, advertisements, fees from the members, technical assistance fees / fee for services rendered, subscriptions, gifts, sale of produce or publications, etc.
 - (a) Donations and grants received in the nature of **promoter's contribution** are in the nature of capital receipts and shown as liabilities in the Balance Sheet of NGO. These may either be in the form of corpus contribution or a contribution towards revolving fund. **A contribution made towards the capital or the corpus of an NGO is known as corpus contribution.** The donors are generally required to specify whether the donation/grant given by him shall form part of the corpus of the NGO. Such contributions are generally given with reference to the total funds required by an NGO.

- (b) Section 11(1)(d) of the Income Tax Act 1961 also states that income in the form of **voluntary contributions** made with a specific direction that they shall form part of the corpus of the trust or institution shall not be included in the computation of total income.
 - (c) The objective of a contribution or grant towards a **Revolving Fund** is to rotate the amount by giving temporary loans from the fund to other NGO or beneficiaries for their projects and then recover the loan so as to give temporary loans again and so on. However, any interest earned from the beneficiary on such temporary loans from the revolving fund could be either added back to the fund or credited to the Income and Expenditure Account depending on restrictions laid down by the authority providing the contribution (for the revolving fund) or by the rules and regulations laid down by the concerned NGO in this regard.
 - (d) Donations and grants received for acquisition of **specific** fixed assets are those grants whose primary condition is that an NGO accepting them should purchase, construct or otherwise acquire the assets for which the grant is given.
 - (e) Many a times NGOs receive **contributions in kind**. These contributions include assets such as land, buildings, vehicles, office equipment, etc. and articles related to programmes / projects such as food, books, building materials, clothes, beds, and raw material for training purposes, e.g., Wool, reeds, cloth, etc.
- (2) The areas of application of funds for an NGO include Establishment Costs, Office and Administrative Expenses, Maintenance Expenses, Programme / Project Expenses, Charity, Donations and Contributions given, etc.

3.3 Provisions Relating to Audit

The auditors of an NGO registered under the Societies Registration Act, 1860 (or under any law corresponding to this Act, in force in any part of India) or the Indian Trusts Act 1882 are normally appointed by the Management of the Society or Trust. **The auditors of NGO registered under section 8 of the Companies Act, 2013 are appointed by the members of the company.** Some of the statutes such as the Companies Act, 2013, Foreign Contribution (Regulation) Act 2010, Income Tax Act 1961 required that the accounts of the NGO be audited and submitted to the

prescribed authorities and failure to do so could lead to forfeiture of certain exemptions and benefits. In the case of NGO/PDA's different statutes have specified certain audit reports. The Foreign Contribution (Regulation) Act 2010 has prescribed the format and requires that the same be furnished to the Ministry of Home Affairs within 60 days from the close of the financial year i.e. by May 30 each year.

While planning the audit, the auditor may concentrate on the following:

- (i) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operate.
- (ii) Updating knowledge of relevant statutes especially with regard to recent amendments, circulars, judicial decisions viz. Foreign Contribution (Regulation) Act 2010, Societies Registration Act, 1860, Income Tax Act 1961 etc. and the Rules related to the statutes.
- (iii) Reviewing the legal form of the Organisation and its Memorandum of Association, Articles of Association, Rules and Regulations.
- (iv) Reviewing the NGO's Organisation chart, then Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.
- (v) Examination of minutes of the Board/Managing Committee/Governing Body/ Management and Committees thereof to ascertain the impact of any decisions on the financial records.
- (vi) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.
- (vii) Setting of materiality levels for audit purposes.
- (viii) The nature and timing of reports or other communications.
- (ix) The involvement of experts and their reports.
- (x) Review the previous year's Audit Report.

The **audit programme** should include in a sequential order all assets, liabilities, income and expenditure ensuring that no material item is omitted.

- (i) **Corpus Fund:** The contributions / grants received towards corpus be vouched with special reference to the letters from the donor(s). The interest income be checked with Investment Register and Physical Investments in hand.
- (ii) **Reserves:** Vouch transfers from projects / programmes with donors letters and board resolutions of NGO. Also check transfer of gross value of asset sold from capital reserve to general reserve and adjustments during the year.
- (iii) **Ear-marked Funds:** (Earmarking refers to a fund allocation practice in which an entity, a government, or an individual sets aside a determined amount of funds to use for a specific goal). Check requirements of donors institutions, board resolution of NGO, rules and regulations of the schemes of the ear-marked funds.
- (iv) **Project / Agency Balances:** Vouch disbursements and expenditure as per agreements with donors for each of the balances.
- (v) **Loans:** Vouch loans with loan agreements, counterfoil of receipt issued.
- (vi) **Fixed Assets:** Vouch all acquisitions / sale or disposal of assets including depreciation and the authorisations for the same. Also check donor's letters/ agreements for the grant. In the case of immovable property check title, etc.
- (vii) **Investments:** Check Investment Register and the investments physically ensuring that investments are in the name of the NGO. Verify further investments and dis- investments for approval by the appropriate authority and reference in the bank accounts for the principal amount and interest.
- (viii) **Cash in Hand:** Physically verify the cash in hand and imprest balances, at the close of the year and whether it tallies with the books of account.
- (ix) **Bank Balance:** Check the bank reconciliation statements and ascertain details for old outstanding and unadjusted amounts.
- (x) **Inventory:** Verify inventory in hand and obtain certificate from the management for the quantities and valuation of the same.

- (xi) Programme and Project Expenses:** Verify agreement with donor/contributor(s) supporting the particular programme or project to ascertain the conditions with respect to undertaking the programme/project and accordingly, in the case of programmes/projects involving contracts, ensure that income tax is deducted, deposited and returns filed and verify the terms of the contract.
- (xii) Establishment Expenses:** Verify that provident fund, life insurance premium, employees state insurance and their administrative charges are deducted, contributed and deposited within the prescribed time. Also check other office and administrative expenses such as postage, stationery, travelling, etc.

The receipt of income of NGO may be checked on the following lines:

- (i) Contributions and Grants for projects and programmes:** Check agreements with donors and grants letters to ensure that funds received have been accounted for. Check that all foreign contribution receipts are deposited in the foreign contribution bank account as notified under the Foreign Contribution (Regulation) Act, 2010
- (ii) Receipts from fund raising programmes:** Verify in detail the internal control system and ascertain who are the persons responsible for collection of funds and mode of receipt. Ensure that collections are counted and deposited in the bank daily.
- (iii) Membership Fees:** Check fees received with Membership Register. Ensure proper classification is made between entrance and annual fees and life membership fees. Reconcile fees received with fees to be received during the year.
- (iv) Subscriptions:** Check with subscription register and receipts issued. Reconcile subscription received with printing and dispatch of corresponding magazine / circulars / periodicals. Check the receipts with subscription rate schedule.
- (v) Interest and Dividends:** Check the interest and dividends received and receivable with investments held during the year.

4. AUDIT OF SOLE TRADER

A sole trader is under no legal obligation to have his accounts audited. However, many such individuals get their financial statement audited due to regulatory requirements, such as inventory brokers or on a specific instructions of the bank for approval of loans, etc.



source :- otrination.com

Appointment of Auditor: Auditors of sole- proprietary concern shall be appointed by the sole proprietor himself. In case of change of auditor, it would be duty of incoming auditor to communicate with the previous auditor. As such, sole proprietor can determine the scope of the audit as well as the conditions under which it will be carried out.

Example

He can stipulate that only a partial audit shall be carried out, that certain parts of the accounts shall not be checked or that the auditor also shall prepare the final statements of account. He can also decide whether the audit shall be carried out continuously or at the end of the year.

On these considerations, it is desirable that the contract of appointment of auditor in such a case should be in writing; also that it should clearly define the scope of the work which the auditor is expected to carry out. This helps to prevent misunderstanding. If the appointment of the auditor is not in writing, the auditor should write to his client explaining the scope of his duties. While doing so, he should state the limitations, if any, placed upon his work to obtain the client's confirmation.

The advantages and audit procedure discussed in following paragraphs of audit in case of partnership firm would be similar in case of proprietorship.



5. AUDIT OF FIRM

Appointment of Auditors: The auditor to a firm is usually appointed by the partners either on the basis of a decision taken by them or to comply with a condition in the partnership agreement. His remuneration is also fixed by the partners. It is important that the letter of appointment should clearly state the nature and scope of audit which is to be carried out and particulars of limitations, if any, under which he would have to function. In case of change of auditor, it would be duty of incoming auditor to communicate with the previous auditor.

The auditor may, particularly, ensure application of accounting standards prescribed by the Institute of Chartered Accountants of India. In case the firm is required to get its accounts audited under the requirements of any statute, the auditor will have to qualify the report in case of non-compliance with the accounting standards. Alternatively, only disclosure of non-compliance with the accounting standards, would be sufficient without making it a subject matter of qualification.

Matters to be considered before starting audit: Also, before starting the audit, he should examine the partnership agreement and note the provisions therein as regards the following matters:

1. The name and style under which the business shall be conducted.
2. The duration of the partnership, if any, that has been agreed upon.
3. The amount of capital that shall be contributed by each partner—whether it will be fixed or could be varied from year to year.
4. The period at the end of which the accounts of the partnership will be closed periodically and the proportions in which the profit shall be divided among the partners or losses shall have to be contributed by them; whether the losses shall be borne by the partners or whether any of the partners will not be required to do so.
5. The provisions as regards maintenance of books of account and the matters which must be taken into account for determining the profits of the firm available for division among the partners *e.g.*, creation of reserves, provision for depreciation, etc. also the period within which accounts can be reopened for correcting a manifest error.

6. Borrowing capacity of the partnership (when it is not implied as in the case of non-trading firms).
7. The rate at which interest will be allowed on the capitals and loans provided by partners and the rate at which it will be charged on their drawings and current accounts.
8. Whether any salaries are payable to the partners or withdrawals are permitted against shares of profits and, if so, to what extent?
9. Duties of the partners as regards the management of business of the firm; also, the partners who shall act as managing partners.
10. Who shall operate the bank account of the firm? How will the surplus funds of the partnership be invested?
11. Limitations and restrictions that have been agreed upon, the rights and powers of partners and on their implied authority to pledge the firm's credit or to render it liable.

Advantages of Audit of a Partnership Firm - On broad considerations, the advantages of audit of accounts of a partnership could be stated as follows:

- (1) **Disputes:-** Audited accounts provide a convenient and reliable means of settling accounts between the partners and, thereby, the possibility of occurrence of a dispute among them is mitigated. On this consideration, it is usually provided in and accepted by the partners, shall be binding upon them, unless some manifest error is brought to light within a specified period subsequent to the accounts having been signed.
- (2) **Dissolution:-** On the retirement or death of a partner, audited accounts, which have been accepted by the partners, constitute a reliable evidence for computing the amounts due to the retiring partner or to the representative of the deceased partner in respect of his share of capital, profits and goodwill.
- (3) **Reliable:-** Audited statement of accounts are relied upon by the banks when advancing loans, as well as by prospective purchasers of the business, as evidence of the profitability of the concern and its financial position.

- (4) **Admission:-** Audited statements of account can be helpful in the negotiations to admit a person as a partner, especially when they are available for a number of past years.
- (5) **Control:-** An audit is an effective safeguard against any undue advantage being taken by a working partner or partners especially in the case of those partners who are not actively associated with the working of the firm.

Matters which should be specially considered in the audit of accounts of a partnership:

- (i) **Letter of Appointment:-** Confirming that the letter of appointment, signed by a partner, duly authorised, clearly states the nature and scope of audit contemplated by the partners, specially the limitation, if any, under which the auditor shall have to function.
- (ii) **Partnership Documents:-** Studying the minute book, if any, maintained to record the policy decision taken by partners specially the minutes relating to authorisation of extraordinary and capital expenditure, raising of loans; purchase of assets, extraordinary contracts entered into and other such matters as are not of a routine nature.
- (iii) **Objects of Partnership:-** Verifying that the business in which the partnership is engaged is authorised by the partnership agreement; or by any extension or modification thereof agreed to subsequently.
- (iv) **Books of Account:-** Examining whether books of account appear to be reasonable and are considered adequate in relation to the nature of the business of the partnership.
- (v) **Mutual Interest:-** Verifying generally that the interest of no partner has suffered prejudicially by an activity engaged in by the partnership which, it was not authorised to do under the partnership deed or by any violation of a provision in the partnership agreements.
- (vi) **Provision for Taxes:-** Confirming that a provision for the firm's tax payable by the partnership has been made in the accounts before arriving at the amount of profit divisible among the partners.
- (vii) **Division of Profits:-** Verifying that the profits and losses have been divided among the partners in their agreed profit-sharing ratio.

From the foregoing steps involved in the audit of a partnership it would be observed that like the audit of every other commercial undertaking, it culminates in the verification of the Balance Sheet and the Statement of Profit and Loss to ensure that these exhibit a true and fair state of affairs of the firm.

The object of examining the partnership agreement, which is an important feature of such an audit, is that the auditor may be able to report to the partners if the interest of any partner has been prejudicially affected, on account of the firm having engaged itself in an activity which it was not authorised to do or violation of any provision of the partnership agreement.

Test Your Understanding 2

CA Akash Virmani is auditor of a partnership firm consisting of 4 partners. During the year, one of the partners has retired and another partner has joined the next day. Discuss, any one point, which shall be considered by you to ensure that financial statements of firm are not misstated due to change of constitution of firm.

5.1 Basics of Limited Liability Partnerships (LLP) Audit

LLP is governed by Limited Liability Partnership Act, 2008. It is a form of business organisation which enshrines in itself the advantages of both the Company and Partnership forms of Organisation. Minimum of 2 Partners can form an LLP and atleast two partners would be Designated Partners who would be required to take DPIN (Designated Partner Identification Number) The Partners in an LLP and their rights and duties are governed by way of an agreement between them.

It defines a Small Limited Liability Partnership to denote any LLP:

- a) the **Contribution** of which, does not exceed **twenty-five lakh rupees (INR 25,00,000)** or such higher amount, not exceeding **five crore rupees**, as may be prescribed; and
- b) the **Turnover** of which, as per the Statement of Accounts and Solvency for the immediately preceding financial year, does not exceed **forty lakh rupees (INR 40,00,000)** or such higher amount, not exceeding **fifty crore rupees**, as may be prescribed;



Whether LLP is required to maintain Books of Accounts:- An LLP shall be under obligation to maintain annual accounts reflecting true and fair view of its state of affairs. **LLP's are required to maintain books of accounts which shall contain-**

1. Particulars of all sums of money received and expended by the LLP and the matters in respect of which the receipt and expenditure takes place,
2. A record of the assets and liabilities of the LLP,
3. Statements of costs of goods purchased, inventories, work-in-progress, finished goods and costs of goods sold,
4. Any other particulars which the partners may decide.

Audit of the Accounts of an LLP:- The accounts of every LLP shall be audited in accordance with Rule 24 of LLP, Rules 2009. Such rules, inter-alia, provides that any LLP, whose turnover does not exceed, in any financial year, forty lakh rupees, or whose contribution does not exceed twenty five lakh rupees, is not required to get its accounts audited. However, if the partners of such limited liability partnership decide to get the accounts of such LLP audited, the accounts shall be audited only in accordance with such rule.

Advantages / Purpose / Need of Audit

1. **Detection of Errors**:- Auditing the accounts of a LLP helps in detecting errors & frauds & verification of financial statements.
2. **Disputes**:-Disputes, if any between any partners in the matter of accounts can be settled with the help of audited accounts.
3. **Reliability**:- Banks & financial institutions lend money to the firms only on the basis of audited accounts.
4. **Better Compliance and Management**:-Periodical visits & suggestions by the auditor will be helpful in improving the management of the LLP.
5. **Reconstitution**:- For settling accounts between partners at the time of admission, death, retirement, insolvency, insanity, etc. audited accounts are accepted by those concerned who have dealings with the LLP.

Returns to be maintained and filed by an LLP :-

- ◆ Every LLP would be required to file annual return in Form 11 with ROC within 60 days of closer of financial year. The annual return will be available for public inspection on payment of prescribed fees to Registrar.
- ◆ Every LLP is also required to submit Statement of Account and Solvency in Form 8 which shall be filed within a period of thirty days from the end of six months the financial year to which the Statement of Account and Solvency relates.

Appointment of Auditor: The auditor may be appointed by the designated partners of the LLP –

1. At any time for the first financial year but before the end of first financial year,
2. At least thirty days prior to the end of each financial year (other than the first financial year),
3. To fill the casual vacancy in the office of auditor,
4. To fill the casual vacancy caused by removal of auditor.

The partners may appoint the auditors if the designated partners have failed to appoint them.

Auditor's Duty Regarding Audit of LLP

- 1. Engagement Letter :-** The auditor should get definite instructions in writing as to the work to be performed by him.
- 2. Minutes Book :-** If partners maintain minute book he shall refer it for any resolution passed regarding the accounts
- 3. LLP Agreement:-** The auditor should read the LLP agreement & note the following provisions
 - (a) Nature of the business of the LLP.
 - (b) Amount of capital contributed by each partner.
 - (c) Interest – in respect of additional capital contributed.
 - (d) Duration of partnership.
 - (e) Drawings allowed to the partners.
 - (f) Salaries, commission etc. payable to partners.
 - (g) Borrowing powers of the LLP.
 - (h) Rights & duties of partners.
 - (i) Method of settlement of accounts between partners at the time of admission, retirement, admission etc.
 - (j) Any loans advanced by the partners.
 - (k) Profit sharing ratio
- 4. Reporting :-** The auditor should mention
 - (a) Whether the records of the firm appear to be correct & reliable.
 - (b) Whether he was able to obtain all information & explanation necessary for his work.
 - (c) Whether any restriction was imposed upon him.



6. AUDIT OF CHARITABLE INSTITUTION



source :- charities.gov.sg

In the case of audit of a charitable institution, attention should be paid to the following matters-

(1) General

- (i) Studying the **constitution** under which the charitable institution has been set up.
- (ii) Verifying whether the institution is being managed in the manner contemplated by the law under which it has been set up.
- (iii) Examining the **system of internal check**, especially as regards accounting of amounts collected.
- (iv) Verifying in detail the income and confirming that the amounts received have been deposited in the bank regularly and promptly.
- (v) Examine the Trust Deed or the Regulations as laid down.

(2) Subscriptions and donations

- (i) Ascertaining, if any, the changes made in amount of **annual or life membership** subscription during the year.
- (ii) Whether **official receipts** are issued;
 - (a) confirming that adequate control is imposed over unused receipt books;
 - (b) obtaining all receipt books covering the period under review;
 - (c) test checking the counterfoils with the cash book; any cancelled receipts being specially looked into;

- (d) obtaining the printed list of subscriptions and donations and agreeing them with the total collections shown in the accounts;
- (e) examining the system of internal check regarding moneys received from box collections, flag days, etc. and checking the amount received from representatives, with the correspondence and the official receipts issued; paying special attention to the system of control exercised over collections and the steps taken to ensure that all collections made have been accounted for; and
- (f) verifying the total subscriptions and donations received with any figures published in reports, etc. issued by the charity.

(iii) In case of *online/digital receipts of subscriptions and donations*

- (a) *Verifying subscriptions and donations received through UPI, internet banking, credit cards, debit cards, payment gateways and other electronic payment modes by reconciling the collections with bank statements, payment gateway settlement reports and the books of account. Any unreconciled differences should be examined and suitably explained.***
- (b) *Where subscriptions and donations are collected through the institution's website or online donation portal, verifying that all successful transactions have been completely recorded in the books and that pending settlements, failed transactions, refunds and chargebacks have been duly authorised and correctly accounted for.***
- (c) *Examining whether transaction charges, payment gateway fees or bank charges deducted from online collections have been correctly accounted for and appropriately disclosed.***
- (d) *Where the institution uses an integrated donor management system or accounting software, verifying that adequate interface controls exist to ensure complete and accurate transfer of digital receipt data to the accounting records without unauthorised alteration or omission.***

(e) *Reviewing the access controls over online donation and subscription systems to ensure that only authorised personnel can modify donor records, cancel receipts or process refunds, and that adequate audit trails are maintained for such transactions.*

(3) Legacies – Verifying the amounts received by reference to correspondence with any figures and other available information.

(4) Grants

- (i) Vouching the amount received with the relevant correspondence, receipts and minute books.
- (ii) Obtaining a **certificate** from a responsible official showing the amount of grants received.

(5) Investments Income

- (i) Vouching the amounts received with the **dividend** and **interest** counterfoils.
- (ii) Checking the **calculations** of interest received on securities bearing fixed rates of interest.
- (iii) Checking that the appropriate dividend has been received where any investment has been sold ex-dividend or purchased cum-dividend.
- (iv) Comparing the amounts of dividend received with **schedule of investments** making special enquiries into any investments held for which no dividend has been received.

(6) Rent

- (i) Examining the rent roll and inspecting **tenancy agreements**, noting in each case:
 - (a) the amounts of the rent, and
 - (b) the due dates.
- (ii) Vouching the rent on to the rent roll from the counterfoils of receipt books and checking the totals of the cash book.

- (7) **Special function, etc.** - Vouching gross receipts and outgoings in respect of any special functions, *e.g.* concerts, dramatic performance, etc., held in aid of the charity with such vouchers and cash statements as are necessary. In particular, verifying that the proceeds of all tickets issued have been accounted for, after making the allowance for returns.
- (8) **Income Tax Refunds** - Where income-tax has been deducted at source from the Investment income, it should be seen that a refund thereof has been obtained since charitable institutions are exempt from payment of Income-tax. This involves:
- (i) vouching the Income-tax refund with the correspondence with the Income- tax Department; and
 - (ii) checking the calculation of the repayment of claims.
- (9) **Expenditure**
- (i) Vouching payment of grants, also verifying that the grants have been paid only for a charitable purpose or purposes falling within the purview of the objects for which the charitable institution has been set up and that no trustee, director or member of the Managing Committee has benefited there from either directly or indirectly.
 - (ii) Verifying the schedules of securities held, as well as inventories of properties both movable and immovable by inspecting the securities and title deeds of property and by physical verification of the movable properties on a test- basis.
 - (iii) Verifying the cash and bank payments.
 - (iv) Ascertaining that any funds contributed for a special purpose have been utilised for the purpose.



7. AUDIT OF EDUCATIONAL INSTITUTIONS (SCHOOL, COLLEGE OR UNIVERSITY)

The special steps involved in their audit are the following-

(A) General :-

1. Examine the Trust Deed or Regulations, in the case of school or college and note all the provisions affecting accounts. In the case of a university, refer to the Act of Legislature and the Regulation framed thereunder.
2. Read through the minutes of the meetings of the Managing Committee



or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.

(B) Fee from Students :-

1. Check names entered in the Students Fee Register for each month or term, with the respective Class Registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.
2. Check fees received by comparing counterfoils of receipts granted with entries in the Cash Book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.

3. ***Check fees received through UPI, credit cards, debit cards, net banking, payment gateways and other electronic modes by reconciling the collections with bank statements, settlement reports and entries in the Students' Fee Register or Student Information System (SIS). Investigate any unreconciled differences.***
4. ***Verify that refunds, fee reversals, failed transactions and chargebacks have been duly authorised and correctly accounted for. Also examine whether transaction charges deducted by banks or payment gateway service providers have been properly recorded.***
5. Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and that the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.
6. Check admission fees with admission slips signed by the head of the institution and confirm that the amount has been credited to a Capital fund, unless the Managing Committee has taken a decision to the contrary.
7. See that free studentship and concessions have been granted by a person authorised to do so, having regard to the Rules prepared by the Managing Committee.
8. Confirm that fines for late payment or absence, etc. have been either collected or remitted under proper authority.
9. Confirm that hostel dues were recovered before student's accounts were closed and their deposits of caution money refunded.
10. ***Where the institution uses an integrated Student Information System (SIS) or Enterprise Resource Planning (ERP) system, examine whether interface controls ensure complete and accurate transfer of fee collection data to the accounting records without unauthorised alteration.***

(C) Other Receipts/Grants & Donations :-

1. Verify rental income from landed property with the rent rolls, etc.
2. Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.
3. Verify any Government or local authority grant with the memo of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons thereof.

(D) Expenditure :-

1. Verify that the Provident Fund money of the staff has been invested in appropriate securities.
2. Vouch donations, if any with the list published with the annual report. If some donations were meant for any specific purpose, see that the money was utilised for the purpose.
3. Vouch, all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.
4. Vouch, in the usual manner, all establishment expenses and enquire into any unduly heavy expenditure under any head. If there was any annual budget prepared, see that any excess under any head over the budgeted amount was duly sanctioned by the Managing Committee. If not, bring it to the Committee's notice in your report.
5. See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.

(E) Assets & Liabilities :-

1. Report any old heavy arrears on account of fees, dormitory rents, etc. to the Managing Committee.
2. Confirm that caution money and other deposits paid by students on admission, have been shown as liability in the balance sheet not transferred to revenue, unless they are not refundable.

3. See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.
4. Ascertain that the system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.
5. Verify the inventories of furniture, stationery, clothing, provision and all equipment etc. These should be checked by reference to Inventory Register or corresponding inventories of the previous year and values applied to various items should be test checked.

(F) Compliances :-

1. Confirm that the refund of taxes deducted from the income from investment (interest on securities etc.) has been claimed and recovered since the institutions are generally exempted from the payment of income-tax.
2. Finally, verify the annual statements of account and, while doing so see that separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel and Provident Fund of staff, etc.
2. Finally, verify the annual statements of account and, while doing so see that separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel and Provident Fund of staff, etc.

Test Your Understanding 3

You are auditor of a school operating in your city. During audit of a year, it is noticed that fees concessions to students have been provided in substantial number of cases. Discuss, how, you as an auditor, would proceed to verify the same?

8. AUDIT OF HOSPITAL

The special steps involved in such an audit are stated below-



Source of image: [tobuz.com](https://www.tobuz.com)

1. **Register of Patients:** Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.
2. **Collection of Cash:** Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.
3. **Digital Collections (Online/UPI/Credit Card Payments):** *With the increasing use of digital payment modes, the auditor should verify that amounts received through UPI, credit cards, debit cards, internet banking and payment gateways have been completely and accurately recorded in the books of account.*

The auditor should perform the following procedures:

- (i) ***Reconcile daily collections as per the Hospital Management Information System (HMIS) or billing software with settlement reports received from banks and payment gateway service providers.***

- (ii) Verify that all digital receipts have been credited to the hospital's bank accounts and investigate any pending settlements, failed transactions or unreconciled differences.**
- (iii) Examine deductions made by banks or payment gateways towards Merchant Discount Rate (MDR), convenience charges or other transaction fees and ensure that such charges have been correctly accounted for.**
- (iv) Verify that refunds made to patients through digital payment modes have been duly authorised, supported by appropriate documentation and correctly recorded in the books.**
- (v) Ensure that cancelled bills, reversed transactions and chargebacks have been properly approved and reconciled with the original billing records.**
- (vi) Review period-end reconciliation of digital collections to ensure that payments received before the balance sheet date but credited by banks or payment gateways after the year-end have been appropriately accounted for.**
- (vii) Where the hospital uses an integrated Hospital Management Information System (HMIS), billing software and accounting system, examine whether interface controls ensure complete and accurate transfer of billing and collection data without unauthorised alteration.**

Example: Suppose Mr. A is admitted to the hospital.

- The HMIS records admission , room charges ,, doctor consultation , laboratory tests, medicines issued etc.**
- The information is automatically transferred to the Billing Software, which generates a bill of ₹50,000.**
- After the patient pays through UPI, the collection is automatically transferred to the Accounting System.**

- (viii) Verify that access to the digital payment and billing systems is restricted to authorised personnel and that adequate audit trails are maintained for recording, modifying and reversing transactions.*
- (ix) The auditor should reconcile the total amount billed to patients with collections received through cash, UPI, credit cards, debit cards, insurance companies and other digital payment modes. Any material differences arising on account of outstanding receivables, refunds, write-offs or settlement delays should be examined and suitably explained.*
4. **Legacies and Donations:** Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.
 5. **Reconciliation of Subscriptions:** Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).
 6. **Authorisation and Sanctions:** Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorised.
 7. **Grants and TDS:** Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.
 8. **Budgets:** Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee, significant variations which have taken place.
 9. **Internal Check:** Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to ensure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorisation.
 10. **Depreciation:** See that depreciation has been written off against all the assets at the appropriate rates.

- 11. Registers:** Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.
- 12. Inventories:** Obtain inventories, especially of stocks and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.
- 13. Management Representation and Certificate:** Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.

9. AUDIT OF CLUB

The special steps involved in such an audit are stated below-

- (1) Entrance Fee :-** Vouch the receipt on account of **entrance fees** with members' applications, counterfoils issued to them, as well as on a reference to minutes of the Managing Committee.
- (2) Subscriptions :-** Vouch **members' subscriptions** with the counterfoils of receipt issued to them, trace receipts for a selected period to the Register of Members; also reconcile the amount of total subscriptions due with the amount collected and that outstanding.

In case of online/digital collection of subscriptions:

- (i) *Vouch subscriptions received through UPI, internet banking, credit cards, debit cards, payment gateways and other electronic payment modes with bank statements, payment gateway settlement reports and the Register of Members to ensure that all receipts have been completely and correctly accounted for.***
- (ii) *Reconcile the subscriptions recorded in the Club Management System or membership software with the books of account and bank credits. Investigate any differences arising on account of pending settlements, failed transactions, refunds or chargebacks.***

- (iii) Verify that transaction charges deducted by banks or payment gateway service providers have been correctly accounted for and appropriately classified in the books of account.*
 - (iv) Where subscriptions are collected through an online membership portal or mobile application, ensure that all successful transactions have been duly credited to the respective members' accounts and that receipts have been generated for every collection.*
 - (v) Examine whether adequate interface controls exist between the Club Management System, online payment platform and accounting system to ensure complete and accurate transfer of subscription data without unauthorised alteration or omission.*
 - (vi) Review the controls over user access to the online membership and payment systems to ensure that only authorised personnel can modify members' subscription records, reverse transactions or process refunds and that adequate audit trails are maintained for such transactions.*
- (3) **Arrears of Subscriptions** :- Ensure that **arrears of subscriptions** for the previous year have been correctly brought over and arrears for the year under audit and subscriptions received in advance have been correctly adjusted.
- (4) **Arithmetical accuracy** :- Check totals of various columns of the Register of members and tally them across.
- (5) **Irrecoverable Member Dues** :- See the Register of Members to ascertain the **Member's dues** which are in arrear and enquire whether necessary steps have been taken for their recovery; the amount considered irrecoverable should be mentioned in the Audit Report.
- (6) **Pricing** :- Verify the internal check as regards members being charged with the **price of foodstuffs and** drinks provided to them and their guests, as well as, with the fees chargeable for the special services rendered, such as billiards, tennis, etc.

- (7) **Member Accounts** :- Trace debits for a selected period from subsidiary registers maintained in respect of supplies and services to members to confirm that the account of every member has been debited with amounts recoverable from him.
- (8) **Purchases** :- Vouch **purchase** of sports items, furniture, crockery, etc. and trace their entries into the respective inventory registers.
- (9) **Margins earned** :- Vouch purchases of foodstuffs, cigars, wines, etc., and test their sale price so as to confirm that the normal **rates of gross profit** have been earned on their sales. The inventory of unsold provisions and stores, at the end of year, should be verified physically and its valuation checked.
- (10) **Inventories** :- Check the **inventory** of furniture, sports material and other assets physically with the respective inventory registers or inventories prepared at the end of the year.
- (11) **Investments** :- Inspect the share scrips and bonds in respect of **investments**, check their current values for disclosure in final accounts; also ascertain that the arrangements for their safe custody are satisfactory.
- (12) **Management Powers** :- Examine the **financial powers of the secretary** and, if these have been exceeded, report specific case for confirmation by the Managing Committee.

10. AUDIT OF CINEMA

The special steps involved in its audit are stated below-



source :- indiatvnews.com

- (1) Verify the **internal control mechanism**-
 - (a) that entrance to the cinema-hall during show is only through printed tickets;
 - (b) that they are serially numbered and bound into books;
 - (c) that the number of tickets issued for each show and class, are different though the numbers of the same class for the show on the same day, each week, run serially;
 - (d) that for advance booking a separate series of tickets is issued; and
 - (e) that the inventory of tickets is kept in the custody of a responsible official.
- (2) Confirm that at the end of show, a **statement of tickets sold** is prepared and cash collected is agreed with it.
- (3) Verify that a record is kept of the '**free passes**' and that these are issued under proper authority.
- (4) Reconcile the amount of **Tax** collected with the total number of tickets issued for each class and vouch and verify the tax returns filed each month.
- (5) Vouch the entries in the Cash Book in respect of cash collected on **sale of tickets** for different shows on a reference to Daily Statements which have been test checked as aforementioned with record of tickets issued for the different shows held.
- (6) Verify the charges collected for **advertisement** slides and shorts by reference to the Register of Slides and Shorts Exhibited kept at the cinema as well with the agreements, entered into with advertisers in this regard.
- (7) Vouch the **expenditure** incurred on advertisement, repairs and maintenance. No part of such expenditure should be capitalized.
- (8) Confirm that **depreciation** on machinery and furniture has been charged at an appropriate rate.
- (9) Vouch payments on account of film hire with bills of **distributors** and in the process, the agreements concerned should be referred to.

- (10) Examine unadjusted balance out of **advance paid to the distributors** against film hire contracts to see that they are good and recoverable. If any film in respect of which an advance was paid has already run, it should be enquired as to why the advance has not been adjusted. The management should be asked to make a provision in respect of advances that are considered irrecoverable.
- (11) The arrangement for collection of the share in the **restaurant income** should be enquired into either a fixed sum or a fixed percentage of the taking may be receivable annually. In case the restaurant is run by the Cinema, its accounts should be checked. The audit should cover sale of various items of foodstuffs, purchase of foodstuffs, cold drink, etc. as in the case of club.

Additional Considerations:

(12) Verify controls over online ticket booking platforms:

- Evaluate the controls over tickets booked through the cinema's website, mobile application and third-party booking platforms. Verify that ticket sales recorded in the accounting system are completely and accurately captured from these platforms.
- Verify revenue sharing arrangements with **online booking platforms** wherever applicable.
- Review **cybersecurity and backup controls** over the ticketing database and customer transaction records.

(13) Verify reconciliation of digital collections: Reconcile ticket sales recorded in the booking system with collections received through payment gateways, UPI, debit/credit cards, net banking and wallets. Verify settlement reports received from payment gateway service providers and identify any pending settlements, chargebacks or refunds.

(14) Verify QR code/barcode-based admission controls: Review the controls relating to QR code or barcode scanning at entry gates to ensure that each ticket is validated only once and that reports of scanned tickets are reconciled with tickets sold. Investigate instances of duplicate scans, cancelled tickets or manual overrides.

- (15) **Verify accounting for convenience fees, promotional discounts and loyalty programmes:** Examine the accounting treatment of convenience fees, booking charges, promotional discounts, cashback offers, coupon redemptions and loyalty reward points. Ensure that revenue is recognised appropriately after considering contractual arrangements with third-party booking platforms.
- (16) **Verify automated reports generated from ERP and POS systems:** Where ticketing, food and beverage sales and accounting are integrated through ERP/POS systems, verify the reliability of system-generated reports by testing relevant IT controls, interface controls and automated reconciliations between ticketing, POS and financial accounting systems.

Point of Sale (POS) System: A computerized system used for processing ticket sales and food & beverage transactions, generating invoices, accepting digital payments, updating inventory, and recording accounting entries in an integrated manner.

- (17) **Verify audit trail and system access controls:** Review user access rights to the ticketing system and verify that cancellations, complimentary tickets, refunds, price overrides and manual modifications are properly authorised, logged and supported by an audit trail. Examine exception reports for unusual transactions.

11. AUDIT OF HIRE PURCHASE AND LEASING COMPANIES



source :- efinancemanagement.com

(A) HIRE - PURCHASE :-

(1) A Hire-purchase agreement means an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which-

- (i) possession of goods is delivered by the owner thereof to a person on condition that such person pays the agreed amount in periodical instalments,
- (ii) the property in the goods is to pass to such person on the payment of the last of such instalments, and
- (iii) such person has a right to terminate the agreement at any time before the property so passes.

(2) **Hirer** means the person who obtains or has obtained possession of goods from an owner under a hire- purchase agreement and **owner** means the person who lets or has let, delivers or has delivered possession of goods to a hirer under a hire-purchase agreement in order to complete the purchase of, or the acquisition of property in the goods of which the agreement relates; and includes any sum so payable by the hirer under the hire- purchase agreement by way of a deposit or other initial payment.

(3) While checking the hire- purchase transaction, the auditor may examine the following:

- (i) Hire purchase agreement is in writing and is signed by all parties.
- (ii) Hire purchase agreement specifies clearly-
 - (a) The hire-purchase price of the goods to which the agreement relates;
 - (b) The cash price of the goods, that is to say, the price at which the goods may be purchased by the hirer for cash;
 - (c) The date on which the agreement shall be deemed to have commenced;
 - (d) The number of instalments by which the hire- purchase price is to be paid, the amount of each of those instalments, and the date, or the mode of determining the date, upon which it is payable, and the person to whom and the place where it is payable; and

- (e) The goods to which the agreement relates, in a manner sufficient to identify them.
- (iii) Ensure that instalment payments are being received regularly as per the agreement.

(B) LEASES :-

(1) In a **lease agreement**, a party (called '**lessee**') acquires the right to use an asset for an agreed period of time in consideration of payment of rent to another party (called '**lessor**').

(2) In certain lease agreements, the legal ownership of the asset remains with the lessor (the leasing company), but in substance, all the risks and rewards of ownership of the asset are transferred to the lessee. In other words, the lease is, in effect, a financing arrangement. Such leases are termed as finance leases. An operating lease, on the other hand, is a simple arrangement where, in return for rent, the lessor allows the lessee to use the asset for a certain period.

(3) A normal finance lease transaction usually goes through the following modality:

- I. The lessee will select the equipment, and satisfy himself about its functional fitness and specifications, the lessor has no participation at this stage.
- II. Having chosen the equipment, the lessee approaches a lessor, either directly or through a lease-broking agency.
- III. The lease agreement is broadly negotiated and the rates are finalised. The lessor places an order on the manufacturer as chosen by the lessee.
- IV. The manufacturer delivers the equipment at the site of the lessee, and the latter gives notice of acceptance to the lessor.
- V. The lease agreement giving detailed terms of contract is signed between the parties. Leases will normally be full pay-out, with term varying as per requirements.
- VI. During the lease period, the lessee:
 - Will pay rentals regularly at periods agreed-upon, which are usually each calendar month;

- Will keep the equipment in good repair and working condition, etc.
 - Will be entitled to any manufacturer's warranties or after-sales services.
- VII. At the end of the lease period, the equipment shall retreat to the lessor. The lessee may, however, be given a renewal right, or may be allowed to participate in purchase of the equipment when the lessor intends to sell it. No purchase option shall be given to the lessee in the lease agreement itself.

(4) Auditor's Procedures:- In respect of leasing transaction entered into by the leasing company, the following procedures may be adopted by the auditor:

- I. The object clause of leasing company to see that the goods like capital goods, consumer durables etc. in respect of which the company can undertake such activities. Further, to ensure that whether company can undertake financing activities or not.
- II. Whether there exists a procedure to ascertain the credit analysis of lessee like lessee's ability to meet the commitment under lease, past credit record, capital strength, availability of collateral security, etc.
- III. The lease agreement should be examined and the following points may be noted:
 - (i) the description of the lessor, the lessee, the equipment and the location where the equipment is to be installed. (The stipulation that the equipment shall not be removed from the described location except for repairs. For the sake of identification, the lessor may also require plates or markings to be attached to the equipment).
 - (ii) the amount of tenure of lease, dates of payment, late charges, deposits or advances etc. should be noted.
 - (iii) whether the equipment shall be returned to the lessor on termination of the agreement and the cost shall be borne by the lessee.
 - (iv) whether the agreement prohibits the lessee from assigning the subletting the equipment and authorises the lessor to do so.

- IV. Examine the lease proposal form submitted by the lessee requesting the lessor to provide him the equipment on lease.
- V. Ensure that the invoice is retained safely as the lease is a long-term contract.
- VI. Examine the acceptance letter obtained from the lessee indicating that the equipment has been received in order and is acceptable to the lessee.
- VII. See the Board resolution authorising a particular director to execute the lease agreement has been passed by the lessee.
- VIII. See that the copies of the insurance policies have been obtained by the lessor for his records.

Students need to pay attention that AS-19 define that lease arrangements could be of 2 types i.e. 1 Finance Lease and 2 Operating Lease.

Finance Lease: An arrangement with the following attributes qualifies as a Finance Lease:

The lease arrangement transfers ownership of the asset to the lessee at the end of the lease term;

- ◆ The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
- ◆ The lease term is for the major part of the economic life of the asset even if title is not transferred;
- ◆ At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- ◆ the leased assets are of such a specialized nature that only the lessee can use them without major modifications

Operating Lease

An arrangement that does not transfer substantially all the risks and rewards incidental to ownership qualifies as an Operating Lease. In other words, an operating lease is a lease arrangement "Other than finance lease".

The below table captures the broad differences under both the above said types of lease arrangements:

	Operating Lease	Finance Lease
Common examples	Lease of Projector, Computers, Laptops, Coffee Dispensers etc.	Lease of Plant and Machinery, Land, Office Building etc.
Ownership	Ownership of the asset remains with the lessor for the entire period of lease.	Ownership transfer option at the end of the lease period is with the lessee. Title may or may not be eventually transferred.
Accounting treatment	Operating lease is generally treated like a renting arrangement. That means, the lease payments are treated as operating expenses and the asset does not appear as an asset on lessee's balance sheet.	Finance lease is treated like loan arrangement. Hence, the asset ownership is considered of that of the lessee and thus appears on the balance sheet of the lessee.
Purchase Option	Under operating lease, the lessee does not have any option to buy the asset during the lease period.	Finance lease allows the lessee to have a purchase option at less than the fair market value of the asset.
Lease Term	Lease term generally extends to less than 75% of the projected useful life of the leased asset.	Lease term is generally more than or equal to estimated economic life of the asset under the lease arrangement.
Operating/ running expenses	Lessee pays only the monthly lease payments. No running or administration costs are to be borne for example: registration, repairs etc. since it gives only right to use the asset.	Lessee generally bears insurance, maintenance and taxes.

Tax benefit	Since operating lease is as good as renting, lease payment is considered as expense. No depreciation can be claimed by the lessee.	Lessee can claim both interest and depreciation expense as financial lease is treated like a loan.



12. AUDIT OF HOTELS

The special considerations in a hotel audit can be summarised as follows:

(1) Internal Controls - Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined. It is the responsibility of management to introduce controls which will minimise the leakage as far as possible. Evidence of their success is provided by the preparation of regular perhaps weekly, trading accounts for each sales point and a detailed scrutiny of the resulting profit percentages, with any deviation from the anticipated form being investigated. The auditor should obtain these regular trading accounts for the period under review, examine them and obtain explanations for any apparent deviations.

The auditor should verify a few restaurant bills by reference to K.O.T.s (Kitchen Order Tickets) or basic record. This would enable the auditor to ensure that controls regarding revenue cycle are in order.

The auditor should satisfy himself that all taxes collected from occupants on food and occupation have been paid over to the proper authorities. If the internal control in a hotel is weak or perhaps breaks down, then a very serious problem exists for the auditor. As a result of the transient nature of many of his clients' records, the auditor must rely to a very large extent on the gross margin shown by the accounts. As a result, the scope of his audit tests will necessarily be increased and, in the event of a material margin discrepancy being unexplained, he will have to consider qualifying his audit report.

(2) Room Sales & Hall Bookings - The charge for room sales is normally posted to guest bills by the receptionist/ front office or in the case of large hotels by the night auditor. The source of these entries is invariably the guest register and audit tests should be carried out to ensure that the correct numbers of guests are

charged for the correct period. Any difference between the charged rates used on the guests' bills and the standard room rate should be investigated to ensure that they have been properly authorised.

In many hotels, the housekeeper prepares a daily report of the rooms which were occupied the previous night and the number of beds kept in each room. This report tends not to be permanently retained and the auditor should ensure that a sufficient number of reports are available for him to test both with the guest register and with the individual guest's bill. The auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts. The auditor should ensure that proper records are maintained for booking of halls and other premises for special parties and recovered on the basis of the tariff.

(3) Inventories - The inventories in any hotel are both readily portable and saleable particularly the food and beverage inventories. It is therefore extremely important that all movements and transfers of such inventories should be properly documented to enable control to be exercised over each individual stores areas and sales point. The auditor should carry out tests to ensure that all such documentation is accurately processed.

Areas where large quantities of inventory are held should be kept locked, the key being retained by the departmental manager. The key should be released only to trusted personnel and unauthorised persons should not be permitted in the stores areas except under constant supervision. In particular, any movement of goods in or out of the stores should be checked. Many hotels use specialised professional valuers to take and value the inventories on a continuous basis throughout the year. Such a valuation is then almost invariably used as the basis of the balance sheet inventory figure at the year end. Although such valuers are independent of the audit client, it is important that the auditor satisfies himself that the amounts included for such inventories are reasonable. In order to satisfy himself of this, the auditor should consider attending the physical inventory taking and carrying out certain pricing and calculation tests. The extent of such tests could well be limited since the figures will have been prepared independently of the hotel.

(4) Fixed Assets - The accounting policies for fixed assets of individual hotels are likely to differ. However, many hotels account for certain quasi-fixed assets such as silver and cutlery on inventory basis. This can lead to confusion between each inventory items and similar assets which are accounted for on a more normal form on assets basis. In such cases, it is important that very detailed definitions of inventory items exist and the auditor should carry out tests to ensure that the definitions have been closely followed. The auditor should see that costs of repairs and minor renovation and redecoration are treated as revenue expenditure, where as costs of major alterations and additions to the hotel building and facilities capitalised.

(5) Casual Labour - The hotel trade operates to very large extent on casual labour. The records maintained of such wage payments are frequently inadequate. The auditor should ensure that defalcation on this account does not take place by suggesting proper controls to the management.

(6) Travel Agents & Shops -

- (i) For ledgers coming through travel agents or other booking agencies the bills are usually made on the travel agents or booking agencies. The auditor should ensure that money are recovered from the travel agents or booking agencies as per the terms of credit allowed.
- (ii) Commission, if any, paid to travel agents or booking agents should be checked by reference to the agreement on that behalf.

(7) Online Bookings and Digital Reservation Platforms : With the increasing use of hotel websites, mobile applications and Online Travel Agencies (OTAs), such as online booking platforms, the auditor should pay special attention to controls over electronically generated reservations and related revenue.

(i) Completeness of Booking Revenue: The auditor should verify that all confirmed bookings received through the hotel's website, mobile application and third-party booking platforms are automatically recorded in the Property Management System (PMS) and are completely accounted for in the books of account. Reconciliation should be performed between reservation reports, PMS records and revenue recognised.

(ii) Reconciliation with Online Travel Agencies (OTAs): Amounts receivable from Online Travel Agencies should be reconciled with statements received

from such agencies. The auditor should examine deductions made towards commission, promotional discounts, cancellation charges and taxes to ensure that they are in accordance with the contractual terms and have been correctly accounted for.

- (iii) Advance Receipts and Deferred Revenue:** Advance amounts received against future reservations should be verified with booking confirmations and bank records. The auditor should ensure that such receipts are recognised as revenue only when the accommodation or related services have actually been provided and that unearned revenue outstanding at the balance sheet date has been appropriately disclosed.
- (iv) Cancellation, Refunds and No-show Charges:** The auditor should examine the system of recording cancellations, refunds and no-show charges. Adequate audit procedures should be performed to ensure that refunds have been duly authorised, correctly processed and supported by appropriate documentation, and that revenue adjustments have been properly recorded.

No-show charges are charges recovered by a hotel when a guest makes a confirmed reservation but fails to arrive and does not cancel the booking within the stipulated cancellation period.

- (v) Dynamic Pricing and Rate Authorisation:** Many hotels adopt dynamic pricing based on demand, occupancy levels, seasonality and special events. The auditor should satisfy himself that changes in room tariffs are made only by authorised personnel and are supported by the pricing policy approved by the management. Material deviations from approved rates should be investigated.
- (vi) Promotional Offers, Coupons and Loyalty Programmes:** The auditor should verify that discounts, promotional offers, coupon redemptions and loyalty programme benefits have been granted in accordance with the schemes approved by the management. The accounting treatment of such incentives should also be examined for correctness.
- (vii) Interface Controls:** Where the reservation platform, Property Management System (PMS), Point-of-Sale (POS) system and accounting software are integrated, the auditor should evaluate the effectiveness of interface controls

to ensure that booking, billing and collection data are transferred completely and accurately without unauthorised modification.

- (viii) Online Payment Gateway Collections:** Collections received through payment gateways should be reconciled with bank credits, settlement reports and accounting records. The auditor should verify the accounting treatment of gateway charges, convenience fees, taxes and settlement adjustments.
- (ix) User Access and System Controls:** The auditor should review controls over user access to the online reservation system, including creation, modification and cancellation of bookings. Appropriate authorisation, password controls and audit trails should exist to prevent unauthorised transactions and manipulation of reservation data.
- (x) Data Security and Customer Information:** Since online booking systems maintain customers' personal and payment-related information, the auditor should evaluate whether appropriate controls exist for safeguarding such data against unauthorised access, alteration or loss and whether the entity complies with applicable legal and regulatory requirements relating to data protection.
- (xi) Cut-off Procedures:** The auditor should verify that bookings spanning the year-end are appropriately accounted for and that revenue is recognised in the correct accounting period. Advance collections relating to future stays should not be recognised as current year revenue.
- (xii) Analytical Review:** The auditor may compare occupancy percentage, Average Daily Rate (ADR), Revenue Per Available Room (RevPAR), cancellation ratio and online booking trends with those of previous periods and investigate significant or unusual variations.



source :- [agoda.com](https://www.agoda.com)

13. AUDIT OF CO-OPERATIVE SOCIETIES



source :- [quora.com](https://www.quora.com)

13.1 Background

A Cooperative (also known as co-operative, co-op, or coop) is "an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned enterprise".

The Co-operative Societies Act, 1912, a Central Act, contains the fundamental law regarding the formation and working of the co-operative societies in India and is applicable in many states with or without amendments. In many states, viz., Maharashtra, West Bengal, Orissa, the co-operative societies are governed by specific state Acts. An auditor of a co-operative society should be familiar with the provisions of the particular Act governing the society under audit.

Co-operative society is a business organisation with a special mode of doing business, by pulling together all the means of production co-operatively, elimination of middlemen and exploitation from outside forces.

A chartered accountant has to play a significant role in the development of co-operative organisations on scientific lines. In this Unit, it is proposed to give a few guidelines in the matter of audits of co-operative societies.

Apart from audit, some other professional services could be rendered by chartered accountants such as-

- (1) guidance in accounts writing,

- (2) installation of accounting system,
- (3) internal audit,
- (4) management accounting services,
- (5) taxation etc.

However, the main focus is to give some guidelines about the audit of co-operative societies in general. The special features of audit applicable to all societies will be considered first, and subsequently a few special points with reference to audit programmes of specific types of societies will be considered.

13.2 Audit as per Section 17 of the Co-Operative Societies Act, 1912

- (1) The Registrar shall audit or cause to be audited by some person authorised by him by general or special order in writing in this behalf the accounts of every registered society once at least in every year.
- (2) The audit under sub-section (1) shall include an examination of overdue debts, if any, and a valuation of the assets and liabilities of the society.
- (3) The Registrar, the Collector or any person authorised by general or special order in writing in this behalf by the Registrar shall at all times have access to all the books, accounts, papers and securities of a society, and every officer of the society shall furnish such information in regard to the transactions and working of the society as the person making such inspection may require.

“Registrar” means a person appointed to perform the duties of a Registrar of Co- operative Societies under this Act.

The following points should be kept in mind in connection with the audit of a co-operative society:

1. Qualifications of Auditors - Apart from a chartered accountant within the meaning of the Chartered Accountants Act, 1949, some of the State Co-operative Acts have permitted persons holding a government diploma in co-operative accounts or in co-operation and accountancy and also a person who has served as an auditor in the co-operative department of a government to act as an auditor.

2. Appointment of the Auditor - An auditor of a co-operative society is appointed by the Registrar of Co-operative Societies and the auditor so appointed conducts the audit on behalf of the Registrar and submits his report to him as also to the society. The audit fees are paid by the society on the basis of statutory scale of fees prescribed by the Registrar, according to the category of the society audited.

3. Books, Accounts and other records of Co-operative Societies - Under section 43(h) of the Central Act, a state government can frame rules prescribing the books and accounts to be kept by a co-operative society.

***For example,** in Maharashtra, the co-operative societies are required to maintain books of account in terms of the instructions of the Registrar as following:*

- (i) All sums of money received and expended by the society and the matters in respect of which receipts and expenditure take place.
- (ii) All sales and purchases of goods by the society.
- (iii) Assets and liabilities of the society.

In order to maintain proper financial accounting records so as to disclose full financial results of working of the society, the statutory or mandatory provisions provide a directive, but they are not conclusive. The society is at liberty to maintain such additional records according to its convenience and which it thinks more useful for clarity and detailed explanation. Ultimately the financial transactions and the results thereof must be presented very clearly and in the best possible manner.

Depending upon the nature and object of the society, different kinds of books and registers will be maintained, so as to disclose a proper and fair picture of financial transactions. In case of large scale co-operative organisation, different subsidiary books and registers shall be maintained and the daily summary totals will be transferred to main Cash Book. For example:

- (a) Daily cash sales summary register.
- (b) A register of collection from debtors if credit sales are allowed by bye-laws of society.
- (c) A register of recovery of loans from salaries and directly by receipts from members in case of credit society.

- (d) Loan disbursement register in case of credit society.
- (e) Any other columnar subsidiaries depending upon the nature and functions of society.

4. Restrictions on share holdings - According to section 5 of the Central Act, in the case of a society where the liability of a member of the society is limited, no member of a society other than a registered society can hold such portion of the share capital of the society as would exceed a maximum of **twenty percent** of the total number of shares or of the value of shareholding to ₹ **1,000/-**. The auditor of a co-operative society will be concerned with this provision so as to watch any breach relating to holding of shares. One should also watch whether any provision in the bye-laws of the society is not contrary to this statutory position. The State Acts may provide limits as to the shareholding, other than that provided in the Central Act.

5. Restrictions on loans - Section 29 of the Central Act puts restriction on loan. It states that a registered society shall not make a loan to any person other than a member. However, with the special sanction of the Registrar, a registered society may make a loan to another registered society.

The State Government may further put such restrictions as it thinks fit on the loaning powers of the society to its members or to other societies in the interest of the society concerned and its members.

6. Restrictions on borrowings - Section 30 of the Central Act further puts restriction on borrowings. According to this section, a registered society shall accept loans and deposits from persons who are not members subject to the restrictions and limits of the bye-laws of the society. The auditor will have to examine the bye-laws in this respect.

7. Investment of funds - According to section 32 of the Central Act, a society may invest its funds in any one or more of the following:

- (a) In the Central or State Co-operative Bank.
- (b) In any of the securities specified in section 20 of the Indian Trusts Act, 1882.
- (c) In the shares, securities, bonds or debentures of any other society with limited liability.

- (d) In any co-operative bank, other than a Central or State co-operative bank, as approved by the Registrar on specified terms and conditions.
- (e) In any other moneys permitted by the Central or State Government.

In the principal provision relating to the investments of funds of a co-operative society, the Central as well as State Acts does not mention anything about the investment of reserve fund outside the business specifically.

8. Appropriation of profits - According to section 33 of the Central Act, a prescribed percentage of the profits should be transferred to Reserve Fund, before distribution as dividends or bonus to members.

9. Contributions to Charitable Purposes - According to section 34, a registered society may, with the sanction of the Registrar, contribute an amount not exceeding 10% of the net profits remaining after the compulsory transfer to the reserve fund for any charitable purpose as defined in section 2 of the Charitable Endowments Act, 1890.

10. Investment of Reserve Fund outside the business or utilisation as working capital - Some of the State Acts provide that a society may use the Reserve Fund:

- (a) in the business of a society, as working capital (subject to the rules made in this behalf).
- (b) may invest as per provisions of the Act.
- (c) may be used for some public purposes likely to promote the object of the society. The auditor should ensure strict compliance with the State Act and Rules in this regard.

11. Contribution to Education Fund - Some of the State Acts provide that every society shall contribute annually towards the Education Fund of the State Federal Society, at the appropriate rate as per the class of the society. Contribution to Education Fund is a charge on profits and not an appropriation.

Apart from statutory provisions relating to Reserve Fund, the auditor may have regard to the provisions in bye-laws and Rules and Regulations of the society regarding the appropriation of profits. Transfers to other reserves, dividends to

members etc. are the other appropriations. Appropriations of profits must be approved by the General Body of the society, which is the supreme authority in the co-operative management. Further, it may be noted that necessary accounting entries for the appropriation of profits must be passed after the date of approval by the General Body. Here there is a departure from corporate accounting practice, where entries are passed for proposed appropriations, subject to approval of Annual General Meeting.

According to certain State Acts, transfers to Dividend Equalization Reserve and Share Capital Redemption Fund are stated as charges against profits. According to the generally accepted principles of accountancy these items are not charges, but appropriation of profits. The auditor should point out such spots where statutory provisions of any law are in contradiction with the generally accepted accounting principles.

13.3 Special Features of Co-operative Audit

The general processes of auditing involved in audit work such as checking of posting, ascertainment of arithmetical accuracy, vouching, verification of assets and liabilities and final scrutiny of Balance Sheet are well known to the students, and the same are to be applied in co-operative audit as well. It need not be discussed in detail.



However, the special features of co-operative audit, to be borne in mind in general while conducting the audit are as follows:

- 1. Examination of overdue debts** - Overdue debts for a period from 6 months to 5 years and more than 5 years will have to be classified and shall have to be reported by an auditor. Overdue debts have far reaching consequences on the working of a credit society. It affects its working capital position. A further analysis of these overdue debts from the viewpoint of chances of recovery will have to be made, and they will have to be classified as good or bad. The auditor will have to ascertain whether proper provisions for doubtful debts are made and whether the same is satisfactory.
- 2. Overdue Interest** - Overdue interest should be excluded from interest outstanding and accrued due while calculating profit. Overdue interest is interest accrued or accruing in accounts, the amount of which the principal is overdue. In practice an overdue interest reserve is created and the credit of overdue interest credited to interest account is reduced.
- 3. Certification of Bad Debts** - A peculiar feature regarding the writing off of the bad debts as per Maharashtra State Co-operative Rules, 1961, is very interesting to note. As per the said rules, bad debts can be written off only when they are certified as bad by the auditor. Bad debts and irrecoverable losses before being written off against Bad Debts Funds, Reserve Fund etc. should be certified as bad debts or irrecoverable losses by the auditor where the law so requires. Where no such requirement exists, the managing committee of the society must authorise the write-off.
- 4. Valuation of Assets and Liabilities** - Regarding valuation of assets there are no specific provisions or instructions under the Act and Rules and as such due regard shall be had to the general principles of accounting and auditing conventions and standards adopted. The auditor will have to ascertain existence, ownership and valuation of assets. Fixed assets should be valued at cost less adequate provision for depreciation. The incidental expenses incurred in the acquisition and the installation expenses of assets should be properly capitalised. If the difference in the original cost of acquisition and the present market price is of far reaching significance, a note regarding the present market value may be appended; so as to have a proper disclosure in the light of present inflatory conditions. The current

assets be valued at cost or market price, whichever is lower. Regarding the liabilities, the auditor should see that all the known liabilities are brought into the account, and the contingent liabilities are stated by way of a note.

5. Adherence to Co-operative Principles - The auditor will have to ascertain in general, how far the objects, for which the co-operative organisation is set up, have been achieved in the course of its working. The assessment is not necessarily in terms of profits, but in terms of extending of benefits to members who have formed the society. Considered from the viewpoint of social benefits it may be looked into that how far the sales could be affected at lower prices. For the achievement of these activities, cost accounting methods, store control methods, techniques of standard costing, budgetary control etc. should be adopted. However, these modern techniques are mostly not in application and as such in practice a wide gap is found in the goals to be achieved and the actual achievements. While auditing the expenses, the auditor should see that they are economically incurred and there is no wastage of funds. Middlemen commissions are, as far as possible, avoided and the purchases are made by the committee members directly from the wholesalers. The principles of propriety audit should be followed for the purpose.

6. Observations of the Provisions of the Act and Rules - An auditor of a co-operative society is required to point out the infringement with the provisions of Co-operative Societies Act and Rules and bye-laws. The financial implications of such infringements should be properly assessed by the auditor and they should be reported. Some of the State Acts contain restrictions on payment of dividends, which should be noted by the auditor.

7. Verification of Members' Register and examination of their pass books- Examination of entries in members pass books regarding the loan given and its repayments, and confirmation of loan balances in person is very much important in a co-operative organisation to assure that the entries in the books of accounts are free from manipulation. Specifically in the rural and agricultural credit societies, members are not literate and as such this is a good safeguard on their part. Of course this checking will be resorted to on a test basis, which is a matter of judgement of the auditor.

8. Special report to the Registrar - During the course of audit, if the auditor notices that there are some serious irregularities in the working of the society he may report these special matters to the Registrar, drawing his specific attention to

the points. The Registrar on receipt of such a special report may take necessary action against the society. In the following cases, for instance, a special report may become necessary:

- (i) Personal profiteering by members of managing committee in transactions of the society, which are ultimately detrimental to the interest of the society.
- (ii) Detection of fraud relating to expenses, purchases, property and stores of the society.
- (iii) Specific examples of mis-management. Decisions of management against co-operative principles.
- (iv) In the case of urban co-operative banks, disproportionate advances to vested interest groups, such as relatives of management, and deliberate negligence about the recovery thereof. Cases of reckless advancing, where the management is negligent about taking adequate security and proper safeguards for judging the credit worthiness of the party.

9. Audit classification of society - After a judgement of an overall performance of the society, the auditor has to award a class to the society. This judgement is to be based on the criteria specified by the Registrar. It may be noted here that if the management of the society is not satisfied about the award of audit class, it can make an appeal to the Registrar, and the Registrar may direct to review the audit classification. The auditor should be very careful, while making a decision about the class of society.

10. Discussion of draft audit report with managing committee - On conclusion of the audit, the auditor should ask the Secretary of the society to convene the managing committee meeting to discuss the audit draft report. The audit report should never be finalised without discussion with the managing committee. Minor irregularities may be got settled and rectified. Matters of policy should be discussed in detail.

13.4 Audit, Inquiry and Inspection of Multi-State Co-Operative Societies

The Multi-State Co-operative Societies Act, 2002, which came into force in August, 2002 applies to co-operative societies whose objects are not confined to one State. The Act contains detailed provisions regarding registration, membership and management of such societies. The funds of a Multi-State co-operative society cannot be utilised for any political purpose. The Act contains detailed provisions regarding the investment of funds and restrictions on loans, borrowings, etc.



source :- qsstudy.com

Books of Accounts - As per Multi-State Co-operative Society Rules 2002, every Multi- State Co-operative society shall keep books of account with respect to-

- a. all sum of money received and expended and matters in respect of which the receipt and expenditure take place;
- b. all sale and purchase of goods;
- c. the assets and liabilities;
- d. in the case of a Multi-State Co-operative society engaged in production, processing and manufacturing, particulars relating to utilization of materials or labour or other items of cost as may be specified in the bye-hours of such a society.

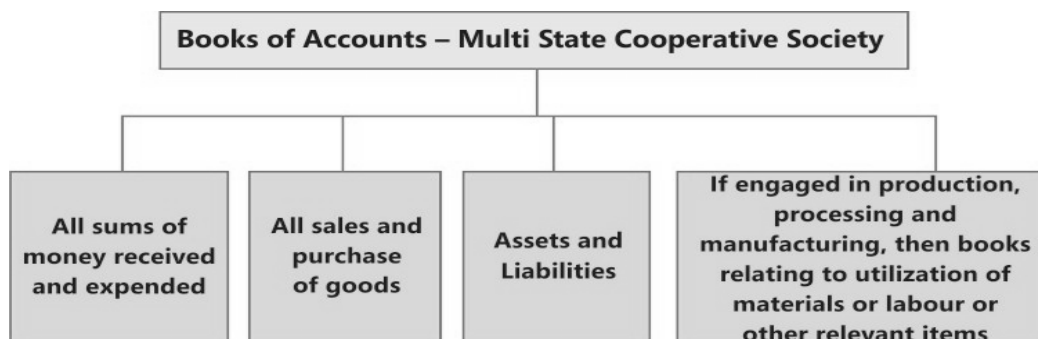


**Diagram showing the Books of Accounts to be maintained by Multi State
Co-operative Society**

13.4.1 Audit of Multi-State Co-operative Society –

1. Qualification of Auditors - Section 72 of the Multi-State Co-operative Societies Act, 2002 states that a person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 can only be appointed as auditor of Multi-State co-operative society.

However the following persons are not eligible for appointment as auditors of a Multi- State co-operative society-

- (a) A body corporate.
- (b) An officer or employee of the Multi-State co-operative society.
- (c) A person who is a member or who is in the employment, of an officer or employee of the Multi-State co-operative society.
- (d) A person who is indebted to the Multi-State co-operative society or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the Multi-State co-operative society for an amount exceeding one thousand rupees.

If an auditor becomes subject, after his appointment, to any, of the disqualifications specified above, he shall be deemed to have vacated his office as such.

2. Appointment of Auditors - Section 70 of the Multi-State Co-operative Societies Act, 2002 provides that the first auditor or auditors of a Multi-State co-operative society shall be appointed by the board within one month of the date of

registration of such society and the auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting. If the board fails to exercise its powers under this sub-section, the Multi-State co-operative society in the general meeting may appoint the first auditor or auditors.

The subsequent auditor or auditors are appointed by Multi-State co-operative society, at each annual general meeting. The auditor or auditors so appointed shall hold office from the conclusion of that meeting until the conclusion of the next annual general meeting.

3. Power and duties of Auditors – Section 73 of the Multi-State Co-operative Societies Act, 2002 discusses the powers and duties of auditors. According to this, every auditor of a Multi-State co-operative society shall have a right of access at all times to the books accounts and vouchers of the Multi-State co-operative society, whether kept at the head office of the Multi-State co-operative society or elsewhere, and shall be entitled to require from the officers or other employees of the Multi- State co-operative society such information and explanation as the auditor may think necessary for the performance of his duties as an auditor.

As per section 73(2), the auditor shall make following inquiries:

- (a) Whether loans and advances made by the Multi-State co-operative society on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the Multi-State co- operative society or its members,
- (b) Whether transactions of the Multi-State co-operative society which are represented merely by book entries are not prejudicial to the interests of the Multi-State co-operative society,
- (c) Whether personal expenses have been charged to revenue account, and
- (d) Where it is Stated in the books and papers of the Multi-State co-operative society 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 as correct regular and not misleading.

4. Content of Auditor's Report - As per sub-section (3) & (4) of section 73 of Multi- state Co-operative Societies Act, 2002, the auditor shall make a report to the members of the Multi-State co-operative society on the accounts examined by him and on every balance-sheet and profit and loss account and on every other document required to be part of or annexed to the balance-sheet or profit and loss account, which are laid before the Multi-State co-operative society in general meeting during his tenure of office, and the report shall state whether, in his opinion and to the best of his information and according to the explanation given to him, the said account give the information required by this act in the manner so required, and give a true and fair view:

- (a) In the case of the balance-sheet, of the Multi-State co-operative society's affairs as at the end of its financial year; and
- (b) In the case of the profit and loss account, of the profit or loss for its financial year.

The auditor's report shall also state:

- (i) Whether he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purpose of his audit.
- (ii) Whether, in his opinion, proper books of account have been kept by the Multi-State co-operative society so far as appears from his examination of these books and proper returns adequate for the purpose of his audit have been received from branches or offices of the Multi-State co-operative society not visited by him.
- (iii) Whether the report on the accounts of any branch office audited by a person other than the Multi-State co-operative society's auditor has been forwarded to him and how he has dealt with the same in preparing the auditor's report.
- (iv) Whether the Multi-State co-operative society's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and return.

Where any of the matters referred to in sub-section (3) or (4) is answered in the negative or with a qualification, the auditor's report shall state the reason for the answer.

5. Power of Central Government to direct special audit in certain cases -

Under section 77 of the Multi-State Co-operative Societies Act, 2002, where the Central Government is of the opinion:

- (a) that the affairs of any Multi-State co-operative society are not being managed in accordance with self-help and mutual deed and co-operative principles or prudent commercial practices or with sound business principles; or
- (b) that any Multi-State co-operative society is being managed in a manner likely to cause serious injury or damage to the interests of the trade industry or business to which it pertains; or
- (c) that the financial position of any Multi-State co-operative society is such as to endanger its solvency.



Diagram showing Power of Central Government to Direct Special Audit

1. Central Government's Order :- The Central Government may at any time by order direct that a special audit of the Multi-State co-operative society's accounts for such period or periods as may be specified in the order shall be conducted.

2. Appointment of the Auditor :- It may appoint either a chartered accountant or the Multi-State co-operative society's auditor himself to conduct the special audit.

3. Shareholding Restriction :- However, Central Government shall order for special audit only if that Government or the State Government either by itself or both hold fifty-one percent or more of the paid-up share capital in such Multi-State co-operative society.

4. Special Auditor's Powers, Duties & Report :- The special auditor shall have the same powers and duties in relation to the special audit as an auditor of a Multi-State co-operative society has under section 73. However the special auditor shall instead of making his report to the members of the Multi-State co-operative society make the report to the Central Government. The report of the special auditor shall, include all the matters required to be included in the auditor's report under section 73 and any other matter as directed by the Central Government.

5. Action by the Central Government :- On receipts of the report of the special auditor the Central Government may take such action on the report as it considers necessary in accordance with the provision of the Act or any law for the time being in force. However, if the Central Government does not take any action on the report within four months from the date of its receipt, that Government shall send to the Multi-State Co-operative society either a copy of, or relevant extract from, the report with its comments thereon and require the Multi-State Co-operative society either to circulate that copy or those extracts to the members or to have such copy or extracts read before the Multi-State Co-operative society at its next general meeting.

6. Expenses pertaining to the Special Audit :- The expenses of, and incidental to, any special audit under this section (including the remuneration of the special auditor) shall be determined by the Central Government which determination shall be final and paid by the Multi-State Co-operative society and in default of such payment, shall be recoverable from the Multi-State Co-operative society as an arrear of land revenue.

13.4.2 Inquiry by Central Registrar under Section 78

1. When:- The Central Registrar may, on a request from :-

- a federal co-operative to which a Multi- State Co-operative society is affiliated or
- a creditor or not less than one-third of the members of the board or
- not less than one-fifth of the total number of members of a Multi-state co-operative society,

- 2. How:-** hold an inquiry or direct some person authorized by him by order in writing in his behalf to hold an inquiry into the constitutions, working and financial condition of a Multi-State Co-operative society.
- 3. Opportunity of being Heard:-** However, before holding such inquiry fifteen days notice must be given to the Multi-State co-operative society.
- 4. Powers given:-** The Central Registrar or the person authorized by him shall have the following powers, namely:
- (a) he shall at all reasonable times have free access to the books, accounts, documents, securities, cash and other properties belonging to or in the custody of the Multi-State co-operative society and may summon any person in possession or responsible for the custody of any such books, accounts, documents securities, cash or other properties to produce the same at any place specified by him.
 - (b) he may, notwithstanding any bye-law specifying the period of notice for a general meeting of the Multi-State co-operative society, require the officers of the society to call a general meeting of the society by giving notice of not less than seven days at such time and place at the head quarters of the society to consider such matters as may be directed to him, and where the officers of the society refuse or fail to call such a meeting, he shall have power to call it himself.
 - (c) he may summon any person who is reasonably believed by him to have any knowledge of the affairs of the Multi-State co-operative society to appear before him at any place at the headquarters of the society or any branch thereof and may examine such person on oath.
- 5. Follow up:-** The Central Registrar shall, within a period of three months of the date of receipt of the report, communicate the report of inquiry to the Multi-State co-operative society, the financial institutions, if any, to which the society is affiliated, and to the person or authority, if any at whose instance the inquiry is needed.

13.5.3 Inspection of Multi-State Co-operative societies under Section 79

- 1. When:-** The Central Registrar may, on a request from
 - federal co-operative to which a Multi- State Co-operative society is affiliated or a creditor or
 - not less than one-third of the members of the board or
 - not less than one-fifth of the total number of members of a Multi-State co-operative society
- 2. How:-** By general or special order in writing in this behalf inspect or direct any person authorized by him by order in writing in this behalf to make an inspection into the constitution, working and financial condition of a Multi- State co-operative society.
- 3. Opportunity of Being heard:-** No inspection shall be made unless a notice of not less than fifteen days has been given to the multi-state co-operative society.
- 4. Powers available:-** The Central Registrar or the person authorized by him shall have the following powers:
 - (a)** He shall at all times have access to all books, accounts, papers, vouchers, securities, stock and other property of that society and may, in the event of serious irregularities discovered during inspection, take them into custody and shall have power to verify the cash balance of the society and subject to the general or special order of the central registrar to call a meeting of the society where such general meeting is, in his opinion necessary.
 - (b)** Every officer or member of a Multi-State Co-operative society shall furnish such information with regard to the working of the society as the central registrar or the person making such inspection may require.
- 5. Inspection Report:-** A copy of the report of inspection under this section shall be communicated to the Multi-State Co-operative society within a period of three months from the date of completion of such inspection.

A society has been formed by pan India employees of a public sector bank. The purpose of society is to promote savings habits of members and to grant loan to them up to a small specified amount. Small savings are promoted amongst members by way of compulsory contribution from monthly salary. Identify type of society and also discuss nature of books of accounts to be maintained by such a society.

There are three basic legal forms of charitable entities under Indian law: trusts, societies, and section 8 companies. The legal framework governing the charitable institution will depend on the form of business organization the charitable institution takes.

- If the charitable institution is formed as a Public Trust, it will be governed by the Public Trust Act applicable in the relevant State. However, if no Public Trust Act exists in that state, then the applicable legislation will be the Indian Trusts Act, 1882.
- If the charitable institution is formed as a Society, it will be governed by the Societies Registration Act, 1860.
- The charitable institution can also be formed as a non-profit company under section 8 of the Companies Act, 2013.
- Apart from the above legislations, the Income Tax Act 1961 will be applicable to charitable institutions.
- And in the case of foreign contributions to these charitable institutions, the Foreign Contribution (Regulation) Act, 2010 will be applicable.



Source :- capindia.in

BOOKS OF ACCOUNT:- Charitable and religious trusts should maintain regular books of account. This will enable management to demonstrate due discharge of responsibilities they assume. The Auditor is required to report whether the Trust has maintained proper books of accounts, including the following, namely: -

- (i) cash book;
- (ii) ledger;
- (iii) journal;
- (iv) copies of bills, whether machine numbered or otherwise serially numbered, wherever such bills are issued by the trust, and copies or counterfoils of machine numbered or otherwise serially numbered receipts issued by the trust;
- (v) original bills wherever issued to the person and receipts in respect of payments made by the person;
- (vi) any other book that may be required to be maintained in order to give a true and fair view of the state of the affairs of the person and explain the transactions effected;

FINANCIAL STATEMENTS:- Every year the trust has to prepare financial statements like the Balance sheet and Income and expenditure statements based on its books of accounts. The format for preparation and presentation of financial statements is prescribed under respective state laws. Charitable Organisations are governed by different laws as well as different forms of organisations also necessitate different accounting aspects to be complied.

Auditor's responsibility

The auditor should obtain the list of the books and records maintained by the Trust. The list should be matched with the above requirement for maintaining mandatory books and records as may be applicable in each case. The auditor should then verify the records for the purpose of its audit. He has to comply with the Accounting Standards (AS) and Standards on Auditing (SA) prescribed and made mandatory by the Institute of Chartered Accountants of India. In giving his report the auditor will have to use his professional skill and expertise and apply such audit tests as the circumstances of the case may require, considering the contents of the audit report.

He will have to conduct the audit by applying the generally accepted auditing procedures, which are applicable for any other audit. He can apply the test checks depending on the evaluation of internal control procedures followed by the assessee. The auditor will also have to keep in mind the concept of materiality depending upon the circumstances of each case.

He should keep detailed notes about the evidence on which he has relied upon while conducting the audit and also maintain all his working papers.

Such working papers should include his notes on the following, amongst other matters:

- (a) work done while conducting the audit and by whom;
- (b) explanation and information given to him during the course of the audit and by whom;
- (c) decision on the various points taken;
- (d) the judicial pronouncements relied upon by him while drafting the audit report; and
- (e) certificates issued by the client / management letters.

It is important that the audit working papers prepared and/or obtained by the auditor provide evidence that:

- (i) the opinion expressed by the auditor is based on the examination made by him;
- (ii) in arriving at his opinion, the auditor has given due cognizance to the information and explanations given by the assessee and that his opinion is not arbitrary;
- (iii) the information and explanations obtained were full and complete that is, the auditor has called for all the information and explanations which were necessary to be considered before arriving at his opinion; and
- (iv) the auditor did not merely rely upon the information or explanations given by the assessee but that he subjected such information and explanations to reasonable tests to verify their accuracy and completeness

TRUSTS

The auditor has to ascertain :-

- (a) whether accounts are maintained regularly and in accordance with the provisions of the applicable Act and the rules;
- (b) whether receipts and disbursements are properly and correctly shown in the accounts and money received in the form of donations is being applied as per the objects of the trust and as per the specific direction by the donor, if any.
- (c) whether the cash balance and vouchers in the custody of the manager or trustee on the date of audit were in agreement with the accounts;
- (d) whether all books, deeds, accounts, vouchers or other documents or records required by the auditor were produced before him;
- (e) whether a register of movable and immovable properties is maintained, the changes therein are communicated from time to time to the regional office, and the defects and inaccuracies mentioned in the previous audit report have been duly complied with and rectified.
- (f) whether the manager or trustee or any other person required by the auditor to appear before him did so and furnished the necessary information required by him;
- (g) whether any property or funds of the Trust were applied for any object or purpose other than the object or purpose of the Trust;
- (h) the amounts of outstanding for more than one year and the amounts written off, if any;
- (i) whether any money of the public trust has been invested contrary to the provisions of applicable Act which have come to the notice of the Auditor
- (j) all cases of irregular, illegal or improper expenditure, or failure or omission to recover monies or other property belonging to the public trust or of loss or waste of money or other property thereof, and whether such expenditure, failure, omission, loss or waste was caused in consequence of breach of trust or misapplication or any other misconduct on the part of the trustees or any other person while in the management of the trust

- (k) whether the maximum and minimum number of the trustees is maintained;
- (l) whether the meeting are held regularly as provided in such instrument
- (m) whether the minute books of the proceedings of the meeting is maintained
- (n) whether any of the trustees has any interest in the investment of the trust
- (o) whether any of the trustees is a debtor or creditor of the trust.
- (p) whether anonymous donations received are properly accounted for and donations in cash are not received by the Trust over and above the prescribed limit of accepting cash donations.
- (q) whether the irregularities pointed out by the auditors in the accounts of the previous year have been duly complied with by the trustees during the period of audit →
- (r) any special matter which the auditor may think fit or necessary to bring to the notice of the Deputy or Assistant Charity Commissioner

SOCIETIES

The auditor's considerations:-

- (a) The auditor should ascertain governing legislation of society i.e. Societies Registration act, 1860 or any applicable state law under which it has been registered.
- (b) Object of society needs to be ascertained from its memorandum of association/bye laws. Its activities may include charitable, social, cultural or educational activities.
- (c) Ascertain whether society has obtained registration under Foreign Contribution (Regulation) Act, 2010 in case foreign contributions are received.
- (d) Ascertain whether it is also registered under relevant provisions of Income Tax Act which may make it eligible for tax exemption on its income.
- (e) Obtain an understanding of internal control to design audit procedures with special reference to donations and various expenditures incurred in relation to achievements of objects of society.

- (f) Evaluate appropriateness of accounting policies with special reference to donations and grants. Also evaluate accounting policies in relation to specific grants.
- (g) In case some expenses incurred by society are reimbursed by donors, ascertain how these are recognized in financial statements.
- (h) Ascertain, if any inquiry has been held by Registrar under applicable law in the working or financial condition of society and its implications for auditor's opinion.
- (i) Ascertain all cases of irregular, illegal or improper expenditure or failure or omission to recover monies or other property belonging to society or of loss or waste of money or other property thereof.
- (j) Ascertain whether such expenditure or waste was caused in consequence of breach of trust or misapplication or any other misconduct on the part of governing body.

CASE STUDY

Consider the following five descriptions: -

- (A) Audit of "Implementation of Nagpur Metro Rail Project" was conducted by the Comptroller and Auditor General of India.

Following is extract of few audit findings placed on website cag.gov.in.

"The location of New Airport station was not ideal from the viewpoint of ridership due to sparse population in and around the station and also from the accessibility point of view.

Cotton Market station, the second additional station was projected to have high peak hour peak direction trips but the work was kept on hold midway citing fund crunch due to non-release of pending contribution from stakeholders. However, the situation could have been managed through prioritization of works."

- (B) Another set of audit findings in respect of audit of Haryana Power Generation Corporation Limited, a wholly owned government company responsible for operation of power generation plants in state of Haryana is as under: -
- “The main reason for low generation was higher variable cost of thermal power stations which resulted in backing down of plants.”
- (C) A report was tabled in Parliament highlighting main features of direct taxes administration of country as mandated in Constitution of India. This report primarily discussed compliance to the provisions of the Income Tax Act, 1961 and the associated rules and procedures etc. as applied to administration of direct taxes including irregularities noticed in finalizing assessments etc.
- (D) Radial finance corporation Limited is a government company. The audit of the company is conducted by statutory auditors appointed by Comptroller and Auditor General of India.
- (E) Bharat Insurance Company Limited is a general insurance government owned company. The statutory auditor is appointed by Comptroller and Auditor General of India.

The annual report for a particular year also contains comments of statutory auditors on matters such as whether company has carried out reconciliations in respect of its inter-company balances with other government owned insurance companies.

Based on above, answer following questions:

- (1) *Based upon plain reading of audit findings stated at Para (A), identify type of audit carried out by office of the Comptroller and Auditor General of India.*
- (a) *Audit against provision of funds*
 - (b) *Propriety audit*
 - (c) *Performance audit*
 - (d) *Compliance audit*
- (2) *Keeping in view audit findings in respect of Haryana Power Generation Corporation Limited, identify type of audit carried out.*
- (a) *Audit of Government Company*

- (b) *Audit against rules and orders*
 - (c) *Compliance audit*
 - (d) *Performance audit*
- (3) *Which of the following is the most appropriate statement in context of report tabled in Parliament regarding administration of direct taxes?*
- (a) *It is likely to be a report prepared for submission to the President under Article 151 of the Constitution of India by Comptroller and Auditor General of India.*
 - (b) *It is likely to be a report prepared for submission to the Prime Minister under Article 151 of the Constitution of India by an independent task force of experts.*
 - (c) *It is likely to be a report prepared for submission to the President under Article 151 of the Constitution of India by Central Board of Direct Taxes.*
 - (d) *It is likely to be a report prepared for submission to the Prime Minister under Article 151 of the Constitution of India by Central Board of Direct Taxes.*
- (4) *Who is empowered to conduct "supplementary audit" in case of Radial finance Corporation Limited, a government company?*
- (a) *Central Government*
 - (b) *Another independent auditor appointed by CAG*
 - (c) *CAG*
 - (d) *Another independent auditor appointed by Ministry of Corporate Affairs*
- (5) *As regards comments of auditors specified in respect of audit report of above insurance company, which of the following is likely to be most appropriate statement?*
- (a) *Such are likely to be comments of test audit carried out by CAG.*
 - (b) *Such are likely to be comments in respect of directions to statutory auditor by CAG for reporting on specific aspect of their audit work.*

- (c) *Such are likely to be comments of supplementary audit carried out by CAG*
- (d) *Such are likely to be comments of statutory auditors in accordance with requirements of Standards on Auditing*

Answers to Questions involving case study

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

SUMMARY

- ◆ The main objective of government audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration.
- ◆ In India, the function of Government Audit is discharged by the independent statutory authority of the Comptroller and Auditor General through the agency of the Indian Audit and Accounts Department.
- ◆ The Constitution guarantees the independence of the C&AG of India by prescribing that he shall be appointed by the President of India and shall not be removed from office except on the ground of proven mis-behaviour or incapacity.
- ◆ Besides conducting audit of receipts and expenditure of government, the Comptroller and Auditor General of India has power for appointment of auditors of government companies. He has the power to conduct supplementary audits of such government companies.
- ◆ The Local Fund Audit Wing of the State Govt. is generally in-charge of the audit of municipal accounts.
- ◆ NGOs can be defined as non-profit making organisations which raise funds from members, donors or contributors apart from receiving donation of time, energy and skills for achieving their social objectives like imparting education, providing medical facilities, economic assistance to poor, managing disasters and emergent situations. Auditors of NGOs receiving foreign funds should pay special attention to compliance by NGO with Foreign Contribution (Regulation) Act, 2010.

- ◆ LLP is governed by the Limited Liability Partnership Act 2008, It is a form of business organisation which enshrines in itself the advantages of both the Company and Partnership forms of Organisation. Minimum of 2 Partners can form an LLP. The auditor of a LLP has to pay attention to compliance by LLP of the above law.
- ◆ In case of audits of charitable institutions, hospitals, clubs and hotels, special attention should be paid by auditors with respect to their constitution and type of activities these entities are engaged in.
- ◆ Co-operative society is a business organisation with a special mode of doing business, by pulling together all the means of production co-operatively, elimination of middlemen and exploitation from outside forces.
- ◆ The Multi-State Co-operative Societies Act, 2002, applies to co-operative societies whose objects are not confined to one State.

For a concise revision of the key concepts covered in this chapter, students may refer to the **Saransh Booklet for Paper 5: Auditing and Ethics**, which serves as a useful last-mile revision resource for examination preparation. Saransh Booklet can be accessed at <https://resource.cdn.icai.org/85998bos-aps751-int-p5.pdf>

TEST YOUR KNOWLEDGE

MCQs based Questions

- (1) *The audit of municipal corporation of a large metro city is in progress. Which of the following is not likely an objective of such as audit?*
- (a) *To report on the adherence to legal and administrative requirements*
 - (b) *To report on whether value is being fully received for money spent*
 - (c) *To report on the weakness of systems of financial control*
 - (d) *To provide better civic amenities to residents of metro city*

- (2) *"Save Democracy" is an NGO working in cause of promoting democracy and democratic institutions in many countries including India. Its Indian counterpart has received funds from a renowned "Flower Trust" of US. As auditor of NGO, which of the following laws/orders would be relevant to you in context of above information?*
- (a) *Income Tax Act, 1961*
 - (b) *Foreign Contribution Regulation Act, 2010*
 - (c) *Companies Act, 2013*
 - (d) *Orders issued by Ministry of Social Justice and Empowerment*
- (3) *The appointment of first auditor of a multi-state cooperative society is made by: -*
- (a) *Central Registrar*
 - (b) *Board of society*
 - (c) *Members of society*
 - (d) *Central Government*
- (4) *Consider following revenue sources of Union Government.*
- (P) *Revenues from direct taxes*
 - (Q) *Revenues from Goods and Services Tax*
 - (R) *Revenues from Custom Duties*
 - (S) *Revenues from Excise Duties*
- Out of P, Q, R and S, which of the following flow to "Consolidated Fund of India"?*
- (a) *P, Q and R*
 - (b) *P, Q and S*
 - (c) *P and Q*
 - (d) *P, Q, R and S*

(5) *An LLP files compliance returns with: -*

- (a) *Registrar of firms & societies*
- (b) *Central Registrar*
- (c) *Registrar of Companies*
- (d) *Local fund audit wing*

Correct / Incorrect :-

State with reasons (in short) whether the following statement is correct or incorrect:

- (1) *Article 150 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the Finance Minister may on the advice of the C&AG prescribe.*
- (2) *According to 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations.*
- (3) *Expenditure incurred by the municipalities and corporations can be broadly classified under the following heads: (a) general administration and revenue collection, (b) public health, (c) public safety, (d) education, (e) public works, and (f) others such as interest payments.*
- (4) *The external control of municipal expenditure is exercised by the Central Government through the appointment of auditors to examine municipal accounts.*
- (5) *NGOs may be defined as non-profit making organisations which raise funds from members, donors or contributors apart from receiving donation of time, energy and skills for achieving their social objectives.*
- (6) *The accounts of every LLP shall be audited in accordance with rule 24 of LLP Rules 2009.*
- (7) *The auditor of an LLP may be appointed by the Designated Partners or other Partners whosoever is available at the time of appointment.*

- (8) *The Comptroller and Auditor General does not have any authority to audit the accounts of stores and inventory kept in any office or department of the Union or of a State .*
- (9) *An Operating Lease is a kind of Financing arrangement.*
- (10) *An auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts in the case of audit of a Hotel.*
- (11) *The first auditor of a Multi-State co-operative Society will be appointed in Annual General Meeting.*
- (12) *Small LLPs are mandatorily required to get their Books of account audited.*

Theoretical Questions

1. *Discuss, in what circumstances, Central Registrar can hold an inquiry into working and financial condition of a multi-state cooperative society.*
2. *Nature Charitable Trust runs a multi-specialty hospital in Noida. The hospital earns revenue from patients, donations, subscriptions, government grants and income from investments.*

During the audit for the year ended 31st March 2026, the auditor, CA A, observed the following:

- *The hospital maintains a patient register, billing system, and cash collection records.*
- *Donations and legacies are received, some of which are earmarked for specific purposes like construction of wards.*
- *The hospital owns investments and rental properties.*
- *There are inventory items such as medicines, surgical instruments, linen, etc.*
- *Budgetary controls exist but significant variations were noticed in certain expense heads.*
- *Internal controls over issue of medicines and stores appear weak.*
- *Capital expenditures were incurred during the year.*

As an auditor, explain the important audit procedures you would perform while auditing such a hospital.

3. *Tomo Construction Engineering LLP approached CA K to understand various returns to be filed by them as part of statutory compliance. Discuss, how, CA K should advise them.*
4. *GreenGrow Multi-State Co-operative Society Ltd. (GMSCSL) is engaged in procurement and export of agricultural produce and operates across 6 states in India. The Society has reported continuous expansion in turnover over the past 4 years. However, during the financial year 2025–26, the following issues came to the notice of the Ministry of Cooperation:*
 1. *Large advances were granted to related parties without adequate security.*
 2. *Procurement contracts were awarded without competitive bidding.*
 3. *Internal audit reports highlighting diversion of funds were ignored by the management.*
 4. *The debt-equity ratio increased abnormally due to heavy borrowings.*
 5. *There were persistent cash flow mismatches and short-term loans were being used for long-term capital projects.*
 6. *Trade associations complained that the Society's pricing practices were distorting the agricultural export market.*

On the basis of preliminary inquiry, the Central Government is considering to direct a special audit of the Society.

- (a) *Examine whether the Central Government is empowered to order a special audit in the above case.*
 - (b) *State the statutory provisions governing such power.*
 - (c) *Conclude whether invocation of Section 77 is justified in the given case.*
5. *A muti-speciality hospital has come up in your city. You are appointed as auditor for first year. Discuss, any four, broad areas to be kept in mind while conducting audit of accounts of such a newly opened multi-speciality hospital.*

6. *You have been appointed as an auditor of an NGO, briefly state the points on which you would concentrate while planning the audit of such an organisation?*
7. *The general transactions of a hospital include patient treatment, collection of receipts, donations, capital expenditures. You are required to mention special points of consideration while auditing such transactions of a hospital?*
8. *Mention the special points to be examined by the auditor in the audit of a charitable institution running hostel for students pursuing the Chartered Accountancy Course and which charges only INR 500 per month from a student for their lodging/boarding.*
9. *Explain in detail the duties of Comptroller and Auditor General of India*
10. *An NGO operating in Delhi had collected large scale donations for Tsunami victims. The donations so collected were sent to different NGOs operating in Tamil Nadu for relief operations. This NGO operating in Delhi has appointed you to audit its accounts for the year in which it collected and remitted donations for Tsunami victims. Draft audit programme for audit of receipts of donations and remittance of the collected amount to different NGOs. Mention six points each, peculiar to the situation, which you will like to incorporate in your audit programme for audit of said receipts and remittances of donations.*
11. *As an auditor, what would be your areas of consideration while auditing the element of ROOM SALES during the audit of a 5-Star Hotel.*
12. *You are auditing the Books of accounts of Karla Multiplex which runs 15 Film shows everyday. One of the major issues which are of concern to you as an auditor is the Agreement entered into the Multiplex owners with the Film Distributors. State what points would you check as an auditor in this respect.*
13. *Define Government Audit & explain its objectives.*
14. *CA A is appointed as the auditor of a charitable institutions. Discuss the audit procedure undertaken by him while auditing the Subscription and Donation received by the charitable institution.*
15. *In case of Government entities, audit of accounts of stores and inventories has been developed as a part of expenditure audit. Discuss about the duties and responsibilities entrusted to C&AG.*

16. *Local Fund Audit Wing of a State of a State Government has appointed you to audit the accounts of one of the Local body governed by it. As an auditor, what will be your reporting areas?*
17. *You have been appointed as an auditor of VJM Schools. Discuss the points which merit your consideration as an auditor while verifying Assets and Liabilities of VJM Schools.*
18. *State the points which merit consideration in the audit of a CLUB w.r.t its members.*
19. *No inspection under Section 79 of Multi-State Co-operative Societies Act, 2002 shall be made unless a notice has been given to the multi-state co-operative society. Explain clearly when and how such inspection can be made. Also state the powers available with the Central Registrar in this regard along with provisions relating to communication of the inspection report under the said section.*
20. *Aman Cooperative Society appointed FAB & Associates as an auditor for the financial year 2025-26. During the audit, the auditors noted the following details:*

<i>Number of shares</i>	<i>1000 shares @ ₹ 10/- each</i>
<i>Net Profit before compulsory transfer to reserve fund</i>	<i>₹ 10,000/-</i>
<i>Net Profit after compulsory transfer to reserve fund</i>	<i>₹ 8000/-</i>

- (I) *Mr. Dhairya, a member of society, holds 200 shares amounting to ₹ 2000 from the previous year.*
- (II) *Upon verifying the society's borrowings, the auditors found that Cooperative Society had accepted a loan from Mr. Shivam, a non-member. The auditors did not find any restrictions regarding this in the society's bye laws.*

Comment on the above transactions of the society with reference to the Co-operative Societies Act, 1912.

21. You are appointed as an auditor of "The Prestigious Township Club". As the auditor of "The Prestigious Township Club" for the financial year 2025-26, what are the key points you would consider while auditing the income and expenditure items of the club?
22. While auditing the financial statements of Bro Traders LLP, CA L is carefully going through LLP agreement. Briefly discuss the key points CA L should pay attention in the LLP agreement and the reporting responsibilities of CA L concerning the financial statements of Bro Traders LLP?
23. You are appointed as an auditor of M/s Shine & Co., a partnership firm. During your review, you observed that:
- The audit appointment was informal and not documented properly.
 - The firm started a new business activity which is not covered in the partnership deed.
 - Major financial decisions were made without proper records.

As an auditor, briefly explain the matters that should be specially considered by you while auditing the accounts of the partnership firm, M/s Shine & Co.

24. A government department has been allocated a budget for infrastructure development. During the audit, the auditor observes the following:
- (i) Some payments were processed without proper approval from the competent authority.
 - (ii) A large-scale project was implemented, but no assessment has been made regarding the expected benefits were achieved or not.
 - (iii) Funds were utilised from an account for which no budgetary provision was made.
 - (iv) Certain expenditures were made without following the prescribed financial regulations.
 - (v) There were instances of unnecessary spending that did not align with financial propriety.

Identify the different types of audits applicable to each of these observations.

25. *M/S PQ & Co., Chartered Accountants have been appointed as statutory auditors of CBD Multiplex Cinema Ltd. The audit team started the audit and verified the ledger and other books of accounts for the F.Y. 2025-26. However, one of the team members is of the view that the internal control mechanism of the company should also be verified.*

Can you guide the audit team about the areas that will be covered in verifying the internal control mechanism?

26. *State the auditor's duty regarding audit of LLP.*
27. *XYZ Sewa Foundation a registered NGO receives income from various sources such as foreign grants, membership fees, subscription etc. As the audit assistant you are assigned to verify the receipt of income of the NGO for the year.*

You are required to describe the audit procedures you would perform to verify the receipt of income of an NGO

28. *STP Ltd. has entered into lease arrangements for two different categories of equipment from the same lessor. The key terms of the arrangements are summarised below:*

Particulars	Manufacturing equipment	Specialised Manufacturing Equipment
<i>Lease period</i>	<i>5 years</i>	<i>8 years</i>
<i>Estimated economic life</i>	<i>10 years</i>	<i>8 years</i>
<i>Transfer of ownership</i>	<i>NO</i>	<i>NO</i>
<i>Insurance and major maintenance</i>	<i>Borne by lessor</i>	<i>Borne by STP Ltd.</i>
<i>Alternative use after lease period</i>	<i>Available</i>	<i>Not Available</i>

- (i) *Analyse the above arrangements and determine the appropriate classification of lease in case of Manufacturing Equipment and Specialised Manufacturing Equipment.*
- (ii) *As a senior auditor of STP Ltd., suggest the accounting treatment and Tax benefits for:*

- Manufacturing Equipment
- Specialised Manufacturing Equipment

29. *The office of the Comptroller and Auditor General (C&AG) undertook an Audit of Receipts in the Department of Indirect Taxes. During the audit, it was observed that although all taxes collected were credited to the Government account, several procedural deficiencies existed. There were delays in detecting double refunds, weak internal checks on assessments and absence of a proper mechanism to review judicial decisions taken by tax authorities. The audit team also noted that the extent of audit was predetermined by the C&AG based on test checks and in-depth studies of specified areas, which were not open to negotiation by the department.*

Explain the main checks carried out in the audit of government receipts.

ANSWERS / SOLUTIONS

Answers to the MCQs based Questions

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

Answers to Correct/Incorrect:-

- 1. Incorrect-** Article 150 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the President may on the advice of the C&AG prescribe.
- 2. Correct-** According to 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations i.e. the expenditure is incurred with due regard to broad and general principles of financial propriety.
- 3. Correct-** Expenditure incurred by the municipalities and corporations can be broadly classified under the following heads: (a) general administration and revenue collection, (b) public health, (c) public safety, (d) education, (e) public works, and (f) others such as interest payments, etc., mostly related to civic amenities and local area development and maintenance.

4. **Incorrect-** The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. However, the municipal corporations of Delhi, Mumbai and a few others have powers to appoint their own auditors for regular external audit.
5. **Correct-** NGOs can be defined as non-profit making organisations which raise funds from members, donors or contributors apart from receiving donation of time, energy and skills for achieving their social objectives like imparting education, providing medical facilities, economic assistance to poor, managing disasters and emergent situations. These would include religious organisations, voluntary health and welfare agencies, charitable organisations, hospitals, old age homes, research foundations etc. The scope of services rendered by NGOs is extremely wide.
6. **Incorrect-** Rule 24 of LLP Rules 2009 provides that any LLP, whose turnover does not exceed, in any financial year, forty lakh rupees, or whose contribution does not exceed twenty five lakh rupees, is not required to get its accounts audited. However, if the partners of such limited liability partnership decide to get the accounts of such LLP audited, the accounts shall be audited only in accordance with such rules.
7. **Incorrect-** The auditor is to be appointed by the designated partners of the LLP. However, the Partners may appoint the auditors only if the Designated Partners have failed to appoint them.

8. **Incorrect-** The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State. Audit of the accounts of stores and inventories has been developed as a part of expenditure audit with reference to the duties and responsibilities entrusted to C&AG.
9. **Incorrect-** A Finance Lease is a Financing arrangement. An Operating lease, on the other hand, is a simple arrangement where, in return for rent, the lessor allows the lessee to use the asset for a certain period.
10. **Correct-** The auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts for proper recording of closing and opening entries and maintenance of accounts on Accrual basis as per the Matching concept.
11. **Incorrect-** Section 70 of the Multi-State Co-operative Societies Act, 2002 provides that the first auditor or auditors of a Multi-State co-operative society shall be appointed by the board within one month of the date of registration of such society and the auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting. If the board fails to exercise its powers under this sub-section, the Multi-State Co-operative Society in the general meeting may appoint the first auditor or auditors.
12. **Incorrect-** The accounts of every LLP shall be audited in accordance with Rule 24 of LLP, Rules 2009, which provide that any LLP whose turnover does not exceed, in any financial year, forty lakh rupees, or whose contribution does not exceed twenty-five lakh rupees, is not required to get its accounts audited. Further, a Small LLP is any LLP the Contribution of which, does not exceed twenty-five lakh rupees (INR 25,00,000) or such higher amount, not exceeding five crore rupees, as may be prescribed; and the Turnover of which, as per the Statement of Accounts and Solvency for the immediately preceding financial year, does not exceed forty lakh rupees (INR 40,00,000) or such higher amount, not exceeding fifty crore rupees, as may be prescribed; Hence, the provisions of audit are not applicable on Small LLP's. Therefore, the Small LLPs can prepare its financial statement merely with the signatures of the Designated Partners.

Answers to the Theoretical Questions

1. Refer to topic on Inquiry by Central Registrar
2. Refer para 8.
3. Refer to topic on Basics of LLPs audit
4. Power of Central Government to direct special audit in certain cases – Under Section 77 of the Multi-State Co-operative Societies Act, 2002, where the Central Government is of the opinion:
 - (a) that the affairs of any Multi-State co-operative society are not being managed in accordance with self-help and mutual aid and co-operative principles or prudent commercial practices or with sound business principles; or
 - (b) that any Multi-State co-operative society is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains; or
 - (c) that the financial position of any Multi-State co-operative society is such as to endanger its solvency,

the Central Government may, by order, direct that a special audit of the accounts of the society shall be conducted and may appoint a Chartered Accountant or such other qualified person as may be prescribed to conduct such audit.

Application to the Given Case: In the present case, the following circumstances are observed:

- Granting unsecured advances to related parties and ignoring internal audit findings indicate deviation from prudent commercial practices and sound business principles.
- Awarding procurement contracts without competitive bidding reflects non-adherence to co-operative principles and transparency.
- Abnormal increase in borrowings and use of short-term funds for long-term assets indicates weak financial discipline.
- Persistent cash flow mismatch and solvency concerns suggest that the financial position may endanger its solvency.

- Complaints from trade associations regarding market distortion indicate management in a manner likely to cause serious injury to the trade or industry concerned.

Thus, the facts satisfy clauses (a), (b), and (c) of Section 77.

Considering the above statutory provisions and the facts of the case, the Central Government is legally empowered under Section 77 of the Multi-State Co-operative Societies Act, 2002 to order a special audit of GreenGrow Multi-State Co-operative Society Ltd.

The invocation of special audit provisions is fully justified as the management practices, financial instability, and potential harm to trade clearly fall within the scope of Section 77.

5. Refer to topic on audit of Hospitals
6. Refer to topic on audit of NGOs
7. Refer to topic on audit of Hospitals
8. Refer to topic on audit of Charitable Institutions
9. Refer to topic on audit of Government Audit
10. Receipt of Donations:
 - (i) **Internal Control System:** Existence of internal control system particularly with reference to division of responsibilities in respect of authorised collection of donations, custody of receipt books and safe custody of money.
 - (ii) **Custody of Receipt Books:** Existence of system regarding issue of receipt books, whether unused receipt books are returned and the same are verified physically including checking of number of receipt books and sequence of numbering therein.
 - (iii) **Receipt of Cheques:** Receipt Book should have carbon copy for duplicate receipt and signed by a responsible official. All details relating to date of cheque, bank's name, date, amount, etc. should be clearly stated.

- (iv) **Bank Reconciliation:** Reconciliation of bank statements with reference to all cash deposits not only with reference to date and amount but also with reference to receipt book.
- (v) **Cash Receipts:** Register of cash donations to be vouched more extensively. If addresses are available of donors who had given cash, the same may be cross-checked by asking entity to post thank you letters mentioning amount, date and receipt number.
- (vi) **Foreign Contributions,** if any, to receive special attention to compliance with applicable laws and regulations.

Remittance of Donations to Different NGOs:

- (i) **Mode of Sending Remittance:** All remittances are through account payee cheques. Remittances through Demand Draft would also need to be scrutinised thoroughly with reference to recipient.
 - (ii) **Confirming Receipt of Remittance:** All remittances are supported by receipts and acknowledgements.
 - (iii) **Identity:** Recipient NGO is a genuine entity. Verify address, 80G Registration Number, etc.
 - (iv) **Direct Confirmation Procedure:** Send confirmation letters to entities to whom donations have been paid.
 - (v) **Donation Utilisation:** Utilisation of donations for providing relief to Tsunami victims and not for any other purpose.
 - (vi) **System of NGOs' Selection:** System for selecting NGO to whom donations have been sent.
- 11. Refer to topic on audit of Hotel
 - 12. Refer to topic on audit of Cinema Hall
 - 13. Refer to topic on audit of Government Audit
 - 14. Refer to topic on audit of Charitable Institutions
 - 15. Refer to topic on audit of Government Audit

16. Refer to topic on audit of Local Bodies
17. Refer to topic on audit of Educational Institutions
18. Refer to topic on audit of Club
19. Refer para 13.5.3
20. **Restrictions on share holdings:** - According to section 5 of the Central Act, in the case of a society where the liability of a member of the society is limited, no member of a society other than a registered society can hold such portion of the share capital of the society as would exceed a maximum of twenty percent of the total number of shares or of the value of shareholding to ₹ 1,000/-.

Restrictions on borrowings - Section 30 of the Central Act further puts restriction on borrowings. According to this section, a registered society shall accept loans and deposits from persons who are not members subject to the restrictions and limits of the bye-laws of the society. The auditor will have to examine the bye-laws in this respect."

In the given situation, Mr. Dhairya, a member of the society, is holding 200 shares amounting to ₹ 2000 from the previous year. In view of the aforementioned restriction on shareholding by a member, Mr. Dhairya is allowed to hold a maximum of 100 shares according to the Act.

Further, Aman Co-operative Society had accepted a loan from Mr. Shivam, a non-member. Since, there are no restrictions regarding the acceptance of loan received from non-member in the society's bye-laws, the loan received from Mr. Shivam is permissible.

21. Refer para 9.
22. The auditor, CA L should read the LLP agreement & note the following provisions: -
 - (a) Nature of the business of the LLP.
 - (b) Amount of capital contributed by each partner.
 - (c) Interest – in respect of additional capital contributed.
 - (d) Duration of partnership.

- (e) Drawings allowed to the partners.
- (f) Salaries, commission etc. payable to partners.
- (g) Borrowing powers of the LLP.
- (h) Rights & duties of partners.
- (i) Method of settlement of accounts between partners at the time of admission, retirement, admission etc.
- (j) Any loans advanced by the partners.
- (k) Profit sharing ratio

Reporting Responsibilities of CA L/ concerning the financial statements of Bro Traders LLP is as follows:

The auditor should mention

- (a) Whether the records of the firm appear to be correct & reliable.
- (b) Whether he was able to obtain all information & explanation necessary for his work.
- (c) Whether any restriction was imposed upon him.

23. Refer "Matters which should be specially considered in the audit of accounts of a partnership" described under para 5.

24. The audit of government expenditure is one of the major components of government audit. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred.

- (i) When payments are processed without proper approval from the competent authority, an Audit of Sanctions is required. This ensures that there is sanction, either special or general, accorded by competent authority authorising the expenditure.
- (ii) In cases where a large-scale project has been implemented without any assessment of whether the expected benefits were achieved, a Performance Audit is necessary. This type of audit ensures that the

various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them.

- (iii) When funds were utilised from an account for which no budgetary provision was made, an Audit Against Provision of Funds is conducted. This ensures that there is a provision of funds out of which expenditure can be incurred and the same has been authorised by competent authority.
 - (iv) If expenditures are made without adhering to the prescribed financial regulations, an Audit Against Rules and Orders is applicable. This audit ensures that the expenditure incurred conforms to the relevant provisions of the statutory enactment and in accordance with the Financial Rules and Regulations framed by the competent authority.
 - (v) Instances of unnecessary spending that do not align with financial propriety fall under the scope of a Propriety Audit. It ensures that the expenditure is incurred with due regard to broad and general principles of financial propriety.
- 25.** Refer “internal control mechanism” described under para 10.
- 26.** Refer “Auditor’s Duty Regarding Audit of LLP” described under para 5.1
- 27.** Refer “receipt of income of NGO” described under para 3.3
- 28. (i)** In case of Manufacturing Equipment, Lease is classified as Operating Lease due to following reasons:
- Lease term extends to less than 75% of the projected useful life of the leased asset. In the given case, estimated economic life is 10 years and lease period is 5 years which is significantly less than 75%.
 - Lessee pays only the monthly lease payments. Insurance and major maintenance are borne by lessor.
- In case of Specialised Manufacturing Equipment, Lease is classified as Finance Lease, due to following reasons:

- Lease term is equal to estimated economic life of the asset under the lease arrangement.
- Lessee bears insurance and major maintenance.

(ii) In case of Manufacturing Equipment: Accounting treatment: Operating lease is generally treated like a renting arrangement. That means, the lease payments are treated as operating expenses and the asset does not appear as an asset on lessee's balance sheet.

Tax Benefit: Since operating lease is as good as renting, lease payment is considered as expense. No depreciation can be claimed by the lessee.

In case of Specialised Manufacturing Equipment: Accounting treatment: Finance lease is treated like loan arrangement. Hence, the asset ownership is considered of that of the lessee and thus appears on the balance sheet of the lessee.

Tax Benefit: Lessee can claim both interest and depreciation expense as financial lease is treated like a loan.

29. Refer para 1.5

Answers to Questions involving Test your Understanding:

- (1)** Consolidated Fund of India consists of all the revenue received from direct and indirect taxes, all the loans taken by the Govt. of India and all the amount of repayment of loans received by the Govt. of India. Its importance lies in the fact that all government expenditure is incurred from this fund. No moneys out of the Consolidated Fund of India shall be appropriated except in accordance with law and for the purposes and in the manner provided in the Constitution.
- (2)** The auditor shall consider provisions of retirement deed/partnership deed for date of retiring and joining of partners. It should be ensured that profits are appropriately distributed up to date of retirement. Further, profits after retirement should have been distributed among partners as per terms of new partnership deed.
- (3)** The fees concessions have to be under proper authority of school management. The auditor would verify internal controls in this regard.

Besides, detailed checking of few cases needs to be undertaken to ensure genuineness of fees concessions and proper management approvals.

- (4)** The society is in nature of Multi-state cooperative society as it serves interests of members in more than one state. It accepts small savings from its members and grants loan to members. As per Multi-State Co-operative Society Rules 2002, every Multi- State Co-operative society shall keep books of account with respect to: -
- a. all sum of money received and expended and matters in respect of which the receipt and expenditure take place
 - b. the assets and liabilities

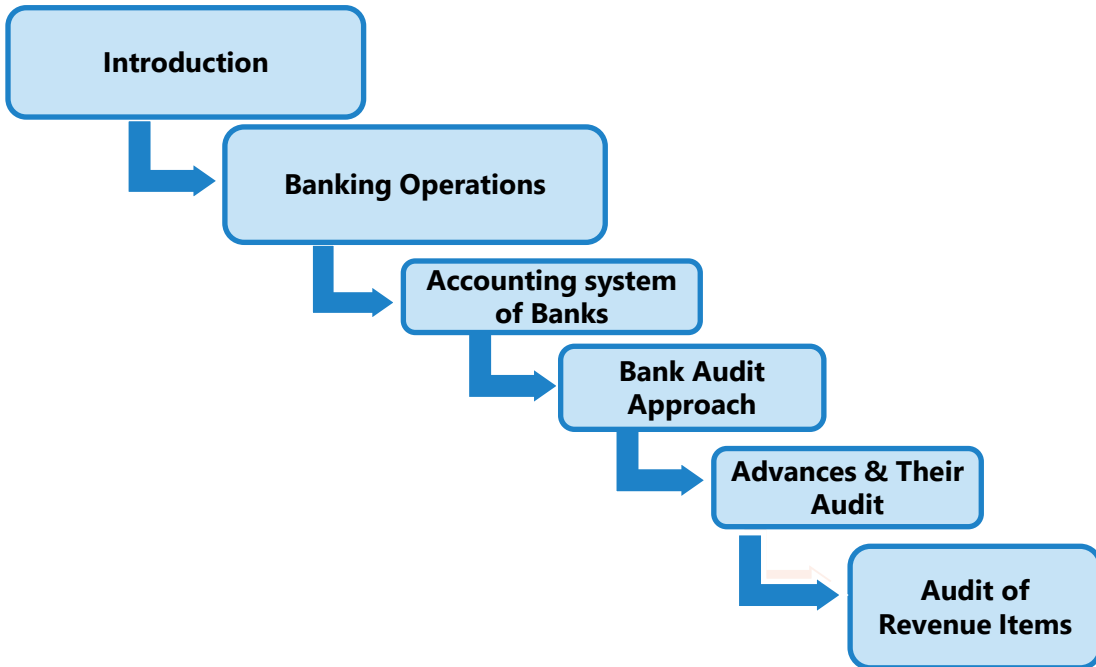
AUDIT OF BANKS



LEARNING OUTCOMES

After studying this chapter, you would be able to:

- ◆ Understand the legal framework for the Bank audit.
- ◆ Gain the knowledge of financial statements of the banks in brief.
- ◆ Understand the audit approach for items of profit and loss in case of banks.
- ◆ Learn the important items such as Advances, NPAs etc. in the context of Bank Audit
- ◆ Understand practicality of above concepts by studying through examples and case studies

CHAPTER OVERVIEW

Sameer was very comfortable with mobile banking app and used to do most of his banking activities from this very app. Payments of house electricity bills, Wi-fi rental bill, payments of little gifts for her mother and younger sister were all made by him using his mobile. Whenever he needed to transfer money to any of his friends as common contribution for an evening get together, he used to send money through UPI using Bhim app.

One day, he happened to visit local branch of the bank in which his account was maintained. He got a feeling that banking operations are very complex and not as simple as he used to think. Since cash deposit machine was out of order on that day, he had to deposit cash by going to the counter. It made him realise that there is a trail for every bank transaction.

Huge volume of bank transactions take place instantly, moneys are deposited and withdrawn from accounts. One can access one's account from any geographical location. Banks work on "*Core Banking Solution*" platforms which make transactions to happen on such a scale by ensuring customer ease. Deliberating upon it, he also thought about processes, controls and automation which makes all this possible.

He was trying to understand broad working of a bank. A bank accepts deposits from its customers and lends money to trade, industry, farmers, needy sections of society and to members of general public. The rate at which a bank pays interest on deposits to customers is lower than the rates at which it charges interest on advances. The spread is used to meet establishment and administrative costs of a bank leaving out profits. In making available money to different sections of society including trade and industry, banks act as drivers of economic growth of country.

Lending of money by a bank leads to reflection of "assets" in form of advances in financial statements of a bank. He had heard the term "non-performing assets" (NPAs) quite a number of times. What do these denote and what is their significance from the point of view of an auditor? Are there some regulatory norms relating to NPAs? Meanwhile, his attention also moved towards encompassing outreach of audit in case of banks. Audit of banks appeared to be special because of huge volume of transactions, extensive use of technology, wide geographical spread of banks and other factors peculiar to banks. Excited, he was thinking of prospects to conduct audit of a bank some day in future!

INTRODUCTION

Banking sector is the backbone of any economy as it is essential for sustainable socio-economic growth and financial stability in the economy. The banking sector is also crucial as it deals with mammoth amounts of public monies and is highly sensitive to reputational risk. Like all economic activities, the banking sector is also exposed to various risks in its operations. It is of utmost importance to ensure that banking sector stays healthy, safe and sound. For safe and sound banking sector, one of the most important factors is reliable financial information supported by quality bank audits.

Types of Banks

There are different types of banking institutions prevailing in India which are as follows:

Commercial Banks	Regional Rural Banks
Co-operative Banks.	Payment Banks.
Development Banks (more commonly known as 'Term-Lending Institutions').	Small Finance Banks.

1. Commercial banks are the most wide spread banking institutions in India, that provide a number of products and services to general public and other segments of economy. Two of its main functions are:-

- (a) accepting deposits and
- (b) granting advances.

2. Regional Rural Banks known as **RRBs** are the banks that have been set up in rural areas in different states of the country to cater to the basic banking and financial needs of the rural communities. **Examples are:-** Punjab Gramin Bank , Tripura Gramin Bank , Allahabad UP Gramin Bank , Andhra Pradesh Grameen Vikas Bank, etc.

3. Co-operative Banks function like Commercial Banks only but are set up on the basis of Cooperative Principles and registered under the Cooperative Societies Act of the respective state or the Multistate Cooperative Societies Act and usually cater to the needs of the agricultural and rural sectors. **Examples are :-** The Gujarat State Co-operative Bank Ltd., Chhatisgarh Rajya Sahakari Bank Maryadit, etc.

4. Payments Banks are a new type of banks which have been recently introduced by RBI. They are allowed to accept restricted deposits but they cannot issue loans and credit cards. However, customers can open Current & Savings accounts and also avail the facility of ATM cum Debit cards, Internet-banking & Mobilebanking. **Examples are :-** Airtel Payments Bank , India Post Payments Bank, Paytm Payments Bank , etc.

5. Development Banks had been conceptualized to provide funds for infrastructural facilities important for the economic growth of the country. **Examples are:-** Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), Small Industries Development Bank of India (SIDBI) , etc.

6. **Small Finance Banks** have been set up by RBI to make available basic financial and banking facilities to the unserved and **unorganised** sectors like small marginal farmers, small & micro business units, etc. **Examples are:-** Equitas Small Finance Bank , AU Small Finance Bank , etc.

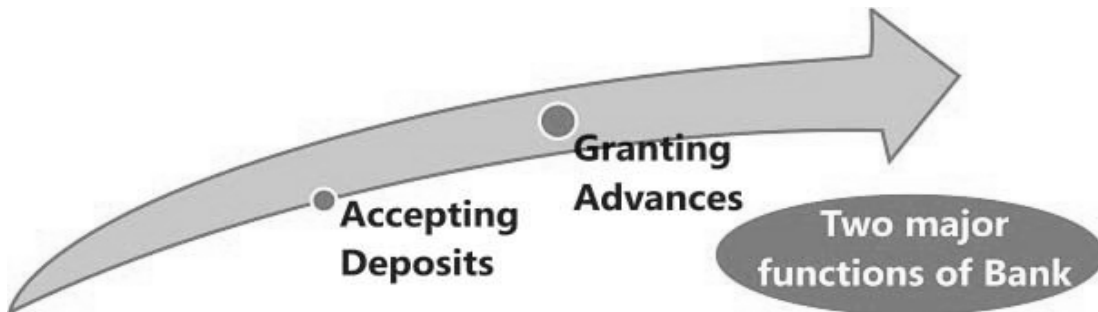


Diagram showing Two Major Functions of Banks



Source :- twitter.com

Reserve Bank of India: Regulating Body

The functioning of banking industry in India is regulated by the Reserve Bank of India (RBI) which acts as the Central Bank of our country.

RBI is responsible for :-

- ♦ development and supervision of the constituents of the Indian financial system (which comprises banks and non-banking financial institutions)
- ♦ determining, in conjunction with the Central Government, the monetary and credit policies keeping in with the need of the hour.
- ♦ regulating the activities of commercial and other banks

Important functions of RBI are :-

- ◆ issuance of currency;
- ◆ regulation of currency issue;
- ◆ acting as banker to the central and state governments; and
- ◆ acting as banker to commercial and other types of banks including term-lending institutions. Besides, RBI has also been entrusted with the responsibility of regulating the activities of commercial and other banks.

No bank can commence the business of banking or open new branches without obtaining license from RBI. The RBI also has the power to inspect any bank.

Independent audit of financial statement of banks is important for a healthy, safe and sound banking system.

Banking Operations - Conducted only at Branches

Banking operations are conducted only at the branches, while other offices act as controlling authorities or administrative offices that lay down policies, systems and internal control procedures for conduct of business, in compliance with the statutory/ regulatory impositions and in compliance of accepted accounting principles and practices that cover all transactions and economic events. These controlling/ administrative offices also stipulate the delegation of powers and fix responsibilities and accountability and these are involved generally in effective supervision, monitoring and control over the business activities and operations, including seeking faithful compliance of the bank's laid down policies/ procedures/controls and deal with deviations therefrom.

Regulatory Framework

Banking Regulation Act, 1949.	State Bank of India Act, 1955.
Companies Act, 2013.	
Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970.	
Regional Rural Banks Act, 1976.	
Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.	
Information Technology Act, 2000.	Prevention of Money Laundering Act, 2002.
Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.	
Credit Information Companies Regulation Act, 2005.	
Payment and Settlement Systems Act, 2007.	

Besides, the above enactments, the provisions of the Reserve Bank of India Act, 1934, (RBI Act) also affect the functioning of banks. The RBI Act gives wide powers to the RBI to give directions to banks which also have considerable effect on the functioning of banks.

Peculiarities involved:

- ❑ Huge volumes and complexity of transactions;
- ❑ Wide geographical spread of banks' network;
- ❑ Large range of products and services offered;
- ❑ Extensive use of technology;
- ❑ Strict vigilance by the banking regulator etc.

Types of Bank Audit Reports to be issued (generally):

Presently, the Statutory Central Auditors (SCAs) have to furnish the following reports in addition to their main audit report:

- (a) Report on adequacy and operating effectiveness of Internal Controls over Financial Reporting in case of banks which are registered as companies under the Companies Act in terms of Section 143(3)(i) of the Companies Act, 2013 which is normally to be given as an Annexure to the main audit report as per the Guidance Note on Audit of Internal Financial Controls over Financial Reporting issued by the ICAI.
- (b) Long Form Audit Report. (LFAR)
- (c) Report on compliance with SLR requirements.
- (d) Report on whether the treasury operations of the bank have been conducted in accordance with the instructions issued by the RBI from time to time.
- (e) Report on whether the income recognition, asset classification and provisioning have been made as per the guidelines issued by the RBI from time to time.
- (f) Report on whether any serious irregularity was noticed in the working of the bank which requires immediate attention.
- (g) Report on status of the compliance by the bank with regard to the implementation of recommendations of the Ghosh Committee relating to frauds and malpractices and of the recommendations of Jilani Committee on internal control and inspection/credit system.
- (h) Report on instances of adverse credit-deposit ratio in the rural areas.



1. UNDERSTANDING OF ACCOUNTING SYSTEM IN BANKS

From the time that customers had to physically visit and deal with a bank, there is a sea change in banking as use of technology and its continuous evolution has enabled banks to reach their customers in providing them the convenience and comfort of *anytime-anywhere-banking* by letting them access their information/data on real time basis, as stored in a safe and secure environment on the bank's servers. With many customers having access to Internet and mobile connectivity, monetary transactions from inception to finish have become expeditious through E-banking; but for Core banking technology and extensive advancement therein and the availability and extensive use of technology tools, banks could not have achieved such phenomenal and accelerated growth, and could not have ventured into and offered a wide range of innovative products and services to their customers. The transactions in banks have become voluminous and it needs to be ensured that in the system of recording, transmission and storage of information/ data, integrity thereof is optimally maintained and control systems ensure that the same is free of errors, omissions, irregularities and frauds. Considering the challenges of technology, bank managements continuously endeavor to make their internal control systems robust, safe and secure as well as convenient and expeditious for the customers.

In the computerized environment, it is imperative that the auditor is familiar with and satisfied that all the norms/parameters as per the latest applicable RBI guidelines are incorporated and built into the system that generates information/data having a bearing on the classification/ provisions and income recognition. The auditor should not go by the assumption that the system generated information is correct and can be relied upon without evidence that demonstrates that the system driven information is based on the required parameters. He should use Professional Skepticism and Prudence wherever he feels that something manually needs to be performed to check the authenticity and consistency of the information obtained from the systems and document the results of such activities performed.



2. BANK AUDIT APPROACH

1. **Drawing an Audit Plan:** An audit plan should be drawn up based on :-

- ♦ the nature and level of operations,
- ♦ nature of adverse features,
- ♦ level of compliance based on previous reports and
- ♦ audit risks based on inadequacy in or breach of internal controls and the familiarization exercise carried out,

2. **Control Environment at the Bank:** A bank should have appropriate controls to mitigate its risks, including effective segregation of duties (particularly, between front and back offices), accurate measurement and reporting of positions, verification and approval of transactions, reconciliation of positions and results, setting up limits, reporting and approval of exceptions, physical security and contingency planning.

The following are certain common questions /steps, which have to be kept in mind while undertaking/ performing control activities:

Nature of Questions	Questions to be considered / answered
Who	☐ Who performs the control? ☐ Does the above person have requisite knowledge and authority to perform the control?
What	☐ What evidence is available to demonstrate /prove that the control is performed?
When	☐ When and with what frequency is the control performed? ☐ Is the frequency enough to prevent, detect and correct risk of material misstatements?
Where	☐ Where is the evidence of performance of the control retained? ☐ For how long is the evidence retained? ☐ Is the evidence accessible/ available for audit?
Why	☐ Why is the control being performed? ☐ What type of errors are prevented or detected through the performance of the control?

How	☐ How is the control performed? ☐ What are the control activities? ☐ Can these activities be bypassed? ☐ Can the bypass, if any, be detected? ☐ How are exceptions / deviations resolved on identification? ☐ What is the time frame for resolving the exceptions / deviations?

3. Engagement Team Discussions: All personnel performing an engagement, including any experts contracted by the firm in connection with that engagement are known to be the "*Engagement Team*". The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference. The discussion between the members of the engagement team and the audit engagement partner should be done on the susceptibility of the bank's branch financial statements to material misstatements. These discussions are ordinarily done at the planning stage of an audit.

The engagement team discussion ordinarily includes a discussion of the following matters:

- (a) Errors that may be more likely to occur;
- (b) Errors which have been identified in prior years;
- (c) Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures;
- (d) Audit responses to Engagement Risk, Pervasive Risks, and Specific Risks;
- (e) Need to maintain professional skepticism throughout the audit engagement;
- (f) Need to alert for information or other conditions that indicates that a material misstatement may have occurred (e.g., the bank's application of accounting policies in the given facts and circumstances).

Advantages of such a discussion :-

- ◆ Specific emphasis should be provided to the susceptibility of the bank's financial statements to material misstatement due to fraud, that enables the engagement team to consider an appropriate response to fraud risks, including those related to engagement risk, pervasive risks, and specific risks.

- ◆ It further enables the audit engagement partner to delegate the work to the experienced engagement team members, and to determine the procedures to be followed when fraud is identified.
- ◆ Further, audit engagement partner may review the need to involve specialists to address the issues relating to fraud.

3. INCOME RECOGNITION POLICY

The policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations. Income from non-performing assets (NPA) is not recognized on accrual basis but is booked as income only when it is actually received. *(Dealt in detail later on)*

4. FORM AND CONTENT OF FINANCIAL STATEMENTS

Sub-sections (1) and (2) of Section 29 of the Banking Regulations Act, 1949 deal with the form and content of financial statements of a banking company and their authentication. These sub-sections are also applicable to nationalised banks, State Bank of India, and Regional Rural Banks.

Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Act or as near thereto as the circumstances admit. Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.

Every banking company needs to comply with the disclosure requirements under the various Accounting Standards, as specified under section 133 of the Companies Act, 2013, read with Rule 7 of the Companies (Accounts) Rules 2014, in so far as they apply to banking companies or the Accounting Standards issued by the ICAI.

5. AUDIT OF ACCOUNTS

Sub-section (1) of section 30 of the Banking Regulations Act, 1949 requires that the balance sheet and profit and loss account of a banking company should be audited by a person duly qualified under any law for the time being in force to be an auditor of

companies.

6. ELIGIBILITY, QUALIFICATIONS AND DISQUALIFICATIONS OF AUDITOR

Applicable as to a Company Auditor

7. APPOINTMENT OF AUDITOR

As per the provisions of the relevant enactments:-

- ◆ The auditor of a banking company is to be appointed at the annual general meeting of the shareholders,
- ◆ The auditor of a nationalised bank is to be appointed by the bank concerned acting through its Board of Directors.

(In either case, approval of the Reserve Bank of India is required before the appointment is made.)
- ◆ The auditors of regional rural banks are to be appointed by the bank concerned with the approval of the Central Government.

8. REMUNERATION OF AUDITOR

- (a) The remuneration of auditor of a banking company is to be fixed in accordance with the provisions of Section 142 of the Companies Act, 2013 (i.e., by the company in general meeting or in such manner as the company in general meeting may determine).
- (b) The remuneration of auditors of nationalised banks and State Bank of India is to be fixed by the Reserve Bank of India in consultation with the Central Government.

9. POWERS OF AUDITOR

The auditor of a banking company, nationalised bank, State Bank of India, or regional rural bank has the same powers as those of a company's auditor in the matter of access to the books, accounts, documents and vouchers.



10. AUDITOR'S REPORT

In the case of a nationalised bank, the auditor is required to make a report to the Central Government in which he has to state the following:

- (a) whether, in his opinion, the financial statements present a true and fair view of the affairs of the bank and in case he had called for any explanation or information, whether it has been given and whether it is satisfactory;
- (b) whether or not the transactions of the bank, which have come to his notice, have been made within the powers of that bank;
- (c) whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of his audit; and
- (d) any other matter which he considers should be brought to the notice of the Central Government.

The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalised bank.

10.1 Format of Report

The auditors, central as well as branch, should also ensure that the audit report issued by them complies with the requirements of Standards on Auditing discussed in Chapter 8 on Audit Report. The auditor should ensure that not only information relating to number of unaudited branches is given but quantification of advances, deposits, interest income and interest expense for such unaudited branches has also been disclosed in the audit report. Such disclosure in the audit report is not only in accordance with the best international trends but also provides useful information to users of financial statements.

It may be noted that, in addition to the aforesaid, the auditor of a banking company is also required to state in his report the matters covered by Section 143 of the Companies Act, 2013. **However, it is pertinent to mention that the reporting requirements relating to the Companies (Auditor's Report) Order, 2020 is not applicable to a banking company, as defined in clause (c) of Section 5 of the Banking Regulation Act, 1949.**

10.2 Long Form Audit Report

Besides the audit report as per the statutory requirements discussed above, the terms of appointment of auditors of public sector banks, private sector banks and foreign banks (as well as their branches), require the auditors to also furnish a long form audit report (LFAR). The matters which the banks require their auditors to deal with in the long form audit report have been specified by the Reserve Bank of India.

The Statutory Central Auditors are required to submit the LFAR to the banks latest by **30th June** every year. To ensure timely submission of LFAR, proper planning for completion of the LFAR is required. While the format of LFAR does not require an executive summary to be given, members may consider providing the same to bring out the key observations from the whole document.

Test Your Understanding 1

The financial statements of a bank are prepared in a specified format. Discuss legal provisions in this regard as applicable to financial statements of a nationalized bank.

10.3 Reporting to RBI

1. The RBI issued a Circular relating to implementation of recommendations of Committee on Legal Aspects of Bank Frauds applicable to all scheduled commercial banks (excluding Regional Rural Banks). Regarding liability of accounting and auditing profession, the said circular provided as under:

“If an accounting professional, whether in the course of internal or external audit or in the process of institutional audit finds anything susceptible to be fraud or fraudulent activity or act of excess power or smell any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action”.

As per the above requirement, the member shall be required to report the kind of matters stated in the circular to RBI.

2. Auditor should also consider the provisions of **SA 250, “Consideration of Laws and Regulations in an Audit of Financial Statements”**. The said Standard explains that the duty of confidentiality is over-ridden by statute, law or courts.

3. SA 240, “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements” states that 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.

It must be noted that auditor is not expected to look into each and every transaction but to evaluate the system as a whole. Therefore, if the auditor while performing his normal duties comes across any instance, he should report the matter to the RBI in addition to Chairman/Managing Director/Chief Executive of the concerned bank.

11. CONDUCTING AN AUDIT

The audit of banks or their branches involves the following stages –

1. Initial consideration by the statutory auditor

- (i) **Declaration of Indebtedness:** The RBI has advised that the banks, before appointing their statutory central/branch auditors, should obtain a declaration of indebtedness. Indebtedness refers to the situation of owing money to the bank in any case, whatsoever.
- (ii) **Internal Assignments in Banks by Statutory Auditors:** The RBI decided that the audit firms should not undertake statutory audit assignment while they are associated with internal assignments in the bank during the same year, like *Concurrent audits* (Internal Audit of Banks conducted monthly during the year)
- (iii) **Planning:** Standard on Auditing (SA) 300, “**Planning an Audit of Financial Statements**” requires that the auditor shall undertake the following activities prior to starting an initial audit:
 - (a) Performing procedures required by **SA 220, “Quality Control for Audit Work”** regarding the acceptance of the client relationship and the specific audit engagement; and
 - (b) Establish understanding of terms of engagement as per **SA 210, “Agreeing the Terms of Audit Engagements”**.
- (iv) **Communication with Previous Auditor:** As per Clause (8) of the Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered

Accountant in practice cannot accept position as auditor previously held by another chartered accountant without first communicating with him in writing. He should get a NO Objection Certificate (NOC) from the previous auditor through this communication as to know whether he has any objections to such an appointment made, for any valid reasons.

- (v) **Terms of Audit Engagements: SA 210, "Terms of Audit Engagements"** requires that for each period to be audited, the auditor should agree on the terms of the audit engagement with the bank before beginning significant portions of fieldwork. It is imperative that the terms of the engagement are documented, in order to prevent any confusion as to the terms that have been agreed in relation to the audit and the respective responsibilities of the management and the auditor, at the beginning of an audit assignment.
- (vi) **Initial Engagements:** The auditor needs to perform the audit procedures as mentioned in **SA 510 "Initial Audit Engagements-Opening Balances"** and if after performing that procedures, the auditor concludes that the opening balances contain misstatements which materially affect the financial statements for the current period and the effect of the same is not properly accounted for and adequately disclosed, the auditor should express a qualified opinion or an adverse opinion, as appropriate.
- (vii) **Assessment of Engagement Risk:** The assessment of engagement risk is a critical part of the audit process and should be done prior to the acceptance of an audit engagement since it affects the decision of accepting the engagement and also in planning decisions if the audit is accepted.
- (viii) **Establish the Engagement Team:** The assignment of qualified and experienced professionals is an important component of managing engagement risk. The size and composition of the engagement team would depend on the size, nature and complexity of the bank's operations.
- (ix) **Understanding the Bank and its Environment: SA 315 "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment"** lays down that the auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error and sufficient to design and perform further audit procedures.

2. Identifying and Assessing the Risks of Material Misstatements: SA 315 requires the auditor to identify and assess the risks of material misstatement at the financial statement level and the assertion level for classes of transactions, account balances and disclosures to provide a basis for designing and performing further audit procedures.

3. Understanding the Bank and Its Environment including Internal Control: An understanding of the bank and its environment, including its internal control, enables the auditor:

- ☐ to identify and assess risk;
- ☐ to develop an audit plan so as to determine the operating effectiveness of the controls and to address the specific risks.

4. Understanding the Bank's Accounting Process: The accounting process produces financial and operational information for management's use and it also contributes to the bank's internal control. Thus, understanding of the accounting process is necessary to identify and assess the risks of material misstatement whether due to fraud or not and to design and perform further audit procedures.

5. Understanding the Risk Management Process: Management develops controls and uses performance indicators to aid in managing key business and financial risks. An effective risk management system in a bank generally requires the following:

- (a) Oversight and involvement in the control process by those charged with governance:** Those charged with governance (Board of Directors/Managing Director) should approve written risk management policies. The policies should be consistent with the bank's business objectives and strategies, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable.
- (b) Identification, measurement and monitoring of risks:** Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria.
- (c) Control activities:** A bank should have appropriate controls to mitigate its risks including effective segregation of duties (particularly between front and back offices), accurate measurement and reporting of positions, verification and approval of transactions, reconciliation of positions and results, setting up limits, reporting and approval of exceptions, physical security and contingency planning.

- (d) **Monitoring activities:** Risk management models, methodologies and assumptions used to measure and mitigate risk should be regularly assessed and updated. This function may be conducted by the independent risk management unit.
- (e) **Reliable information systems:** Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis. Those charged with governance and management require risk management information that is easily understood and that enables them to assess the changing nature of the bank's risk profile.



source – educba.com

6. Engagement Team Discussions: The engagement team should hold discussions to gain better understanding of banks and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements.

7. Establish the Overall Audit Strategy: SA 300 “Planning an Audit of financial Statements” states that the objective of the auditor is to plan the audit so that it will be performed in an effective manner. For this purpose, the audit engagement partner should:

- ☐ establish the overall audit strategy, prior to the commencement of an audit; and
- ☐ involve key engagement team members and other appropriate specialists while establishing the overall audit strategy, which depends on the characteristics of the audit engagement.

8. Develop the Audit Plan: SA 300 deals with the auditor's responsibility to plan an audit of financial statements in an effective manner. It requires the involvement of all the key members of the engagement team while planning an audit.

9. Audit Planning Memorandum: *The auditor should summarise the audit plan by preparing an audit planning memorandum in order to:*

- ❑ Describe the expected scope and extent of the audit procedures to be performed by the auditor.
- ❑ Highlight all significant issues and risks identified during their planning and risk assessment activities, as well as the decisions concerning reliance on controls.
- ❑ Provide evidence that they have planned the audit engagement appropriately and have responded to engagement risk, pervasive risks, specific risks, and other matters affecting the audit engagement.

10. Determine Audit Materiality: The auditor should consider the relationship between the audit materiality and audit risk when conducting an audit. The determination of audit materiality is a matter of professional judgment and depends upon the knowledge of the bank, assessment of engagement risk and the reporting requirements for the financial statements.

11. Consider Going Concern: While obtaining an understanding of the bank, the auditor should consider whether there are events and conditions which may cast significant doubt on the bank's ability to continue as a going concern.

12. Assess the Risk of Fraud including Money Laundering: As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the auditor's objective is to identify and assess the risks of material misstatement in the financial statements due to fraud, to obtain sufficient appropriate audit evidence on those identified misstatements and to respond appropriately. The attitude of professional skepticism should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud.

The RBI has framed specific guidelines that deal with prevention of money laundering and "**Know Your Customer (KYC)**" norms. The RBI has from time to time issued guidelines ("Know Your Customer Guidelines – Anti Money Laundering Standards"), requiring banks to establish policies, procedures and controls to deter and to recognise and report money laundering activities.

13. Assess Specific Risks: The auditors should identify and assess the risks of material misstatement at the financial statement level which refers to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions.

14. Risk Associated with Outsourcing of Activities: The modern day banks make extensive use of outsourcing as a means of both reducing costs as well as making use of services of an expert not available internally. There are, however, a number of risks associated with outsourcing of activities by banks and therefore, it is quintessential for the banks to effectively manage those risks.

15. Response to the Assessed Risks: SA 330 “The Auditor’s Responses to Assessed Risks” requires the auditor to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. The auditor should design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.

16. Stress Testing: Stress testing is a software testing activity that determines the robustness of software by testing beyond the limits of normal operation. Stress testing is particularly important for "mission critical" software, but is used for all types of software (**Source – Wikipedia**). RBI has required that all commercial banks shall put in place a Board approved ‘Stress Testing framework’ to suit their individual requirements which would integrate into their risk management systems.

17. BASEL III framework: Basel norms or accords are the International Banking regulations issued by the BCBS. The Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB) has undertaken an extensive review of the regulatory framework in the wake of the sub-prime crisis. In the document titled ‘Basel III: A global regulatory framework for more resilient banks and banking systems’, released by the BCBS in December 2010, it has inter alia proposed certain minimum set of criteria for inclusion of instruments in the new definition of regulatory capital. The set of agreement by the BCBS, which mainly focuses on risks to banks and the financial system are called Basel accord.

18. Reliance on / review of other reports: The auditor should take into account the adverse comments, if any, on advances appearing in the following-

- ☐ Previous year’s audit reports.
- ☐ Latest internal inspection reports of bank officials.
- ☐ Reserve Bank’s latest inspection report.
- ☐ Concurrent / Internal audit report.

- Report on verification of security.
- Any other internal reports specially related to particular accounts.
- Manager's charge-handing-over report when incumbent is changed.

The above reports should be reviewed in detail. The Statutory Central Auditors must review the Annual Financial Inspection report of RBI relating to the bank and ensure that the variations in provisions, etc. reported by RBI have been properly considered by the bank management.

12. ADVANCES

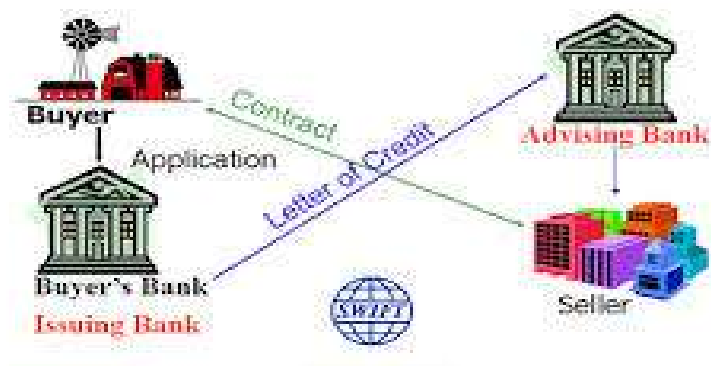
In carrying out his substantive procedures, the auditor should examine all large advances while other advances may be examined on a sampling basis. The accounts identified to be problem accounts, however, need to be examined in detail unless the amount involved is insignificant. The extent of sample checking would also depend on the auditor's assessment of efficacy of internal controls. What constitutes a 'large advance' would need to be determined in the context of volume of operations of the branch e.g. an advance may be considered to be a large advance if the year-end balance is in excess of ₹ 10 crore or 10% of the aggregate year-end advances of the branch, whichever is less.

Lending constitutes a major activity of a bank besides the investment function. The core business of banks is accepting deposits for onward lending. **Advances are amount of money or credit, given as a loan from a bank to another party with an agreement that the money will be repaid.** All Bank Loans are made at interest which is a compensation for borrowing. Advances, generally, constitute the largest item on the assets side of the balance sheet of a bank and are major source of its income. Audit of advances is one of the most important areas covered by auditors in bank audit. It is necessary that auditors should have adequate knowledge of the banking industry and the regulations governing the banks. Auditors must be aware of the various functional areas of the bank/branches, its processes, procedures, systems and prevailing internal controls with regard to advances.

Types of Advances: *Funded Loans & Non-Funded Loans*

- ◆ **Funded** loans are those loans where there is an actual transfer of funds from the bank to the borrower. **Examples of funded loans** are Term loans, Cash credits, Overdrafts, Demand Loans, Bills Discounted and Purchased, Participation on Risk Sharing basis, Interest-bearing Staff Loans.
- ◆ **Non-funded** facilities are those which do not involve such transfer. **Examples of non-funded loans are** Letters of credit, Bank guarantees, etc.

A Letter of Credit



source :- opentoexport.com

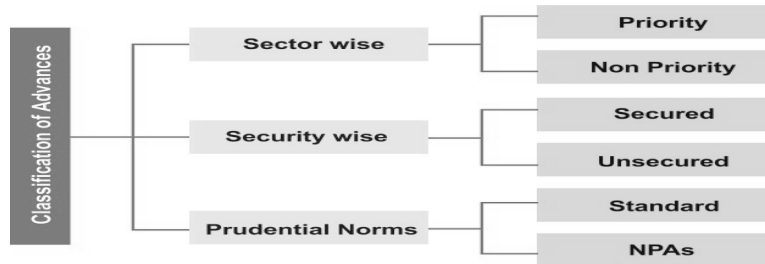
12.1 What do ADVANCES comprise:

Advances comprise of funded amounts by way of:

- ☐ Term loans
- ☐ Cash credits, Overdrafts, Demand Loans
- ☐ Bills Discounted and Purchased
- ☐ Participation on Risk Sharing basis
- ☐ Interest-bearing Staff Loans

12.2 Legal requirements of Disclosure in the Balance Sheet:

- A. (i) Bills purchased and discounted
(ii) Cash credits, Overdrafts and loans repayable on demand
(iii) Term Loans
- B. (i) Secured by tangible assets
(ii) Covered by Bank/Government guarantees
(iii) Unsecured



C. I. Advances in India:	C. II. Advances outside India:
(i) Priority sectors	(i) Due from Banks
(ii) Public sector	(ii) Due from Others:
(iii) Banks	(a) Bills Purchased and discounted
(iv) Others	(b) Syndicated loans
	(c) Others

12.3 Classification of Advances

12.3.1 Sector Wise

RBI issues common guidelines for lending to Priority Sector which banks are required to follow. These guidelines cover rate of interest; service charges, receipt, sanction, rejection, disbursement Register; issue of Loan Application Acknowledgement. RBI also issues targets for banks for lending to Priority Sector.

Examples of Priority Sectors are Agriculture , MSME , Education , Housing , etc.



source:-neoioscape.com

12.3.2 SECURITY WISE

Banks ask Security or Collateral while lending to assure that the Borrower will return the money to bank in prescribed time else the Banks have legal authority to sell the collateral to recover its money.

Nature of Security

A. Primary security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance.

B. Collateral security is an additional security. Security can be in any form i.e. tangible or intangible asset, movable or immovable asset.

Examples of most common types of securities accepted by banks are the following:

- ☐ Personal Security of Guarantor
- ☐ Goods/Stocks/Debtors/Trade Receivables
- ☐ Gold Ornaments and Bullion
- ☐ Immovable Property
- ☐ Plantations (For Agricultural Advances)
- ☐ Third Party Guarantees
- ☐ Banker's General Lien
- ☐ Life Insurance Policies
- ☐ Stock Exchange Securities and Other Instruments

12.4 Mode of Creation of Security

Depending on the nature of the item concerned, creation of security may take the form of a mortgage, pledge, hypothecation, assignment, set-off or lien as follows:-

(i) **Mortgage:** Mortgage are of several kinds but the most important are the Registered Mortgage and the Equitable Mortgage.

- ❑ **Registered Mortgage** can be affected by a registered instrument called the 'Mortgage Deed' signed by the mortgagor. It registers the property to the mortgagee as a security.
- ❑ **Equitable mortgage**, on the other hand, is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof.

(ii) **Pledge:** A pledge thus involves bailment or delivery of goods by the borrower to the lending bank with the intention of creating a charge thereon as security for the advance. The legal ownership of the goods remains with the pledger while the lending banker gets certain defined interests in the goods. The pledge of goods constitutes a specific (or fixed) charge.

(iii) **Hypothecation:** The hypothecation is the creation of an equitable charge (i.e., a charge created not by an express enactment but by equity and reason), which is created in favor of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower.

Neither ownership nor possession is transferred to the bank. However, the borrower holds the physical possession of the goods as an agent/trustee of the bank.

The borrower periodically submits statements regarding quantity and value of hypothecated assets (stocks, debtors, etc.) to the lending banker on the basis of which the drawing power of the borrower is fixed.

(iv) **Assignment:** Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favor of another person. Only actionable claims (i.e., claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of moveable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment.

An assignment gives the assignee absolute right over the moneys/debts assigned to him.

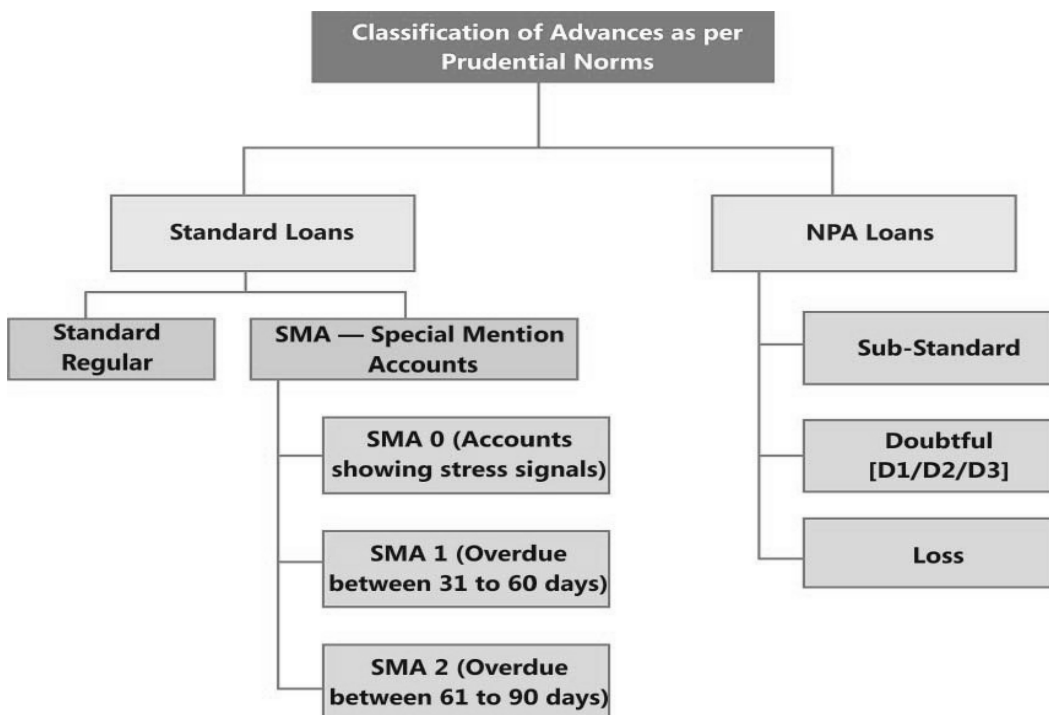
(v) Set-off: Set-off is a statutory right of a creditor to adjust, wholly or partly, the debit balance in the debtor's account against any credit balance lying in another account of the debtor. The right of set-off enables a bank to combine two accounts (a deposit account and a loan account) of the same person provided both the accounts are in the same name and same right (i.e., the capacity of the account holder in both the accounts should be the same).

For the purpose of set-off, all the branches of a bank are treated as one single entity. The right of set-off can be exercised in respect of time-barred debts also.

(vi) Lien: Lien is creation of a legal charge with consent of the owner, which gives lender a legal right to seize and dispose / liquidate the asset under lien.

12.5 Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances:

Classification of Advances as per RBI Prudential Norms



(i) Non-performing Assets: An asset becomes NPA when it ceases to generate income for the Bank.

A non-performing asset (NPA) is a loan or an advance where -:

- ❑ interest and/ or installment of principal remain overdue for a period of more than 90 days in respect of a term loan;
- ❑ the account remains 'out of order' in respect of an Overdraft/Cash Credit (OD/ CC);
- ❑ the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.

(ii) Out of Order: An account should be treated as 'out of order' if:-

- ◆ the outstanding balance remains continuously in excess of the sanctioned limit/drawing power or
- ◆ In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet; or
- ◆ credits are there but are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.

Example

A Ltd. has been sanctioned a Cash Credit Facility by ADB Bank Ltd. for INR 50 lacs but as per the Stock Statements furnished for the last quarter, the Bank has calculated the Drawing power to be INR 42 Lakhs. In this case, the account would be termed as OUT OF ORDER if :-

- ◆ the outstanding balance remains continuously in excess of the INR 50 lacs/42 lacs whatever the case may be; or
- ◆ The outstanding balance in the account is less than INR 42 lacs but there are no credits or any payments deposited into this account continuously for 90 days as on the date of Balance Sheet; or
- ◆ credits are there upto say INR 2 lakhs but are not enough to cover the interest debited during the same period which is around INR 5 lakhs.

(iii) **Overdue:** Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.



REPORT CARD

Standalone data (₹ crore)

Quarter ended	Mar, '19	% Chg *
Net interest income	5,066.96	26.6
Total income	15,284.59	20.0
Provisions & contingencies	5,399.29	-19.1
Taxes	-547.13	-
Net profit	-991.37	Loss
Gross non-performing assets	48,232.77	-14.6
Net non-performing assets	15,609.5	-33.5

* Change over YoY; Compiled by BS Research Bureau
Source: Press release

Source :- business-standard.com

Source :- inventiva.co.in

Categories of Non-Performing Assets:	Provision required
☐ Substandard Assets: Would be one, which has remained NPA for a period less than or equal to 12 months.	15%
☐ Doubtful Assets: Would be one, which has remained in the substandard category for a period of 12 months.	
Sub-categories:	(Secured + Unsecured)
Doubtful up to 1 Year (D1)	25% + 100%
Doubtful 1 to 3 Years (D2)	40% + 100%
Doubtful more than 3 Years (D3)	100% + 100%
☐ Loss Assets: Would be one, where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.	100%

Note :-

- Classification as NPA** should be based on the record of recovery. Availability of security or net worth of borrower/guarantor is not to be taken into account for purpose of treating an advance as NPA or otherwise.

2. Asset classification would be borrower-wise and not facility-wise. All facilities including investments in securities would be termed as NPA.

Example

Mr. Raman has availed two Loan facilities - a Car Loan as well as a Housing Loan from XYZ Bank Ltd. He is regular in depositing the Housing loan EMI but has not deposited the last 4 EMI's of the Car Loan due to paucity of funds. Hence, in this case, not only the Car loan but the Housing Loan would also be treated as an NPA, although it is going good and there are no irregularities because the NPA classification is Borrower wise (Mr. Raman) and not Facility wise (Car & Housing Loan individually).

(iv) Accounts regularized near the Balance Sheet Date: The asset classification of borrower accounts where a solitary or a few credits are recorded before the balance sheet date should be handled with care and without scope for subjectivity. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as NPA. The auditor should check for sample transactions immediately before the closing of the Financial Year and immediately after the closing of the Financial year to get a knowledge of the objective behind the transactions if they have any relation to each other in the Borrower accounts or if any/some transactions are being reversed during the first few days after closing which might show an arrangement to prevent the Borrower account(s) from slipping into the NPA category.

(v) Government Guaranteed advances:-

- ◆ Central Government guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets, but regarded as NPA for Income Recognition purpose.
- ◆ The situation would be different if the advance is guaranteed by State Government, where advance is to be considered NPA if it remains overdue for more than 90 days for both Provisioning and Income recognition purposes.

(vi) Advances under Consortium:

Consortium advances mean advancing loans to a borrower by two or more Banks jointly by forming a Consortium. Joint appraisal, control and monitoring will facilitate for exchange of valuable information among the Banks. Usually, a Bank with a higher share will lead the consortium.

Consortium advances should be based on the record of recovery of the respective individual member banks and other aspects having a bearing on the recoverability of the advances. Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account should be treated as not serviced in the books of the other member banks and therefore, an NPA.

The banks participating in the consortium, therefore, need to arrange to get their share of recovery transferred from the lead bank or to get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.



source :- marketbusinessnews.com

Note:- Drawing Power Allocation in case of Consortium Cash Credit Account:

The Lead Bank would be responsible for computing the drawing power (DP) of the borrower and allocate the same to member banks. In certain special circumstances, at the request of the Borrower, the Lead Bank may allot a higher or lower share of drawing power to the member bank, as against their share of advances. The proforma DP Allocation Letter is presented hereunder for reference:

**Illustrative Drawing Power for December 2025
as per Stock Statement November, 2025**

			(₹ in Crores)
Description of Stocks	Market Value	Margin	Advance Value
Raw Materials	636.27	25	477.20
Finished Goods	372.75	25	279.56
Stock in process	659.35	25	494.51
Stores and Spares	124.51	25	93.38
Book Debts (Upto 120/180 days)	37379.90	35	24296.94
Stock in Transit	52.31	25	39.23
Total	39225.09		25680.82
Less: Unpaid Stocks under LC	0.00	100	0.00
Total	39225.09		25680.82

		(₹ in Crores)
BANKS	Share %	LIMIT/D.P.
State Bank of India	32.25	500.00
Bank of Baroda	2.58	40.00
Bank of India	6.45	100.00
Canara Bank	5.16	80.00
Standard Chartered Bank	9.03	140.00
Union Bank of India	6.45	100.00
HSBC	13.87	215.00
Citi Bank	6.45	100.00
Bank of America	1.29	20.00
BNP Paribas	1.94	30.00
Punjab National Bank	6.45	100.00
ICICI Bank	4.84	75.00
IDBI Bank	3.23	50.00
Unallocated		
TOTAL	100.00	1550.00

12.6 Accounts where there is erosion in the value of security / frauds committed by borrowers

Erosion means ***the gradual destruction or diminution of something*** not prudent to follow stages of asset classification. It should be straight-away classified as doubtful or loss asset as appropriate as follows :-

- (i) Erosion in the value of security can be reckoned as significant when the realisable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI at the time of last inspection, as the case may be. Such NPAs may be straight-away classified under **doubtful category** and provisioning should be made as applicable to doubtful assets.
- (ii) If the realisable value of the security, as assessed by the bank/ approved valuers/ RBI is less than 10 per cent of the outstanding in the borrower accounts, the existence of security should be ignored and the asset should be straight-away classified as **loss asset**. It may be either written off or fully provided for by the bank.

12.7 Advances Against Term Deposits, NSCs, KVPs/ IVPs, etc.

Advances against Term Deposits, NSCs eligible for surrender, KVP/IVP and life policies need not be treated as NPAs, provided **adequate margin** is available in the accounts.

12.8 Agricultural Advances Affected by Natural Calamities

Master Circular issued by the RBI deals elaborately with the classification and income recognition issues due to impairment caused by natural calamities. Banks may decide on their own relief measures, viz., conversion of the short term production loan into a term loan or re-schedulement of the repayment period and the sanctioning of fresh short term loan, subject to the guidelines contained in RBI's latest Master Circular on Prudential Norms on Income Recognition, Asset Classification and provisioning pertaining to Advances. In such cases, the NPA classification would be governed by such rescheduled terms.

12.9 Advances to Staff

Interest-bearing staff advances as a banker should be included as part of advances portfolio of the bank. In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards. Such loans/advances should be classified as NPA only when there is a default in repayment of installment of principal or payment of interest on the respective due dates. The staff advances by a bank as an employer and not as a banker are required to be included under the sub-head 'Others' under the schedule of Other Assets.

12.10 Agricultural Advances

As per the guidelines, Agricultural Advances are of two types:

- (1) Agricultural Advances for "long duration" crops; and
- (2) Agricultural Advances for "short duration" crops.

The "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops.

The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State.

The following NPA norms would apply to agricultural advances (including Crop Term Loans):

- ❑ A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons; and
- ❑ A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

Test Your Understanding 2

Ranjana Ceramic Private Limited is sanctioned a cash credit facility of ₹100 lacs from a branch of LMO Bank. Besides, branch has also sanctioned a one-time bank guarantee of ₹ 10 lacs on behalf of the company in favour of a statutory authority. Discuss, what type of credit facilities have been sanctioned by branch of LMO bank to the company along with probable purpose for each of credit facility.

Test Your Understanding 3

During course of audit of branch of a nationalized bank, you find that system has generated a report marking ten term loan accounts as SMA. Discuss, meaning of SMA accounts and significance of such a classification.

13. COMPUTATION OF DRAWING POWER

1. **Meaning:-** Drawing Power generally addressed as “DP” is an important concept for **Cash Credit (CC)** facility availed from banks and financial institutions. **Drawing power** is the limit up to which a firm or company can withdraw from the working capital limit sanctioned.

2 **Different from Sanctioned Limit:-** The **Sanctioned limit** is the total exposure that a bank can take on a particular client for facilities like cash credit, overdraft, export packing credit, non-funded exposures etc. On the other hand, **Drawing Power** refers to the amount calculated based on primary security less margin as on a particular date.

3. **Considerations:-** All accounts should be kept within both the drawing power and the sanctioned limit at all times. The accounts which exceed the sanctioned limit or drawing power or are against unapproved securities or are otherwise irregular should be brought to the notice of the Management/Head Office regularly.

4. **Bank's Duties:-** Banks should ensure that drawings in the working capital account are covered by the adequacy of the current assets. Drawing power is required to be arrived at based on current stock statement. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months. The outstanding in the account based on drawing power calculated from stock statements older than three months is deemed as irregular.

5. **Auditor's Concern:-** The stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinized in detail. The audited Annual Report submitted by the borrower should be scrutinized properly. The monthly stock statement of the month for which the audited accounts are prepared and submitted should be compared and the reasons for deviations, if any, should be ascertained.

6. Computation of DP:- It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power.

7. Stock Audit:- The stock audit should be carried out by the bank for all accounts having funded exposure of more than ' **5 crores**. Auditors can also advise for stock audit in other cases if the situation warrants the same. Branches should obtain the stock audit reports from lead bank in the cases where the Bank is not leader of the consortium of working capital. The report submitted by the stock auditors should be reviewed during the course of the audit and special focus should be given to the comments made by the stock auditors on valuation of security and calculation of drawing power.

	Particulars of current assets			DP
(A)	Stocks			
	Stocks at realizable value		1000	
	Less: Unpaid stocks:			
	- Sundry creditors	300		
	- Acceptances/LCs etc.	<u>300</u>	<u>600</u>	
	Paid for stocks		400	
	Margin @ 25%		<u>100</u>	300
(B)	Debtors			
	Total Debtors		1000	
	Less: Ineligible debtors		<u>200</u>	
	Eligible debtors		800	
	Margin @ 40%		<u>320</u>	<u>480</u>
	Total DP			780

 14 AUDIT OF ADVANCES

Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors.

In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:

- (a) Amounts included in balance sheet in respect of advances which are outstanding at the date of the balance sheet.
- (b) Advances represent amount due to the bank.
- (c) Amounts due to the bank are appropriately supported by loan documents and other documents as applicable to the nature of advances.
- (d) There are no unrecorded advances.
- (e) The stated basis of valuation of advances is appropriate and properly applied and the recoverability of advances is recognised in their valuation.
- (f) The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.
- (g) Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

- ☐ examining the validity of the recorded amounts;
- ☐ examining loan documentation;
- ☐ reviewing the operation of the accounts;
- ☐ examining the existence, enforceability and valuation of the security;
- ☐ checking compliance with RBI norms including appropriate classification and provisioning; and
- ☐ carrying out appropriate analytical procedures.

In carrying out his substantive procedures, the auditor should examine all large advances while other advances may be examined on a sampling basis. The accounts identified to be problem accounts, however, need to be examined in detail unless the amount involved is insignificant.

Advances which are sanctioned during the year or which are adversely commented by RBI inspection team, concurrent auditors, bank's internal inspection, etc. should generally be included in the auditor's review.



Source : maillie.com

Evaluation of Internal Controls over Advances: The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. In general, the internal controls over advances should include, *inter alia*, the following:

- ❑ The bank should make an advance only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank.
- ❑ All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- ❑ The compliance with the terms of sanction and end use of funds should be ensured.
- ❑ Sufficient margin as specified in the sanction letter should be kept against securities taken so as to cover for any decline in the value thereof. The availability of sufficient margin needs to be ensured at regular intervals.

- ❑ If the securities taken are in the nature of shares, debentures, etc., the ownership of the same should be transferred in the name of the bank and the effective control of such securities be retained as a part of documentation.
- ❑ All securities requiring registration should be registered in the name of the bank or otherwise accompanied by documents sufficient to give title to the bank.
- ❑ In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipt. The godowns should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.
- ❑ Drawing Power Register should be updated every month to record the value of securities hypothecated. These entries should be checked by an officer.
- ❑ The accounts should be kept within both the drawing power and the sanctioned limit.
- ❑ All the accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to the notice of the controlling authority regularly.
- ❑ The operation of each advance account should be reviewed at least once a year and at more frequent intervals in the case of large advances.

Test Your Understanding 4

CA P is conducting stock audit of a borrower availing cash credit facility of ₹100 lacs from branch of a bank. The cash credit facility is against security of paid stocks and debtors up to 90 days. Margin stipulated is 25% for stocks and 40% for debtors. Following further information is available as on 31.12.22: -

Value of stocks	₹ 125 lacs
Value of stocks (fully damaged) included in above	5 lacs
Value of debtors	50 lacs
Value of debtors exceeding 90 days included in above	10 lacs
Value of creditors for goods	50 lacs

Is Drawing Power computed by CA P for ₹ 82.50 lacs proper?



15. AUDIT OF REVENUE ITEMS - PROFIT AND LOSS ACCOUNT

Sub-section (1) of Section 29 of the Banking Regulation Act, 1949, requires the preparation of Profit and Loss Account in Form B of Third Schedule to the Act or as near thereto as the circumstances admit.

यथा 31 मार्च, 2016 को समाप्त वर्ष का लाभ व हानि खाता PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST MARCH 20			
	अनुसूची Schedule	यथा 31.03.2016 को समाप्त वर्ष For the Year ended 31.03.2016 (₹ '000)	यथा 31.03.2015 को समाप्त वर्ष For the Year ended 31.03.2015 (₹ '000)
I. आय / INCOME			
अर्जित व्याज / INTEREST EARNED	13		
अन्य आय / OTHER INCOME	14		
जोड़ / TOTAL			
II. व्यय / EXPENDITURE			
व्यय किया गया व्याज / INTEREST EXPENDED	15		
परिचालन व्यय / OPERATING EXPENSES	16		
प्रावधान और आकस्मिक व्यय / PROVISIONS AND CONTINGENCIES			
जोड़ / TOTAL			
III. वर्ष का निवल लाभ / NET PROFIT FOR THE YEAR			
IV. विनियोजन / APPROPRIATIONS			
निम्नांकित को अंतरण / TRANSFERS TO			
सांविधिक आरक्षित निधियाँ / STATUTORY RESERVES			
मूँजी आरक्षित निधियाँ / CAPITAL RESERVES			
निवेश आरक्षित निधि खाता / INVESTMENT RESERVE ACCOUNT			
राजस्व आरक्षित निधि / REVENUE RESERVE			
विशेष आरक्षित निधियाँ / SPECIAL RESERVE			
अंतरिम लाभांश / INTERIM DIVIDEND			
प्रस्तावित लाभांश / PROPOSED DIVIDEND			
लाभांश कर / DIVIDEND TAX			
जोड़ / TOTAL			
लेखांकन नीतियाँ / ACCOUNTING POLICIES	17		
लेखा संबंधी टिप्पणियाँ / NOTES ON ACCOUNTS	18		
प्रति शेयर अर्जन (मूल व तनुकृत) / EARNINGS PER SHARE (BASIC AND DILUTED) (₹ में / in ₹)			

15.1 Income

The following items are included under this head:

Interest Earned	Other Income
□ Interest/ Discount on Advances/ Bills: □ Interest Income on Investments: □ Interest on Balances with RBI and Other Inter-bank Funds: □ Others: This includes any other interest/discount income not included in the above heads	□ Commission, Exchange and Brokerage: This item comprises of the following: (a) Commission on bills for collection. (b) Commission/exchange on remittances and transfers, e.g. demand drafts, NEFT, RTGS, etc. (c) Commission on letters of credit and guarantees, letter of comforts. (d) Loan processing, arranger and syndication fees. (e) Mobile banking fees. (f) Credit/Debit card fee income including annual fee income, merchant acquiring income, interchange fees, etc. (g) Rent from letting out of lockers (h) Commission on Government business. (i) Commission on other permitted agency business including consultancy and other services. (j) Brokerage on securities. (k) Fee on insurance referral. (l) Commission on referral of mutual fund clients. (m) Service/transaction banking charges including charges levied for transaction at other branches. (n) Income from rendering other services like custodian, demat, investment advisory, cash management and other fee based services. □ Profit on Sale of Investments

	□ Profit/Loss on Revaluation of Investments □ Profit on sale of Land, Buildings and Other Assets: □ Profit/Loss on Revaluation of Fixed Assets □ Profit on exchange transactions: This includes revaluation gains/losses on forward exchange contracts and other derivative contracts, premium income/expenses on options, etc. □ Income earned by way of dividends, etc., from subsidiaries and joint ventures abroad/in India. □ Miscellaneous income.

15.1.1 Audit Approach and Procedures

- **Auditor's Concern:-** In carrying out audit of income, the auditor is primarily concerned with obtaining reasonable assurance that the recorded income arose from transactions, which took place during the relevant period and pertained to the bank, there is no unrecorded income and the income is recorded at appropriate amount.
- **RBI's Directions:-** RBI has advised that in respect of any income which exceeds one percent of the total income of the bank if the income is reckoned on a gross basis or one percent of the net profit before taxes if the income is reckoned net of costs, should be considered on accrual as per Accounting Standard 9.
- **Materiality:-** If any item of income is not considered to be material as per the above norms, it may be recognised when received and the auditors need not qualify their report in that situation.
- **Revenue Certainty:-** Banks recognise income (such as interest, fees and commission) on accrual basis, i.e., as it is earned. It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection. In modern day banking, the entries for interest income on advances are automatically generated through a batch process in the CBS system.□

Revenue Uncertainty:- In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognize income on non-performing assets until it is actually realised. When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realized should be reversed or provided for. This will apply to Government guaranteed accounts also.

- **Advances against Securities:-** Interest on advances against Term Deposits, National Savings Certificates (NSCs), Indira Vikas Patras (IVPs), Kisan Vikas Patras (KVPs) and Life policies may be taken to income account on the due date, provided adequate margin is available in the accounts.
- **Bills Purchased:-** In the case of bills purchased outstanding at the close of the year the discount received thereon should be properly apportioned between the two years. [The Unexpired discount/ rebate on bills discounted i.e., where part of receipt comprising discount charges on bills purchased relate to the period beyond the year-end, should be recorded as "Other Liabilities"]. Interest (discount) component paid by Bank/Branch on rediscount of bills from other financial institutions, is not to be netted off from the discount earned on bills discounted.
- **Bills for Collection:-** In the case of bills for collection, the auditor should also examine the procedure for crediting the party on whose behalf the bill has been collected. The procedure is usually such that the customer's account is credited only after the bill has actually been collected from the drawee either by the bank itself or through its agents, etc. This procedure is in consonance with the nature of obligations of the bank in respect of bills for collection. The commission of the branch becomes due only when the bill has been collected.
- **Renegotiations:-** Fees and commissions earned by the banks as a result of re-negotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit. Test check the interest earned by the banks for the sample selected. Test check the fees and commissions earned by the banks made for commission on bills for collection, letters of credit and bank guarantees.

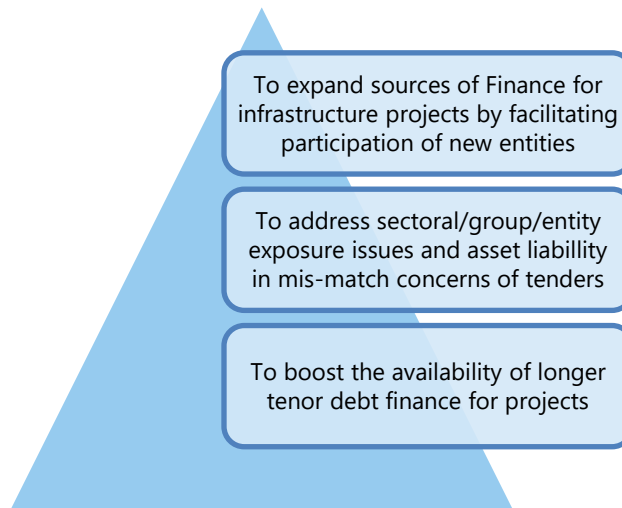
Reversal of Income:

- (a) If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.
- (b) In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.
- (c) Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognized as income in the previous year(s).
- (d) Furthermore, the auditor should enquire if there are any large debits in the Interest Income account that have not been explained. It should be enquired whether there are any communications from borrowers pointing out differences in interest charge and whether appropriate action has been taken in this regard.

On leased assets: The component of finance income (as defined in AS 19 – Leases) on the leased asset which was accrued and credited to the income account before the asset became non-performing and remaining unrealised, should be reversed or provided for in the current accounting period.

On Take-out finance: *A takeout loan is a method of financing whereby a loan that is procured later is used to replace the initial loan. More specifically, a takeout loan, or takeout financing, is long-term financing that the lender promises to provide at a particular date or when particular criteria for completion of a project are met. Takeout loans are commonly used in property development (Source :- Investopedia).* In the case of take-out finance, if based on record of recovery, the account is classified by the lending bank as NPA, it should not recognize income unless realised from the borrower/taking-over institution (if the arrangement so provides).

OBJECTIVE OF TAKEOUT FINANCE



Source :- [slideshare.net](https://www.slideshare.net)

On Partial Recoveries in NPAs:

In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards principal or interest due), banks are required to adopt an accounting policy and exercise the right of appropriation of recoveries in a uniform and consistent manner. The appropriate policy to be followed is to recognise income as per AS 9 when certainty attaches to realisation and accordingly amount reversed/derecognised or not recognised in the past should be accounted.

Interest partly/fully realised in NPAs can be taken to income. However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned.

Memorandum Account: On an account turning NPA, banks should reverse the interest already charged and not collected by debiting Profit and Loss account and stop further application of interest. However, banks may continue to record such accrued interest in a Memorandum account in their books for control purposes. For the purpose of computing Gross Advances, interest recorded in the Memorandum account should not be taken into account.

Income from Investments

Interest Income on Investments: This includes all income derived from Government securities, bonds and debentures of corporates and other investments by way of interest and dividend, except income earned by way of dividends, etc., from subsidiaries and joint ventures abroad/in India. Broken period interest paid on securities purchased and amortisation of premium on SLR investments is net off from the interest income on investments.

Profit on Sale of Investments: Investments are dealt in the course of banking activity and hence the net profit or loss on sale of investments is taken to profit and loss account.

Profit/Loss on Revaluation of Investments: In terms of guidelines issued by the RBI, investments are to be valued at periodical intervals and depreciation or appreciation in valuation should be recognised and taken to profit and loss account.

15.2 Expenses

Expenditure is to be shown under three broad heads:

- (1) Interest expense
- (2) Operating expense
- (3) Provisions and contingencies.

The following items are included under this head:

Interest Expense	Operating Expenses	Provisions and Contingencies
♦ Interest on Deposits	♦ Payments to and Provisions for Employees	♦ Provisions made in respect of the Non-performing assets.
♦ Interest on Reserve Bank of India/Inter-Bank Borrowings	♦ Rent, Taxes and Lighting ♦ Printing and Stationery	♦ Provisions for Taxation
♦ Others	♦ Advertisement and Publicity	♦ Provisions for Diminution in the value of investments

	◆ Depreciation on Bank's Property	◆ Provisions for contingencies
	◆ Directors' Fees, Allowances and Expenses	
	◆ Auditors' Fees and Expenses	
	◆ Legal expenses	
	◆ Postage, Telegrams, Telephones, etc.	
	◆ Repairs and Maintenance	
	◆ Insurance	
	◆ Marketing Expenses	
	◆ Other Expenses	

15.2.1 Audit Approach and Procedures

- In carrying out an audit of interest expense, the auditor is primarily concerned with assessing the overall reasonableness of the amount of interest expense by analysing ratios of interest paid on different types of deposits and borrowings to the average quantum of the respective liabilities during the year. In modern day banking, the entries for interest expenses are automatically generated through a batch process in the CBS system.
- The auditor should obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material. □

- The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences. The auditor should obtain general ledger break-up for the interest expense incurred on deposits (savings and term deposits) and borrowing each month/quarter. The auditor should analyse month on month (or quarter on quarter) cost analysis and document the reasons for the variances as per the benchmark stated. He should examine whether the interest expense considered in the cost analysis agrees with the general ledger. The auditor should understand the process of computation of the average balance and re-compute the same on sample basis.
- The auditor should, on a test check basis, verify the calculation of interest and ensure that:
 - (a) Interest has been provided on all deposits upto the date of the balance sheet;
 - (b) Interest rates are in accordance with the bank's internal regulations, the RBI directives and agreements with the respective deposit holder;
 - (c) Interest on savings accounts are in accordance with the rules framed by the bank/RBI in this behalf.
 - (d) Interest on inter-branch balances has been provided at the rates prescribed by the head office/RBI.

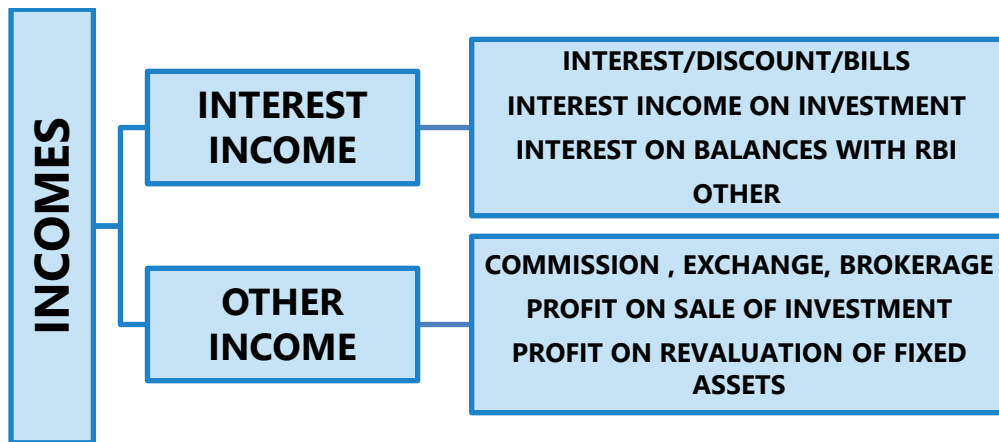
The auditor should ascertain whether there are any changes in interest rate on saving accounts and term deposits during the period. The auditor should obtain the interest rate card for various types of deposits and analyse the interest cost for the period accordingly. The auditor should examine the completeness that interest has been accrued on the entire borrowing portfolio and the same should agree with the general ledgers. The auditor should re-compute the interest accrual i.e., by referring to the parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc. from the term sheet, deal ticket, agreements, etc. and ensure that the recomputed amount is tallying with the amount as per books of accounts without any significant difference.

For audit of Operating expenses, the auditor should :-

- study and evaluate the system of internal control relating to expenses, including authorization procedures in order to determine the nature, timing and extent of his other audit procedures.
- should examine whether there are any divergent trends in respect of major items of expenses.
- perform substantive analytical procedures (*proforma given below for reference*) in respect of these expenses. e.g. *assess the reasonableness of expenses by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years.*
- verify expenses with reference to supporting documents and check the calculations wherever required.

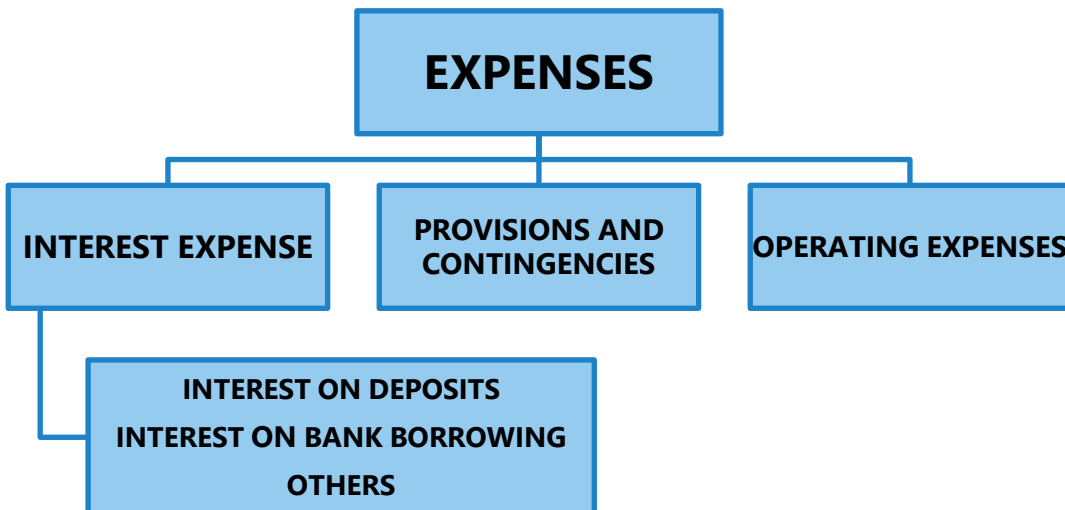
For audit of Provisions and contingencies the auditor should :-

- ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled.
- obtain an understanding as to how the bank computes provision on standard assets and non-performing assets. It will primarily include checking the basis of classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets. The auditor may verify the loan classification on a sample basis.
- obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger.
- obtain the tax provision computation from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain that the same are appropriately considered in the tax provision computation.
- examine the other provisions for expenses vis-a-vis the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.



15.3 Disclosure of the prior period items

Since the format of the profit and loss accounts of banks prescribed in Form B under Third Schedule to the Banking Regulation Act, 1949 does not specifically provide for disclosure of the impact of prior period items on the current year's profit



and loss, such disclosures, wherever warranted, may be given.

Test Your Understanding 5

You are verifying interest on deposits paid by branch of a nationalized bank. Discuss, any two "analytical procedures", to verify interest on deposits paid by branch.

CASE STUDY

CA M is conducting statutory audit of branch of MMC Bank. During the course of audit, it is noticed as under:-

- (i) Loans under "Kisan credit card" are given by Bank to farmers to meet their short-term credit needs for cultivation of crops.

In respect of one agricultural advance classified under "Kisan Credit Card" having an outstanding balance of ₹ 20 lacs as at year end, there is no transaction in account since last 90 days. The said loan has been granted for cultivation of paddy which is harvested in a period of 3-4 months from sowing. The branch has classified the said advance as "Standard asset".

- (ii) It is also observed that account of one borrower availing cash credit limit of ₹50 lacs was taken over from another bank. The proposal was sanctioned by branch manager instead of immediate next higher authority as required in "*Manual of Delegation of Powers*" of Bank.
- (iii) It is noticed that head office of bank has flagged a savings account maintained in branch in which interest was wrongly paid at higher rate due to wrong data feeding entry. Now, situation has been rectified by debiting excess interest paid in the account. Since there was little balance in savings account, a debit balance of ₹1.50 lac was created in the said savings account due to above reversal. The matter was immediately informed to account holder. However, he has not turned up for payment since matter was informed to him about six months ago.
- (iv) There are many cash credit accounts in the branch. Such borrowers are required to submit monthly stock statements to branch showing calculation of drawing power.
- (v) One borrower has availed a housing loan and a car loan from the branch. Housing loan EMIs are overdue for 120 days as on date of Balance sheet. Car loan EMIs are overdue for 60 days as on date of Balance sheet.

Based on above, answer following questions:

- (1) As regards description of agricultural advance, which of the following statements is most appropriate in this regard?
- (a) The branch has erred in making classification as per RBI norms. It is a "Sub-standard" asset.
 - (b) The classification made by branch is proper. However, there are no transactions in account since last 90 days, it is SMA.
 - (c) The classification made by branch is proper.
 - (d) The branch has erred in making classification as per RBI norms. It is a "doubtful" asset.
- (2) Regarding taken over account from another bank, which of following statements is most appropriate?
- (a) It is an internal issue of Bank and auditor is not concerned with it.
 - (b) It is an internal issue of Bank. However, the auditor may, at his discretion, report it.
 - (c) It is a serious violation of laid down procedures of bank for sanction of advances and should be reported by auditor without fail.
 - (d) There is no issue involved as credit facility was properly sanctioned.
- (3) As regards debit balance of ₹ 1.50 lacs in Savings account, which of the following is correct from point of view of an auditor?
- (a) The situation does not attract RBI norms on asset classification.
 - (b) The debit balance of ₹ 1.50 lacs should be classified as NPA.
 - (c) The situation does not attract RBI norms on asset classification as no credit facility was granted.
 - (d) The bank cannot demand excess interest paid to account holder.
- (4) Which of the following statements is not true about "drawing power" (DP)?
- (a) Drawing Power refers to the amount calculated based on primary security less margin as on particular date.
 - (b) It is always less than sanctioned limit.

- (c) *It can be different from sanctioned limit.*
- (d) *Creditors for goods are reduced for purpose of calculating Drawing Power.*
- (5) *Considering housing loan and car loan availed by a borrower, which of the following statements is appropriate?*
- (a) *Both Housing loan as well as car loan should be classified as "Non-Performing Assets" in accordance with RBI norms on asset classification.*
- (b) *Housing Loan should be classified as "Non-Performing Asset" in accordance with RBI norms on asset classification. However, Car loan should be classified as Standard asset.*
- (c) *Car Loan should be classified as "Non-Performing Asset" in accordance with RBI norms on asset classification. However, Housing Loan should be classified as Standard asset.*
- (d) *Both Housing as well as car loans should be classified as Standard assets.*

Answers to Questions involving case study

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

SUMMARY

- ◆ Commercial banks are the most wide spread banking institutions in India, that provide a number of products and services to general public and other segments of economy. Their main functions are accepting deposits and granting advances.
- ◆ Banking operations are conducted only at the branches, while other offices act as controlling authorities or administrative offices that lay down policies, systems and internal control procedures for conduct of business, in compliance with the statutory/ regulatory impositions.
- ◆ Banking operations are peculiar due to huge volume and complexity of transactions, extensive use of technology and wide geographical spread of banks network etc, The approach to a bank audit among other things includes understanding the bank, its environment including internal control, gaining knowledge about bank's accounting system, its risk assessment process, establishing a sound audit strategy and developing the audit plan.

- ◆ Lending constitutes a major activity of a bank. The core business of banks is accepting deposits for onward lending.
- ◆ An asset becomes non-performing (NPA) when it ceases to generate income for the Bank.
- ◆ RBI has stipulated prudential norms for income recognition, asset classification and provisioning pertaining to advances which are to be followed by Banks.
- ◆ Non-performing assets have been further classified into sub-standard, doubtful (D1, D2 and D3) and loss assets.
- ◆ The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures.
- ◆ The auditor is also concerned with audit of items of income and expenditure appearing in profit and loss account of a bank. Suitable substantive procedures and analytical procedures should be designed and performed by auditor in this regard.

For a concise revision of the key concepts covered in this chapter, students may refer to the Saransh Booklet for Paper 5: Auditing and Ethics, which serves as a useful last-mile revision resource for examination preparation. Saransh Booklet can be accessed at <https://resource.cdn.icai.org/85998bos-aps751-int-p5.pdf>

TEST YOUR KNOWLEDGE

MCQs based Questions

- (1) Which of the following is included in "Interest Earned" in Profit & loss A/c of a bank?
- (a) Discount on Bills
 - (b) Loan Processing fees
 - (c) Commission on bills for collection
 - (d) Credit Card Fees

- (2) *While auditing advances of a bank as statutory auditor, which of the following is not a likely concern of auditor?*
- (a) *Appropriate documentation of advances*
 - (b) *Ensuring budgeted targets of advances given by bank management*
 - (c) *Compliance of sanctioned terms and conditions*
 - (d) *Operations in advance accounts*
- (3) *Any amount due to the bank under any credit facility is 'overdue' if: -*
- (a) *it is not paid on the due date fixed by the bank*
 - (b) *it is not paid within 30 days of due date fixed by the bank*
 - (c) *it is not paid within 60 days of due date fixed by the bank*
 - (d) *it is not paid within 90 days of due date fixed by the bank*
- (4) *Which of the following statement is true regarding appointment of statutory branch auditor of a nationalized bank?*
- (a) *The appointment is made by bank acting through its board of directors with prior approval of Central govt.*
 - (b) *The appointment is made by bank acting through its board of directors with prior approval of RBI*
 - (c) *The appointment is made by bank acting through its board of directors with prior approval of ICAI*
 - (d) *The appointment is made by shareholders in AGM.*
- (5) *Identify the correct statement: -*
- (a) *Income from non-performing assets is recognized on accrual basis*
 - (b) *Income from non-performing assets is never recognized.*
 - (c) *Income from non-performing assets is recognized on basis of actual recovery*
 - (d) *Income from non-performing assets is recognized only when such assets are upgraded to standard assets*

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

- (1) *RBI has been entrusted with the responsibility of regulating the activities of commercial banks only.*
- (2) *In the computerised environment, the auditor need not be familiar with latest applicable RBI guidelines.*
- (3) *The auditor can assume that the system generated information is correct and relied upon.*
- (4) *Collateral security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank.*
- (5) *Registered mortgage is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof*
- (6) *Any amount due to the bank under any credit facility is 'overdue' if it is not paid within 90 days of becoming due.*
- (7) *An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power.*
- (8) *Banks recognize income on Non-Performing Assets on accrual basis.*

Theoretical Questions

1. *Discuss outline of audit approach including audit procedures while auditing "provisions and contingencies" in financial statements of a bank.*
2. *Discuss importance of implementation of KYC norms by a bank from perspective of an auditor of bank.*
3. *List out any four points which highlight peculiarities involved in banking operations.*
4. *Is statutory auditor of a bank required to report on the requirements relating to Companies (Auditor's Report) Order, 2020?*
5. *Account of a borrower availing cash credit facility from branch of a bank has become "Out of order." Discuss the term "Out of order".*

6. *The functioning of banking industry in India is regulated by the Reserve Bank of India (RBI) which acts as the Central Bank of our country. Explain*
7. *During the course of statutory branch audit of a nationalized bank, CA Amrish is performing audit procedures in relation to the advances. He has verified the selected sample of borrower accounts representing advances and found nothing unusual. In a banking environment, there exist documentary evidence containing observations/comments on advances which can be useful to the statutory branch auditor in performing an effective audit. List out few such documentary evidence which can be made use of by CA Amrish.*
8. *Write a short note on reversal of income under bank audit.*
9. *Mahavir and Associates is appointed as the statutory auditor of KBC Bank for the financial year 2025-26. During the audit, Ms. Chandana, an article trainee, noticed that Sidharth Industries had an outstanding loan of ₹ 50,00,000 as on March 31, 2026. On March 29, 2026, the company made a payment of ₹ 10,00,000, reducing the outstanding loan balance to ₹ 40,00,000. However, on April 4, 2026, Sidharth Industries initiated a reversal transaction of ₹ 8,00,000, increasing the outstanding loan balance back to ₹ 48,00,000. The payment and subsequent reversal occurred within a short period, with the final outstanding balance remaining ₹ 48,00,000 after the reversal.*

Considering this scenario, what should be the response of Mahavir and Associates to this matter, particularly regarding the classification of the borrower's account and the potential risk of it slipping into the NPA category?

10. *National Bank has advanced cash credit facility of ₹ 25 Lakh to Sun Industries. Following is the extract of account of Sun Industries reflecting in CBS of Bank from December 1, 2025 to March 31, 2026: -*

Date	Particulars	Dr.	Cr.	Balance (Dr.)
01/12/2025	To Transfer	45,000		24,75,000
31/12/2025	By Clearing		1,00,000	23,75,000
31/12/2025	To Interest	25,000		24,00,000
31/01/2026	To Interest	24,700		24,24,700
29/02/2026	To Interest	24,800		24,49,500
31/03/2026	To Inspection charges	1,000		24,50,500
31/03/2026	To Interest	24,900		24,75,400

Drawing power during the above period was consistent at ₹ 25 Lakh. The account was classified as "Standard asset" as on 31.12.2025 in books of Bank. The security charged with the bank remains intact throughout this period.

Comment on "asset classification" of above account as on 31st March 2026 in books of Bank in accordance with RBI norms.

11. *M/s JKL & Associates, Chartered Accountants, are the statutory auditors of M/s IBS Bank Limited for the financial year 2025-26. During the audit, they observed the following items included under interest income in the financial statements of the bank:*

- *An amount of ₹ 5 lakh relating to a short-term crop loan, where the instalment was overdue for one crop season.*
- *An amount of ₹ 7 lakh relating to an advance guaranteed equally by the Government of India and the Government of Tamil Nadu, where the instalment has been overdue for more than six months.*

From the above facts and details, what should be the correct treatment of the above interest income in the bank's financial statements? State the amount that can be recognised as interest income with appropriate reasoning. Also, determine the amount to be classified as Non-Performing Asset (NPA), with reference to applicable RBI norms.

12. *Agrim, a CA student, is part of an engagement team conducting audit of Madurai branch of ARB Bank. CA Bhuvan, engagement partner, has asked him to verify provision made by branch as on March 31st, 2026 in respect of the following non-performing assets: -*

Name of Account	NPA classification	Outstanding amount as on March 31st, 2026 (In ₹ lakhs)	Amount of provision made (In ₹ lakhs)
AK Industries	Doubtful (D1)	10.00	5.00
Jupiter Traders	Substandard asset	50.00	7.50
VT & Co.	Doubtful (D2)	30.00	30.00
ASD & Sons	Loss	1.00	1.00

The engagement partner has already verified NPA classification. Outstanding amounts as on March 31st, 2026, relating to each NPA account listed above

(except ASD & Sons) are fully secured. However, only personal guarantee of proprietor (Net worth of proprietor ₹50 lakhs) is available in account of ASD & Sons. Comment on the correctness of the above provisions.

Agrim is in dilemma regarding classification of above accounts as NPA although these are fully secured or guaranteed. Guide him.

13. K Ltd. is availing cash credit limit of ₹ 25 crores from LMN Bank Ltd. The drawing power of the company range between ₹ 22 crores and ₹ 25 crores during the year 2025-26. The limit availed by the company remained less than ₹ 20 crores during all the days of the financial year 2025-26. The company has not deposited any amount in the cash credit account and there are no other credits to this account during the last two quarters. How will this account be classified in the books of LMN Bank Ltd. as on 31-03-2026? Explain.
14. You are the auditor of Plus Bank Limited. The bank has made following provisions for the year ended on 31.03.2026:

Particulars	Amount (₹ in crores)
Provision for Bad Debts	66
Provision for Sub-standard Assets	78
Provision for Expenses	24
Provision for Income Tax	55

You are in the process of verifying the provisions and contingencies of the bank. What audit approach and procedures will you adopt to verify the above?

15. CA Mini was appointed as the statutory branch auditor of DFC Bank Ltd., for the financial year 2025-26. While verifying advances, she observed the following cases:
- A term loan to JT Mills Ltd. with an outstanding balance of ₹ 140 lakh and security valued at ₹ 80 lakh was classified by the branch as Doubtful-Category D1 (doubtful upto 1 year) with a provision of ₹ 70 lakh created.
 - A Loan to Z Pvt. Ltd. with an outstanding balance of ₹ 65 lakh and realizable security value of ₹ 6 lakh (as per approved valuer) was classified by the branch as a Doubtful Asset and provision for doubtful debts was made accordingly.

You are required to examine whether the asset classification and provisioning made by the branch in both cases are in accordance with the RBI Prudential Norms on Income Recognition, Asset Classification and Provisioning.

16. *While verifying provisions of advances of a branch of HFC Bank as part of statutory branch audit, CA Mini notices that credit facilities consisting of term loan to JT Mills have been classified under doubtful asset (D2) category.*

The outstanding balance in above term loan account as on 31.3.2026 is ₹ 150 lakhs. Value of security held in account is ₹ 100 lakhs. The branch has made provision of ₹ 75 lakhs. Is provision made by branch proper? Discuss.

17. *During the audit of SITU Bank Ltd, the auditor reviews the loan portfolio and comes across the account of M/s Neem Tree Infrastructure Ltd., which has an outstanding balance of ₹ 10 crore. The latest valuation report by an RBI approved valuer indicates that the realisable value of the security available against this loan is only ₹ 80 lakh. The value of the same security during the previous RBI inspection was ₹ 6 crore.*

Additionally, in another borrower account, M/s Gayatri Textiles Pvt. Ltd., with an outstanding balance of ₹ 5 crore, the realisable value of security is estimated to be ₹ 40 lakh.

As an auditor, how should these two accounts be classified as per RBI's prudential norms on income recognition and asset classification? What would be the appropriate provisioning treatment in each case?

18. *You are the statutory auditor of ABC Bank Ltd., a scheduled commercial bank having 350 branches across India. During the audit for the year ended 31st March 2026, you observe the following:*

- *Operating expenses have increased by 28% compared to the previous year, whereas total income has increased only by 10%.*
- *Significant increase is noted in Staff Welfare Expenses, IT Maintenance Charges and Rent.*
- *Certain branch managers have discretionary powers to incur expenses up to specified limits.*
- *The Bank has recently migrated to a centralised expense processing system.*
- *Internal audit reports indicate delays in submission of supporting documents in few regional offices.*

As the statutory auditor, explain the audit procedures you would perform in respect of Operating Expenses of the Bank.

ANSWERS/SOLUTIONS

Answers to the MCQs based Questions

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

Answers to Correct/Incorrect

- (1) **Incorrect.** RBI has been entrusted with the responsibility of regulating the activities of commercial and other banks. All the Banks and even NBFC's fall under the regulatory function of RBI.
- (2) **Incorrect.** In the Computerised environment, it is imperative that the auditor is familiar with, and is satisfied that, all the norms/parameters as per the latest applicable RBI guidelines are incorporated and built into the system that generates information/data having a bearing on the classification/ provisions and income recognition.
- (3) **Incorrect.** The auditor should not go by the assumption that the system generated information is correct and can be relied upon without evidence that demonstrates that the system driven information is based on validation of the required parameters for the time being in force and applicable.
- (4) **Incorrect.** Primary security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance. Collateral security is in addition to the Primary security.
- (5) **Incorrect.** Registered Mortgage can be affected by a registered instrument called the 'Mortgage Deed' signed by the mortgagor. It registers the property to the mortgagee as a security. Equitable mortgage, on the other hand, is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof.
- (6) **Incorrect.** Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank and 90 days of becoming overdue.

- (7) **Correct.** An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power or In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet ; or credits are there but are not enough to cover the interest debited during the same period.
- (8) **Incorrect:** Income from non-performing assets (NPA) is not recognised on accrual basis due to its uncertainty but is booked as income only when it is actually received i.e. on actual receipt basis.

Answers to Theoretical Questions

1. Refer to topic on "Audit of provisions and contingencies"
2. Refer to topic on "Conducting an audit- Assessing the risk of Fraud---"
3. Refer to topic on "Banking Operations"
4. Refer to topic on "Format of report"
5. Refer to topic 12.5 "Classification of Advances as per RBI Prudential Norms"
6. Refer Introduction paragraph
7. Refer Para 11 Point No. 18
8. Refer Para 15.1 "Income"
9. **Accounts regularized near the Balance Sheet Date:** The asset classification of borrower accounts where a solitary or a few credits are recorded before the balance sheet date should be handled with care and without scope for subjectivity. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as NPA.

The auditor should check for sample transactions immediately before the closing of the financial year and immediately after the closing of the financial year to get a knowledge of the objective behind the transactions if they have any relation to each other in the borrower accounts or if any/some transactions are being reversed during the first few days after closing which might show an arrangement to prevent the Borrower account(s) from slipping into the NPA category.

In the given case of Sidharth Industries, a payment of ₹10,00,000 was made on March 29, 2026 reducing the outstanding loan balance to ₹40,00,000. and subsequently reversed by ₹ 8,00,000 on April 4, 2026. Thus, Mahavir and Associates should carefully assess the classification of Sidharth Industries' Account, and determine if the payment and reversal transactions indicate an attempt to prevent the account from slipping into the NPA category. If yes, the account should be classified as an NPA in compliance with regulatory guidelines.

- 10.** In accordance with RBI norms on asset classification, a non-performing asset is a loan or advance where the account remains "out of order" in respect of an Overdraft/Cash Credit.

An account should be treated as 'out of order' if:

- the outstanding balance remains continuously in excess of the sanctioned limit/drawing power or
- In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet; or
- credits are there but are not enough to cover the interest debited during the same period.

In the given case, although outstanding balance in account is less than sanctioned limit/drawing power of ₹ 25 lacs, there are no credits continuously for 90 days as on the date of Balance sheet. Therefore, it has become out of order and is required to be classified as NPA.

Under non-performing assets, it would be classified as "Sub-Standard Asset" as it has remained NPA for a period of less than or equal to 12 months.

- 11. Classification of Non-Performing Asset (NPA) & Treatment of Interest Income:**

- (i) Short-Term Crop Loan:** As per RBI norms, a loan granted for short-duration crops is to be classified as NPA only if the installment remains overdue for two crop seasons.

In the given case, the installment is overdue for only one crop season, hence, the account is not classified as NPA. Therefore, the interest income of ₹ 5 lakh can be recognised in the financial statements.

- (ii) **Advance Guaranteed Equally by Government of India and Government of Tamil Nadu:** If an advance is guaranteed by the Central Government, it need not be classified as NPA until the guarantee is invoked and repudiated. Thus, Central Government guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets but regarded as NPA for Income Recognition purpose. The situation would be different if the advance is guaranteed by the State Government, where advance is to be considered NPA if it remains overdue for more than 90 days for both Provisioning and Income recognition purposes.

In the given case, since the guarantee is shared equally between the Central Government and the State Government (Tamil Nadu), and the installment is overdue for more than 6 months, the portion of loan guaranteed by the Central Government (50%) is not to be classified as NPA unless the guarantee is invoked and repudiated. The remaining 50%, guaranteed by the State Government, must be classified as NPA as the installment is overdue for more than 90 days.

12. The auditor is required to ensure that provision for NPA is made as per its classification in different categories which are given as under:

Categories of Non-Performing Assets:	Provision required
♦ Substandard Assets: Would be one, which has remained NPA for a period less than or equal to 12 months.	15%
♦ Doubtful Assets: Would be one which has remained in the substandard category for a period of 12 months. Sub-categories: • Doubtful up to 1 Year (D1) • Doubtful 1 to 3 Years (D2) • Doubtful more than 3 Years (D3)	(Secured + Unsecured) 25% + 100% 40% + 100% 100% + 100%
♦ Loss Assets	100%

From the above provision, it can be concluded that in case of:

AK Industries- It has been classified as Doubtful (D1) category. Therefore, it requires provision of 25% of secured amount. That is provision of Rs 2.50 lakh (i.e 25% of ₹10 lakh) should be made instead of ₹ 5 lakh.

Jupiter Traders- It has been classified as Substandard asset. It requires provision of 15% of outstanding amount (i.e 15% of ₹ 50 lakhs) which comes to ₹ 7.50 lakh. Therefore, provision made by the branch is correct.

VT & Co.- It has been classified as Doubtful (D2) category. It requires provision of 40% of secured amount. That is provision of ₹ 12.00 lakh (40% of ₹ 30 lakhs) should be made instead of ₹ 30 lakh.

ASD & Sons- It has been classified as a loss asset which requires provision of 100% of outstanding amount. Therefore, the provision made by the branch is correct.

Classification as NPA should be based on the record of recovery. Availability of security or net worth of borrower/guarantor is not to be taken into account for purpose of treating an advance as NPA or otherwise. Hence, these accounts have been classified as NPA on the record of recovery although these are fully secured or guaranteed.

Thus, Amount to be classified as NPA will be ₹ 3.5 lakh (i.e., 50% of ₹ 7 lakh) and amount of interest income to be recognised will be ₹ 5 lakh.

13. An account should be treated as 'out of order' if: -

- the outstanding balance remains continuously in excess of the sanctioned limit/drawing power or
- In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet; or
- credits are there but are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.

In the given case, K Ltd. is availing cash credit limit of ₹ 25 crores from LMN Bank Ltd and the drawing power of the company range between ₹ 22 crores and ₹ 25 crores during the year 2025-26. The limit availed by K Ltd. remained

less than ₹ 20 crores during all the days of the financial year 2025-26 and the company has not deposited any amount in the cash credit account and there are no other credits to this account during the last two quarters.

Thus, account should be treated as out of order in the books of LMN Bank Ltd. as the outstanding balance in the principal operating account (₹ 20 crore) is less than the sanctioned limit/drawing power (₹ 22 cores and ₹ 25 crores), but there are no credits continuously for 90 days as on the date of Balance Sheet.

14. For audit of provisions and contingencies the auditor should:

- ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled.
- obtain an understanding as to how the bank computes provision on standard assets and non-performing assets. It will primarily include checking the basis of classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets. The auditor may verify the loan classification on a sample basis.
- obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger.
- obtain the tax provision computation from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain that the same are appropriately considered in the tax provision computation.
- examine the other provisions for expenses vis-a-vis the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

15. Case (i) – Term Loan to JT Mills Ltd.: The outstanding balance of the term loan to JT Mills Ltd. is ₹140 lakh and the realizable value of security is ₹ 80 lakh. The branch has classified the advance as Doubtful – D1 (up to one year) and created a provision of ₹ 70 lakh.

As per RBI Prudential Norms, in case of a doubtful asset up to one year, provisioning is required at 25% of the secured portion and 100% of the unsecured portion.

In the present case, the secured portion is ₹ 80 lakh and the unsecured portion is ₹ 60 lakh. Accordingly, the required provision is ₹ 20 lakh i.e., (25% of ₹ 80 lakh) plus ₹60 lakh (100% of ₹60 lakh), aggregating to ₹ 80 lakh.

The classification of the advance as Doubtful – D1 is appropriate, however, the provision of ₹ 70 lakh is inadequate. As per RBI norms, a provision of ₹ 80 lakh should be made.

Case (ii) – Loan to Z Pvt. Ltd.: If the realisable value of the security, as assessed by the bank/approved valuers/ RBI is less than 10 per cent of the outstanding in the borrower accounts, the existence of security should be ignored, and the asset should be straight-away classified as loss asset. It may be either written off or fully provided for by the bank.

The loan to Z Pvt. Ltd. has an outstanding balance of ₹ 65 lakh and realisable security value of ₹ 6 lakh. The realisable value of security is less than 10% of the outstanding amount.

As per RBI guidelines on erosion in the value of security, where the realizable value of security is less than 10% of the outstanding balance, the existence of security should be ignored, and the asset should be straight-away classified as a Loss Asset. Such an asset should be either written off or fully provided for by the bank. Therefore, classification of this advance merely as a doubtful asset is not in accordance with RBI norms.

The asset should be straight-away classified as a Loss Asset and 100% provision should be made. The classification and provisioning made by the branch are not in accordance with RBI Prudential Norms.

- 16.** The provision for advances falling in D2 category is required @ 40% of secured portion and 100% of unsecured portion.

Therefore, provision in above case is arrived as under: -

Outstanding balance as on 31.3.25	150 lakhs
Less: Value of security	<u>100 lakhs</u>
Unsecured portion	<u>50 lakhs</u>

Therefore, outstanding balance of ₹ 150 lakhs is secured to the extent of ₹ 100 lakhs and balance ₹ 50 lakhs is unsecured.

Provision calculation	₹
40% of secured part i.e., 40% of ₹ 100 lakhs	40 lakhs
100% of unsecured part i.e., 100% of ₹ 50 lakhs	<u>50 lakhs</u>
Required provision	<u>90 lakhs</u>

In view of above, provision made by branch is not proper. It should have made provision of ₹ 90 lakhs instead of ₹ 75 lakhs.

17. Refer Para 12.7

Based on above, the two accounts can be classified as per RBI norms as under:

M/s Neem Tree Infrastructure Ltd.

- The realizable value of the security (₹ 0.8 crore) is less than 50% of the value assessed at the time of last inspection (₹ 6 crore).
- This represents significant erosion in the value of security.
- Hence, the account should be straight-away classified as a Doubtful Asset, and provisioning should be made as applicable to doubtful assets.

M/s Gayatri Textiles Pvt. Ltd.

- The realizable value of security (₹ 0.4 crore) is less than 10% of the outstanding balance (₹ 5 crore).
- This means the security is practically non-existent.
- Therefore, the account should be classified as a Loss Asset, which may be written off or fully provided for by the bank.

18. In the given case of ABC Bank Ltd., there is a substantial increase in operating expenses disproportionate to growth in income, along with system changes and decentralised authorisation. Accordingly, the auditor needs to design audit procedures addressing both control and substantive aspects.

The auditor should:

- study and evaluate the system of internal control relating to expenses, including authorisation procedures in order to determine the nature, timing and extent of his other audit procedures.

(Considering that branch managers have discretionary powers and the bank has migrated to a centralised expense system, special attention

should be given to approval hierarchies, maker-checker controls, system-based authorization limits, and monitoring controls.)

- examine whether there are any divergent trends in respect of major items of expenses.

(In the present case, abnormal increase in staff welfare expenses, IT maintenance charges and rent requires detailed trend analysis branch-wise and region-wise to identify unusual patterns.)

- perform substantive analytical procedures in respect of these expenses. e.g. assess the reasonableness of expenses by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years.

(The auditor may also compare expense ratios with industry averages of other scheduled commercial banks and correlate expenses with number of branches, employee strength and business volume.)

- verify expenses with reference to supporting documents and check the calculations wherever required.

(Particular emphasis should be placed on high-value payments, year-end provisions, related party transactions and expenses incurred at branches where internal audit observations were adverse.)

In view of the significant increase in operating expenses and control weaknesses indicated by internal audit reports, the auditor should adopt a risk-based approach combining evaluation of internal controls, analytical procedures and detailed substantive testing. If adequate audit evidence is obtained and no material misstatements are found, the auditor may conclude that operating expenses are fairly stated. However, any material weakness in internal controls or unexplained abnormal trends may require appropriate reporting in the audit report or Long Form Audit Report (LFAR), as applicable to banks.

Answers to Questions involving Test Your Understanding

1. Sub-sections (1) and (2) of Section 29 of the Banking Regulations Act, 1949 deal with the form and content of financial statements of a banking company and their authentication. These provisions are also applicable to nationalised banks. Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Act

or as near thereto as the circumstances admit. Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.

2. Cash credit facility sanctioned by bank to company is in nature of funded credit facility. Its purpose is to meet working capital requirements of business.

Bank guarantee sanctioned to the company is in nature of non-funded credit facility. Its probable purpose could be requirement of a guarantee by a statutory authority in exchange of company fulfilling some statutory obligations.

3. Special Mention Account (SMA) is an account which is exhibiting signs of incipient stress resulting in the borrower defaulting in timely servicing of debt obligations, though the account has not yet been classified as NPA as per the RBI guidelines.

In the given case, ten term loan accounts have been classified as SMA. It means that there are overdues in the accounts for a period of 0 to 90 days. Since period of 90 days has not been exceeded as on the date, such accounts have not been classified as NPA as per RBI norms.

Such a classification is significant as early recognition of such accounts enables banks to initiate timely remedial actions to prevent potential slippages of such accounts into NPAs.

4. **The computation of Drawing power is as under: -**

Value of stocks as on 31.12.22	₹ 125 lacs
Less: value of damaged stocks	<u>₹ 5 lacs</u>
	₹ 120 lacs
Less: creditors for goods as on 31.12.22	<u>₹ 50 lacs</u>
Value of Paid stocks	₹ 70.00 lacs
Less: Margin @ 25%	<u>₹17.50 lacs</u>
Drawing power (A)	₹ 52.50 lacs
Value of debtors as on 31.12.22	₹ 50 lacs
Less: debtors exceeding 90 days	<u>₹ 10 lacs</u>
	₹40 lacs

Less: Margin @ 40%	<u>₹ 16 lacs</u>
Drawing Power (B)	₹ 24 lacs
Drawing Power (A+B)	₹ 76.50 lacs

The drawing power calculated by CA P is not proper. Drawing Power comes to ₹ 76.50 lacs.

5. The auditor should obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material.

The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences.

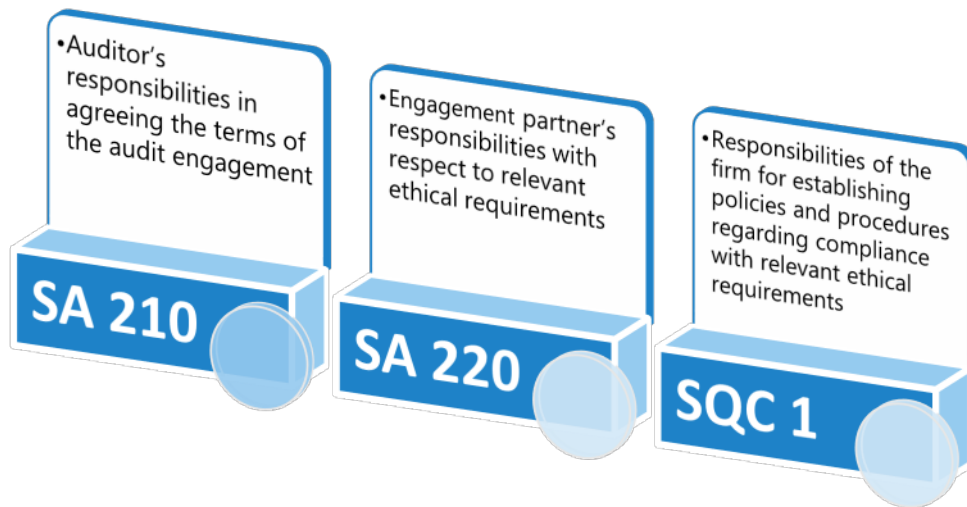
ETHICS AND TERMS OF AUDIT ENGAGEMENTS



LEARNING OUTCOMES

After studying this chapter, you would be able to understand-

- ◆ Meaning of “Ethics”
- ◆ Need for Professional Ethics
- ◆ Fundamental Principles of Professional Ethics
- ◆ Independence of Auditors
- ◆ Threats to Independence
- ◆ Safeguards to Independence
- ◆ Professional Skepticism
- ◆ SA 210 Agreeing the Terms of Audit Engagement
- ◆ About Preconditions for an Audit
- ◆ Basic overview of SQC 1
- ◆ Basic overview of SA 220
- ◆ Practicality of above concepts using examples and case studies.

CHAPTER OVERVIEW

Human civilization is built upon ethics. We cannot think of our daily lives without ethics. Think of any endeavour of human activity- be it imparting of education, running a business, engaging in a profession or carrying out public administration affairs- ethics have a role to play in every field. Ethics guide us and help in building trust.

Consider the case of business. Can a company which does not take care of its workforce or hear its customers achieve heights in its respective trade? A business which dishes out substandard products instead of promised ones would not be able to stay in market for too long. Or take the case of a lawyer who fails to attend legal proceedings of a client without reasonable cause putting his client's interests in jeopardy. Is his conduct ethical? Ultimately, such unprofessional behaviour would tarnish his reputation and credibility.

Sameer was trying to understand importance of ethics in profession of Chartered Accountancy. He was wondering whether a code of ethics exists for Chartered accountants and if so, how exhaustive it would be. Based upon his understanding of auditing till now, he was certain that an auditor must comply with ethical requirements while conducting audit of financial statements. He knew that auditor should be a person of unimpeachable integrity. He gives opinion on financial statements of entities and to maintain sanctity and credibility of his signatures, it is necessary that an auditor should comply with ethics.

A parallel stream of thoughts was also gaining momentum in his mind. Should an auditor follow only those requirements which have been clearly laid down in the rule book? What about situations for which little has been laid down? Thinking about "independence" of auditors, he seemed pretty sure that it was not possible to codify every situation affecting independence of auditor. What approach should auditor follow so that users continue to repose faith? Is there more than one perspective of concept of "independence"? And most importantly, how should an auditor proceed in a situation where he finds his "independence" on a sticky wicket due to extraneous factors?

Performing professional work following ethics also leads to qualitative audits conforming to professional standards. Are there any pronouncements on quality control to be followed by Chartered Accountants? He was yearning to learn about these.



1. MEANING OF ETHICS – A STATE OF MIND

The term “*Ethics*” means moral principles which govern a person’s behaviour or his conducting of an activity. It is the branch of knowledge that deals with moral principles. Ethics is something which comes from an individual intrinsically. It has to be inculcated in the habit and temperament of an individual, so that there is an overall culture of ethics; the force has to be strong enough to withstand any selfish motive or temptation. It is a state of mind to act and perform in accordance with moral principles. Ethics is the science of morals in human conduct. Such moral principles and rules of conduct impose obligations upon individuals.



2. NEED FOR PROFESSIONAL ETHICS

Professions like law, medicine have their code of ethics. Auditing profession is no exception. Rather, in the profession of auditing, requirement of ethics is manifold. It is due to the reason that society in general, governments, clients, taxing authorities, employees, investors, the business and financial community in particular, have reposed tremendous trust in services rendered by Chartered Accountants.

The purpose of assurance engagements is to enhance confidence of the intended users. Therefore, users need to trust the person who is providing such services.

Professional ethics are based on morality. Human nature being what it is, a man, often, places his personal gain above service. Therefore, persons who as individuals and as a class, are willing to place public good above their personal gain have enjoyed respect and honour. But such a relationship can be maintained or enhanced only if the professional body to which they belong would interpret the concept of public interest as broadly as possible. The respect and confidence enjoyed by a profession, to a great extent, is dependent on the strictness and scrupulousness with which such ethics are adhered to by self-discipline.

A distinguishing feature of the accountancy profession is its acceptance of the responsibility to act in the public interest. Professional ethics seek to protect the interests of the profession as a whole and act as a shield that enables us to command respect.

A Chartered Accountant, either in practice or in service, has to abide by ethical behaviours. They are expected to follow the fundamental principles of professional ethics while performing their duties. Service users of professionals should be able to feel secure that there exists a framework of professional ethics which governs the provision of those services.

It is in this spirit of things that the Institute of Chartered Accountants of India (ICAI) requires its members to comply with the principles of ethics while performing their duties. The ethics for Chartered Accountants have, therefore, been codified as ethical compliance has always been a philosophy of the profession. Chartered accountants, whether in practice or in service, are required to comply with the provisions of Code of Ethics.

Any deviation from the ethical responsibilities brings the disciplinary mechanism into action against the Chartered Accountants which may result into fines, suspension of membership, removal from membership or other disciplinary actions.

3. **PRINCIPLES BASED APPROACH VS RULES BASED APPROACH TO ETHICS (ETHICAL OR LEGAL)**

Ethical guidance may follow principles-based approach or rules-based approach. The essence of principles-based approach to ethics is that it requires compliance with spirit of ethics. It requires accountants to exercise professional judgment in every situation based upon their professional knowledge, skill and expertise. It requires that accountants should use professional judgment to evaluate every situation to arrive at conclusions.

However, rules-based approach to ethics strictly follows clearly established rules. It may lead to a narrow outlook and spirit of ethics may be overlooked while strictly adhering to rules. Further, rules-based approach is somewhat rigid as it may not be possible to deal with every practical situation relying upon rules.

Therefore, it is necessary that spirit of code is followed.

4. FUNDAMENTAL PRINCIPLES OF PROFESSIONAL ETHICS

The fundamental principles of ethics establish the standard of behaviour expected of a chartered accountant. A professional accountant shall comply with each of the fundamental principles. The fundamental principles of professional ethics are as under: -



1. Integrity

A chartered accountant shall comply with the principle of integrity, which requires an accountant to be straightforward and honest in all professional and business relationships.

A chartered accountant shall comply with the principle of honesty, which requires an accountant to be honest and upright as a citizen, and in the personal affairs.

A chartered accountant shall imbibe the ideal of Satyameva Jayate (Sanskrit: सत्यमेव जयते) which means 'Truth alone triumphs', being part of the Mundaka Upanishad , and adopted as national motto of India.

Integrity involves fair dealing, truthfulness, and having the strength of character to act appropriately, even when facing pressure to do otherwise or when doing so might create potential adverse personal or organizational consequences.

Acting appropriately involves:

(a) Standing one's ground when confronted by dilemmas and difficult situations; or

(b) Challenging others as and when circumstances warrant, in a manner appropriate to the circumstances.

A chartered accountant shall not knowingly be associated with reports, returns, communications or other information where the accountant believes that the information contains a materially false or misleading statement; contains statements or information provided in grossly negligent manner or omits or obscures required information where such omission or obscurity would be misleading.

2. Objectivity

The principle of objectivity requires an auditor not to compromise professional judgment because of bias, conflict of interest or undue influence of others.

It requires that a chartered accountant shall not undertake a professional activity if a circumstance or relationship unduly influences the accountant's professional judgment regarding that activity.

3. Professional competence and due care

A chartered accountant shall comply with the principle of professional competence and due care, which requires an accountant to attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant

legislation; and act diligently and in accordance with applicable technical and professional standards.

Diligence includes responsibility to act carefully, thoroughly and on a timely basis in accordance with requirements of an assignment.

4. Confidentiality

Confidentiality principle requires a chartered accountant to respect the confidentiality of information acquired as a result of professional or business relationships. Confidentiality serves the public interest because it facilitates the free flow of information from the chartered accountant's client or employing organization to the accountant with the understanding that the information will not be disclosed to a third party.

However, such confidential information may be disclosed, for example, when it is required by law, when it is permitted by law and is authorised by the client or employer or there is a professional duty or right to disclose when not prohibited by law.

5. Professional Behaviour

It requires an accountant to comply with relevant laws and regulations, ***behave in a manner consistent with the profession's responsibility to act in the public interest in all professional activities and business relationships***, and avoid any conduct that the accountant knows or should know might discredit the profession. A chartered accountant shall not knowingly engage in any employment, occupation or activity that impairs or might impair the integrity, objectivity or good reputation of the profession, and as a result would be incompatible with the fundamental principles.

Test Your Understanding 1

CA P. Suryakantam has conducted audit of accounts of an entity for a particular year. ICAI has issued a letter to him relating to certain matters concerning audit. He didn't even bother to reply to the letter despite reminders. Discuss which fundamental principle governing professional ethics is disregarded by him.

Test Your Understanding 2

A Chartered accountant in practice issued a certificate showing original cost of plant and machinery installed in premises of a client for Rs. 9 crores to save some regulatory fees for his client. However, original cost of plant and machinery was Rs.15 crore as per records of client. Which fundamental principle governing professional ethics is violated in this case?



5. INDEPENDENCE OF AUDITORS

Professional integrity and independence are essential characteristics of all the professions but are more so in the case of accountancy profession. Independence implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him, or to his own self-interest.

It is not possible to define "independence" precisely. Rules of professional conduct dealing with independence are framed primarily with a certain objective. The rules, by themselves, cannot create or ensure the existence of independence. Independence is a condition of mind as well as personal character and should not be confused with the superficial and visible standards of independence which are sometimes imposed by law. These legal standards may be relaxed or strengthened but the quality of independence remains unaltered.

There are two interlinked perspectives of independence of auditors, one, independence of mind and two, independence in appearance.

Independence is:

- (a) **Independence of mind** – the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and
- (b) **Independence in appearance** – the avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.

Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons. The relationship between the auditor and his client should be such that firstly, he is himself satisfied about his independence and secondly, no unbiased person would be forced to the conclusion that, on an objective assessment of the circumstances, there is likely to be an abridgement of the auditors' independence.

Independence of an auditor assumes significance in context of providing confidence to users of financial statements. As statutory auditor of a listed company, for example, the Chartered Accountant would cease to perform any useful function if the persons who rely upon the accounts of the company do not have any faith in the independence and integrity of the Chartered Accountant. In such cases, he is expected to be objective in his approach, fearless, and capable of expressing an honest opinion based upon the performance of work such as his training and experience enables him to do so.

Independence is dependent on the state of mind and character of a person and is a very subjective matter. One person might be independent in a particular set of circumstances, while another person might feel he is not independent in similar circumstances. It is therefore the duty of every Chartered Accountant to determine for himself whether or not he can act independently in the given circumstances of a case and quite apart from legal rules, in no case to place himself in a position which would compromise his independence.

6. THREATS TO INDEPENDENCE

Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating action that should be taken. In addition, the nature of assurance engagements may differ and consequently different threats may exist requiring the application of different safeguards.

Following five types of threats to independence of auditors are discussed below: -

1. Self-interest threats

Self-interest threats occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Examples include

- (i) direct financial interest or materially significant indirect financial interest in a client
- (ii) loan or guarantee to or from the concerned client
- (iii) undue dependence on a client's fees and, hence, concerns about losing the engagement
- (iv) close business relationship with an audit client
- (v) potential employment with the client and
- (vi) contingent fees for the audit engagement

2. Self-review threats

Self-review threats occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement, or when a member of the audit team was previously a director or senior employee of the client. Non audit services include any professional services provided to an entity by an auditor, other than audit or review of the financial statements. These include management services, internal audit, investment advisory service etc. Instances where such threats come into play are: -

- (i) when an auditor having recently been a director or senior officer of the company.
- (ii) when auditors perform services that are themselves subject matters of audit.

3. Advocacy threats

Advocacy threats occur when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised, e.g., when an auditor deals with shares or securities of the audited company, or becomes the client's advocate in litigation and third party disputes. In such situations, auditor can be perceived as backing and championing causes of auditee client and it may lead to belief that auditor is not acting and working objectively.

4. Familiarity threats

Familiarity threats are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests. This can occur in many ways including:

- (i) close relative of the audit team working in a senior position in the client company
- (ii) former partner of the audit firm being a director or senior employee of the client
- (iii) long association between specific auditors and their specific client counterparts and
- (iv) acceptance of significant gifts or hospitality from the client company, its directors or employees.

Provisions in the Companies Act, 2013 regarding rotation of auditors mainly address these very familiarity threats. Such provisions prescribe that auditor is rotated after a certain number of years so that auditors do not become too familiar with their clients.

5. Intimidation threats

Intimidation threats occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees or being threatened with litigation. Such threats attempt to intimidate auditors to deter them from acting objectively.

7. SAFEGUARDS TO INDEPENDENCE

Chartered Accountants have a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to address the threats.

Safeguards are actions, individually or in combination, that the chartered accountant takes that effectively reduce threats to comply with the fundamental principles to an acceptable level.

To address the issue, the following guiding principles are to be applied: -

- For the public to have confidence in the quality of audit, it is essential that auditors should always be and appears to be independent of the entities that they are auditing.
- Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.
- When such threats exist, the auditor should either desist from the task or eliminate the threat or at the very least, put in place safeguards which reduce the threats to an acceptable level. All such safeguards measures need to be recorded in a form that can serve as evidence of compliance with due process.
- If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

Note: For more details on threats and safeguards, refer to additional material on BoS Knowledge portal.



8. PROFESSIONAL SKEPTICISM

Professional skepticism refers to an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

It signifies that auditor has to remain alert forever. The auditor's attitude should be of questioning mind- of challenging the things in light of available evidence.

The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated.

Professional skepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the SAs.

Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:

- Overlooking unusual circumstances.
- Over generalising when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

Professional skepticism is necessary to the critical assessment of audit evidence. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount. The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary.

Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence. In cases of doubt about the reliability of information or indications of possible fraud, the SAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.

The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism.

Test Your Understanding 3

CA Raman Gupta is offered appointment as auditor of a company. One of his distant uncles held some shares in the same company. Holding of such shares, by a distant relative, is not prohibited under provisions of law nor does it affect his independence. Before he could accept appointment, he received unfortunate news of death of his uncle who had died without any children. He came to know that he was nominee of these shares having substantial value. It landed him in a tricky situation. What should be proper course of action for him?

Test Your Understanding 4

A Chartered accountant receives about 40% of his total audit fees from a single client. Discuss how it could affect independence of Chartered accountant as auditor of this client. What are such types of threats referred to as?

Test Your Understanding 5

CA Murli Madhavan provides accounting and book keeping services to a leading NGO engaged in environmental protection work. He is also offered audit of the accounts of NGO. Identify and discuss what kind of threat to independence may be involved in accepting such an engagement.

Test Your Understanding 6

The auditors of a company have only relied upon management representation letter regarding treatment of certain tax matters under appeal by the company. The auditors have not carried out any other audit procedures to justify management's treatment of the said tax matters under appeal in the financial statements. What is lacking on part of auditors in such a situation?

AUDIT ENGAGEMENT AND TERMS OF AUDIT ENGAGEMENT

An audit engagement involves engaging an auditor by a client for audit of its financial statements. Audit engagement terms can include matters such as objective and scope of audit of financial statements, responsibilities of auditor, responsibilities of management, identification of applicable financial reporting framework for preparation of financial statements and reference to expected form and contents of report to be issued by auditor.

9. AGREEING THE TERMS OF AUDIT ENGAGEMENTS

SA 210 deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management and, where appropriate, those charged with governance. This includes establishing that certain preconditions for an audit, responsibility for which rests with management and, where appropriate, those charged with *governance*, are present.

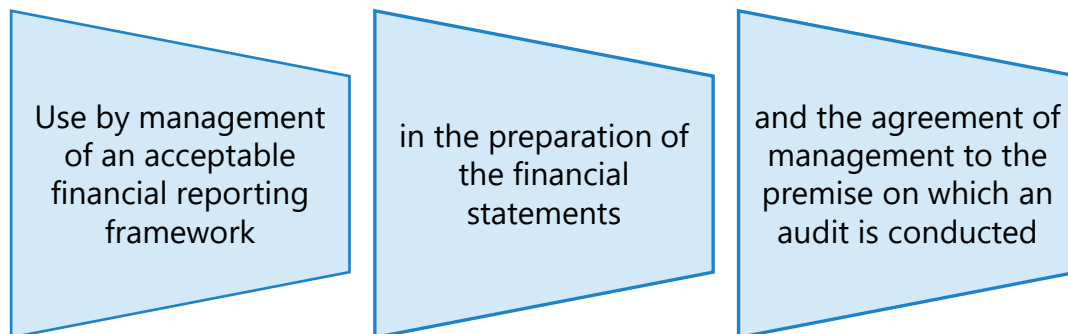
The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:

- (A) Establishing whether the preconditions for an audit are present and
- (B) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.

9A Preconditions for an audit

As per SA 210 "Agreeing the Terms of Audit Engagements", preconditions for an audit may be defined as the use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.

Preconditions for an audit



In order to establish whether the preconditions for an audit are present, the auditor shall:

- (a) Determine whether the financial reporting framework is acceptable and
- (b) Obtain the agreement of management that it acknowledges and understands its responsibility:
 - (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework including where relevant their fair representation;

- (ii) For such internal control as management considers necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
- (iii) To provide the auditor with:
 - Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
 - Additional information that the auditor may request from management for the purpose of the audit; and
 - Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

9B. Agreement on audit engagement terms

Except in the cases where it is required under law to get accounts audited (for example in case of companies), audit is a matter of contract between auditor and client. It is, therefore, important, both for the auditor and client, that each party should be clear about the nature of the engagement. It must be reduced to writing and should exactly specify the scope of the work.

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.

The audit engagement letter is sent by the auditor to his client. It is in the interest of both the auditor and the client to issue an engagement letter so that the possibility of misunderstanding is reduced to a great extent. Such a letter includes:-

- (a) The objective and scope of the audit of the financial statements
- (b) The responsibilities of the auditor
- (c) The responsibilities of management
- (d) Identification of the applicable financial reporting framework for the preparation of the financial statements and

- (e) 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.

If law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities.

10. EXAMPLE OF AN ENGAGEMENT LETTER

Given below is example of an engagement letter: -

PJ Shrimali & Co.	24, MG Road,
Chartered Accountants	Mumbai
	10 th August XXXX

To the Board of Directors of Pristine Products Limited

The objective and scope of the audit

You have requested that we audit the financial statements of Pristine Products Limited, which comprise the Balance Sheet as at March 31st, 20XX, the Statement of Profit & Loss, Cash Flow Statement for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information.

We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. The objectives of our audit 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 Standards on Auditing (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.

The responsibilities of the auditor

We will conduct our audit in accordance with Standards on Auditing (SAs) issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements. 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 company's internal control. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.
- 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 company'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 company to cease to continue as a going concern.

- 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.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with SAs.

The responsibilities of management

Our audit will be conducted on the basis that management and, where appropriate, those charged with governance acknowledge and understand that they have responsibility:

- (a) For the preparation of financial statements that give a true and fair view in accordance with the financial reporting Standards. This includes:
 - The responsibility for the preparation of financial statements on a going concern basis.
 - The responsibility for selection and consistent application of appropriate accounting policies, including implementation of applicable accounting standards along with proper explanation relating to any material departures from those accounting standards.
 - The responsibility for making judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity at the end of the financial year and of the profit or loss of the entity for that period.
- (b) 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
- (c) To provide us with:
 - (i) Access, at all times, to all information, including the books, accounts, vouchers and other records and documentation, of the company, whether kept at the head office of the company or elsewhere, of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters,

- (ii) Additional information that we may request from management for the purpose of the audit and
- (iii) Unrestricted access to persons within the entity from whom we determine it necessary to obtain audit evidence. This includes our entitlement to require from the officers of the company such information and explanations as we may think necessary for the performance of our duties as auditor. As part of our audit process, we will request from management and, where appropriate, those charged with governance, written confirmation concerning representations made to us in connection with the audit.

Fees

Our fees bill for ₹ XXXXXX (plus applicable taxes) and out of pocket expenses will be raised after completion of audit work.

Reporting

We will report to the members of Pristine Products Limited as a body, whether in our opinion, the financial statements give the information required by the Companies Act, 2013 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 March 31, 20XX, and its profit/loss, and its cash flows for the year ended on that date. The form and content of our report may need to be amended in the light of our audit findings.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.

For PJ Shrimali & Co.

Chartered Accountants

Firm's Registration Number

(Signature)

(Name of the Member)

(Designation)

11. WHAT HAPPENS IF PRECONDITIONS FOR AN AUDIT ARE NOT PRESENT?

If the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement: -

- (a) If the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable or
- (b) If the agreement of management is not obtained on matters relating to understanding of responsibility of management on preparation of financial statements, internal controls for preparation of financial statements, providing access to all information to auditor and unrestricted access to persons within the entity.

12. LIMITATION ON SCOPE PRIOR TO AUDIT ENGAGEMENT ACCEPTANCE

If management or those charged with governance impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

13. ACCEPTANCE OF A CHANGE IN THE TERMS OF THE AUDIT ENGAGEMENT

The auditor shall not agree to a change in the terms of the audit engagement where there is no reasonable justification for doing so.

13.1 Request from Entity to change the Terms of Audit Engagement-When Reasonable Justification Exists?

A request from the entity for the auditor to change the terms of the audit engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit as originally requested or

a restriction on the scope of the audit engagement, whether imposed by management or caused by other circumstances. The auditor considers the justification given for the request, particularly the implications of a restriction on the scope of the audit engagement.

A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of the service originally requested may be considered a reasonable basis for requesting a change in the audit engagement.

In contrast, a change may not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory.

An example might be where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the entity asks for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion.

13.2 What should auditor consider before agreeing to change the audit engagement to the engagement providing lower level of assurance?

If, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement that conveys a lower level of assurance, the auditor shall determine whether there is reasonable justification for doing so.

Before agreeing to change an audit engagement to a review or a related service, an auditor who was engaged to perform an audit in accordance with SAs may also need to assess any legal or contractual implications of the change.

If the auditor concludes that there is reasonable justification to change the audit engagement to a review or a related service, the audit work performed to the date of change may be relevant to the changed engagement. However, the work required to be performed and the report to be issued would be those appropriate to the revised engagement. In order to avoid confusing the reader, the report on the related service would not include reference to:

- (a) The original audit engagement or
- (b) Any procedures that may have been performed in the original audit engagement, except where the audit engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.

13.3 Recourse available to auditor in situation of non-agreement to a change in terms of engagement and lack of permission from management to continue original audit engagement

If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:

- (a) Withdraw from the audit engagement where possible under applicable law or regulation and
- (b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.



14. TERMS OF ENGAGEMENT IN RECURRING AUDITS

Recurring audit is an audit which is performed by an auditor over years. On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.

The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

- (i) Any indication that the entity misunderstands the objective and scope of the audit.
- (ii) Any revised or special terms of the audit engagement.
- (iii) A recent change of senior management.
- (iv) A significant change in ownership.

- (v) A significant change in nature or size of the entity's business.
- (vi) A change in legal or regulatory requirements.
- (vii) A change in the financial reporting framework adopted in the preparation of the financial statements.
- (viii) A change in other reporting requirements.

Test Your Understanding 7

Chirag, as part of articled training, is part of an engagement team conducting audit of a company. He has read somewhere that engagement letter issued by auditor to client also includes expected form and content of the auditor's report. He was at a loss to understand how could an auditor include form and content of the report beforehand. Try to help Chirag by making things clear to him.

Test Your Understanding 8

The management of an entity feels that it is not necessary for it to give in writing explicitly to the auditor that it understands its responsibilities for preparation of financial statements in accordance with applicable financial reporting framework. Discuss, whether, it is necessary for the management to do so. In case management refuses, why should an auditor not accept the proposed engagement?

15. AUDIT QUALITY

The purpose of an independent audit is to provide confidence to users of audited financial statements. Therefore, high audit quality is essential to maintain confidence in the independent assurance provided by the auditors. It is the responsibility of auditor to maintain high audit quality.

SQC 1 and SA 220 both deal with quality control. Whereas SQC 1 deals with all engagements including audits, reviews and other assurance and related service engagements, SA 220 applies to audit engagements only.

Further, SQC 1 applies to entire firm. However, SA 220 applies to a particular audit engagement.



16. 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.



17. 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.

Elements of a 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

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.

B. 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.

Observance of "Independence" in all engagements is the basic 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.

C. 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
- 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.

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.

D. 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.

E. 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 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.

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.

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.

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.

Besides, 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. The assembly of 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.

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

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.

F. 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.



18. 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.

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

A. 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, emphasise

- (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.

B. 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.

C. 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.

D. 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.

E. 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.

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.

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.

F. 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.

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.

Test Your Understanding 9

CA PK Nair is offered appointment as auditor of a company engaged in providing tourism services. While making due diligence of the proposed client, he comes to know that there have been raids on premises of the company and residences of its directors by National Investigation Agency (NIA) on suspicion of links with terror outfits. It has been followed up with searches by Enforcement Directorate hunting for illicit money trail. There is a strong suspicion of tourism services provided by company being façade of terror funds. Should proposed offer be accepted by him?

Test Your Understanding 10

CA Arpita has joined a mid-sized CA firm recently. She finds that partners remain too busy and the firm is proposing to accept audit work in areas in which it has no experience or capabilities. The firm is proposing to accept audit of some entities engaged in emerging “fin-tech” sector. Such audits may be requiring extensive use of technology and data analytics. However, the said firm has no such capabilities and trained personnel. Discuss, whether, firm should accept such audits with reason.

CASE STUDY

Das & Co, a firm of auditors, is offered appointment as auditor of a company, a prospective new client. CA Sukanya, one of partners, is dealing with new client. While meeting with officers of the company, she comes to know that Sushant, CFO of the company, was her class mate. In fact, both of them had started CA together. However, Sushant had left CA mid-way due to repeated failures and tried his luck to pursue MBA (finance) from one of leading institutions.

During initial discussions, it transpires that company is going to launch new services in the field of “*weather-forecasting*”. Such services would be available on web site of company and micro weather information would be available on payment of charges. The company requests audit firm to be visibly associated with their marketing blitz.

Assume that firm chooses to accept the offer and writes to previous auditor, Walker & Co., to advise whether there exist any professional reasons for them not to accept the proposed offer. However, Walker & Co. do not reply to the request of Das & Co.

During preliminary discussions, it also became known that the said company has acquired all shares of another company. Under relevant provisions of law, financial statements of both companies needed to be consolidated and audited. Despite this knowledge, Das & Co. failed to advise their client regarding audit of consolidated financial statements.

The company also offers auditors contract for providing IT services pertaining to information system of company.

Based on above, answer following questions:

1. *Considering discussion about Sukanya and Sushant, which of the following statements seems most appropriate?*
 - (a) *The above discussion is irrelevant in context of proposed offer.*
 - (b) *The proposed offer should be accepted by firm. The engagement team may be headed by CA Sukanya for better coordination and results.*
 - (c) *The proposed offer should be accepted by firm. The engagement team may be headed by a different partner of the firm.*
 - (d) *The matter is too trivial to be reported by CA Sukanya to other partners of firm.*
2. *Keeping in view request of the company to be visibly associated with company's new services, identify which type of threat is being faced by audit firm.*
 - (a) *Self-interest threat*
 - (b) *Familiarity threat*
 - (c) *Self-review threat*
 - (d) *Advocacy threat*
3. *The previous auditors, Walker & Co., have not replied to communication of Das & Co. Which fundamental principle of professional ethics is not followed by them?*
 - (a) *Objectivity*
 - (b) *Professional behaviour*
 - (c) *Professional competence and due care*
 - (d) *Integrity*
4. *Das & Co. have failed to advise the company regarding audit of consolidated financial statements. Which fundamental principle of professional ethics is violated by Das & Co.?*
 - (a) *Professional behaviour*
 - (b) *Integrity*
 - (c) *Objectivity*
 - (d) *Professional competence and due care*

5. Which of the following statements is most appropriate regarding providing offer of work of IT services by auditors to the company?
- (a) Such offer may create a self-review threat.
 - (b) Such offer may create an advocacy threat.
 - (c) Such offer does not constitute any threat.
 - (d) Such offer may create self-review and advocacy threats.

Answer to Questions Involving Case Study

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

SUMMARY

- ◆ Fundamental principles of professional ethics include integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.
- ◆ Independence implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him, or to his own self-interest.
- ◆ There are two interlinked perspectives of independence of auditors, one, independence of mind and two, independence in appearance.
- ◆ Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons.
- ◆ Threats to independence of auditors include self-interest threats, self-review threats, advocacy threats, familiarity threats and intimidation threats.
- ◆ Chartered Accountants have a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to address the threats.
- ◆ When such threats exist, the auditor should either desist from the task or eliminate the threat or at the very least, put in place safeguards which reduce the threats to an acceptable level.

- ◆ Professional skepticism refers to an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.
- ◆ Professional skepticism is necessary to the critical assessment of audit evidence. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances.
- ◆ Before accepting or continuing an audit engagement, it is necessary for auditor to establish that preconditions for an audit are present and confirmation that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement. SA 210 deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management.
- ◆ Preconditions for an audit may be defined as the use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.
- ◆ The agreed terms of the audit engagement shall be recorded in an audit *engagement letter* or other suitable form of written agreement.
- ◆ The audit engagement letter is sent by the auditor to his client. It is in the interest of both the auditor and the client to issue an engagement letter so that the possibility of misunderstanding is reduced to a great extent.
- ◆ The auditor shall not agree to a change in the terms of the audit engagement where there is no reasonable justification for doing so.
- ◆ If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall withdraw from the audit engagement where possible under applicable law or regulation and determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

- ◆ High audit quality is essential to maintain confidence in the independent assurance provided by the auditors. It is the responsibility of auditor to maintain high audit quality.
- ◆ SQC 1 and SA 220 both deal with quality control. Whereas SQC 1 deals with all engagements including audits, reviews and other assurance and related service engagements, SA 220 applies to audit engagements only. SQC 1 applies to entire firm. However, SA 220 applies to a particular audit engagement.
- ◆ 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.

For a concise revision of the key concepts covered in this chapter, students may refer to the **Saransh Booklet for Paper 5: Auditing and Ethics**, which serves as a useful last-mile revision resource for examination preparation. Saransh Booklet can be accessed at <https://resource.cdn.icai.org/85998bos-aps751-int-p5.pdf>

TEST YOUR KNOWLEDGE

MCQs based Questions

- (1) Identify the most appropriate statement: -
- (a) SA 220 applies at the level of firm.
 - (b) SQC 1 is premised on the basis that firm is subject to SA 220.
 - (c) SA 220 is premised on the basis that firm is subject to SQC 1.
 - (d) SA 220 applies to all engagements.
- (2) Professional skepticism includes-
- (a) Overlooking unusual circumstances.
 - (b) Using inappropriate assumptions in determining extent of audit procedures.

- (c) *Over generalising when drawing conclusions from audit observations.*
 - (d) *Being vigilant to conditions that might indicate possibilities of fraud.*
- (3) *Which of the following is not a fundamental principle governing professional ethics?*
 - (a) *Professional competence and due care*
 - (b) *Integrity*
 - (c) *Objectivity*
 - (d) *Safeguards to independence*
- (4) *Which of the following is not necessary to establish preconditions for an audit?*
 - (a) *Acceptability of financial reporting framework.*
 - (b) *Acknowledgment of cooperation from management in designing audit procedures.*
 - (c) *Acknowledgment from management of providing access to persons within company.*
 - (d) *Acknowledgment of management in understanding its responsibility for preparation of financial statements.*
- (5) *Identify the most appropriate statement in context of SQC 1.*
 - (a) *Assembly of engagement files should be completed in not more than 60 days after date of auditor's report in case of audit engagements.*
 - (b) *Engagement files should be completed before date of auditor's report in case of audit engagements.*
 - (c) *Engagement files should be completed in not more than 60 days after completion of an engagement.*
 - (d) *Engagement files should be completed on date on which audit report is signed in case of audit engagements.*

Correct /Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

- (i) *The audit engagement letter is sent by the client to auditor.*
- (ii) *The Audit Engagement documentations should ordinarily be retained by the auditor for minimum of six years from the date of the auditor's report or the date of the group auditor's report, whichever is later.*

Theoretical Questions

1. *Briefly outline how principles-based approach differs from rules-based approach to ethics.*
2. *How application of professional skepticism throughout audit is helpful in reducing audit risk?*
3. *How does SQC 1 ensure that independence in engagements is not breached by an audit firm?*
4. *An engagement partner takes overall responsibility for maintaining audit quality in an audit engagement in accordance with SA 220. What are his objectives in taking and emphasizing such responsibility?*
5. *SRT & Co., Chartered Accountants, are the statutory auditors of Dee Infra Projects Ltd., a listed company engaged in large infrastructure contracts.*

During the audit for the year ended 31st March 2026, the Engagement Partner, Mr. A, came to know of the following matters:

1. *The spouse of one of the senior members of the engagement team holds substantial equity shares in Dee Infra Projects Ltd.*
2. *The firm has recently provided consultancy services relating to internal financial controls implementation to the same client.*
3. *A partner of the firm has been offered a position on the advisory board of a group company of Dee Infra Projects Ltd.*

Mr. A believes that certain situations may create threats to independence. However, due to the significance of the client, some partners of the firm are reluctant to consider withdrawal.

As per SA 220 "Quality Control for an Audit of Financial Statements", discuss the responsibilities of the Engagement Partner in relation to ethical requirements in the above circumstances.

6. *Deepa Ltd., initially requested an audit engagement for the financial year 2025-26. However, midway through the audit process, the management claims that they are unable to provide complete supporting documentation for a significant portion of their receivables. As a result, the management asks the auditor to change the audit engagement to a review engagement, arguing that it would prevent the issuance of a qualified opinion.*

The auditor is now facing challenge in determining whether this change is justified or not. Comment in accordance with relevant SA.

7. *Truthful Products Private Limited is engaged in trading stationery items. During the year 2025-26, there was a huge fire in one storage location of the company resulting in loss of inventories of ₹ 5 crores. As a result, the operations of the company were badly affected for about two months. Unfortunately, the insurance claim of the company was rejected due to certain defects in the policy issued and loss was booked by company in the year 2025-26 itself. There was no change in nature of business of company in relation to the last year. The draft financial statements of the company reflect following information:*

(Figures in ₹ crores)

Particulars	FY 2024-25	FY 2025-26
Revenue from Operations	80	100
Net profit before tax	6	10

CA D who has been the statutory auditor for past three years, has decided to rely upon the same tests of details as performed in previous years. In the given situation what is lacking on part of the auditor? Discuss.

8. *CA H has been offered audit of financial statements of a society engaged in promoting social causes, such as setting up of drug de-addiction centres for misguided youth and rehabilitating such young people by helping them find avenues of gainful employment. However, CA H failed to send audit engagement letter to the society's governing body and proceeded to conduct the audit. In the absence of this letter, the governing body is of the view that purpose of such an audit is to provide absolute assurance against probable*

errors and frauds in the financial statements. Does it constitute violation of fundamental principles governing professional ethics? State reasons for the same.

9. *CA Rohit is conducting the audit of Taste Ltd., a food production company, for the last two years. Before commencing the audit for the year, he observed that the company has undergone a major shift in its product line by expanding into pharmaceuticals. Besides this, the company is now subject to new regulatory reporting requirements. These developments were not present at the time of accepting the initial audit engagement. CA Rohit is of the view that there is no need to issue a new audit engagement letter. Examine whether the viewpoint of CA Rohit is appropriate in accordance with the relevant Standards on Auditing.*
10. *CA H is managing partner of HK & Co., a Chartered Accountant firm, having registered office at Delhi. With the annual task of reviewing whether any threat to independence is observed in the firm, CA H noted down the following observations received from the staff and partners of the firm for the F.Y 2025-26 :*
 - (i) *CA J, partner of the firm, performed statutory audit as well as non- audit engagement for M/s. Take Away Private Limited.*
 - (ii) *CA M, partner of the firm, who has done income tax audit for M/s. Happy Associates where in CA M has material significant indirect financial interest.*
 - (iii) *The costs of air travel and stay accommodation of family members of audit team for audit of Chennai was borne by the client stationed at Chennai.*
 - (iv) *One of the clients, M/s. Chalk Limited, threatened to replace them as auditors because the audit team insisted to make provision for expected credit loss which the company was not willing to provide.*
 - (v) *CA N, partner of the firm, who audited M/s. NM Private Limited became arbitrator for dispute between M/s. NM Private Limited and one of its vendors.*
 - (vi) *CA N accepted the assignment of Tax audit (on behalf of firm) of TRF Industries. Management agreed to pay him contingent fee for tax audit.*

You are requested to help CA H in classifying the type of threats to independence in each of the above observation received from the staff and partners of the firm.

In case such threats exist, what should the auditor do?

11. *Identify and explain the fundamental principles being referred to in the following cases.*
 - (i) *Chartered accountants should act diligently and in accordance with applicable technical and professional standards while providing professional services.*
 - (ii) *A chartered accountant shall not knowingly be associated with reports where he believes that the information contains a materially false or misleading statement.*
12. *CA P is a chartered accountant in service. In terms of employment and professional relationships with employer he has to be alert to the possibility of inadvertent disclosure of any information outside the employing organization. However, in view of disclosure required by law, CA P had to divulge the information and documents as evidence in course of legal proceedings. Whether CA P has violated any fundamental principle governing professional ethics in this case? Explain.*
13. *Mentioned below are the threats to independence of auditors. Classify them, with reasons, into the appropriate type of threats viz. Advocacy threat, Intimidation threat, Familiarity threat, Self-review threat, Self-interest threat.*
 - (i) *Close business relationship with an audit client;*
 - (ii) *Auditors perform services that are themselves subject-matter of audit;*
 - (iii) *Auditor deals with shares or securities of the audited company;*
 - (iv) *Long association between specific auditors and their specific client counterparts;*
 - (v) *Auditor deterred from acting objectively with an adequate degree of professional skepticism.*
14. *M/s XYZ & Co., Chartered Accountants, is conducting the statutory audit of ABC Ltd. During the audit, the engagement partner notices certain unusual year-end sales transactions that have significantly increased the company's*

profits. Management explains that these are genuine transactions and provide supporting invoices.

However, the engagement partner expresses concern that such unusual year-end transactions require deeper examination, notwithstanding the availability of documentation. He emphasizes that an auditor should remain alert to conditions that may indicate possible misstatements. He further remarks that although the firm generally follows a rule-based approach to ethics, auditors should not limit themselves to mere compliance with rules but also uphold the spirit of ethical principles while conducting an audit.

- (i) Determine the attitude that the engagement partner expects the audit team to maintain in the above situation. Which risks can be reduced while maintaining such an attitude throughout the audit?
 - (ii) Distinguish briefly between the principles-based approach and the rules-based approach to ethics.
15. CA Jatin is auditor of XYZ Pharma, his brother-in-law's Partnership Firm. His family relationship creates a conflict of interest that could unduly influence his professional judgment, making it difficult for him to provide an unbiased opinion on the firm's financial statements.

In another assignment of Tax Audit of a company, CA Jatin is also required to prepare the company's tax return. He fails to check the latest provision of the Income-tax Act which allows for a major new deduction resulting in the client overpaying income tax.

CA Jatin is also preparing GST returns of one of his clients. The client instructs him to intentionally understate the sales figures to reduce the tax liability.

Identify and explain the fundamental principles of professional ethics involved in above situations.

ANSWERS/SOLUTIONS

Answers to the MCQs based Questions

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

Answers to Correct/Incorrect

- (i) **Incorrect:** As per SA 210 "Agreeing the Terms of Audit Engagements", the Audit engagement letter is sent by the auditor to his client.
- (ii) **Incorrect:** SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements 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.

Answers to Theoretical Questions

1. Refer to topic on principles-based approach vs. rules- based approach to ethics.
2. Refer to topic on "Professional Skepticism".
3. Refer to heading of Ethical requirements under "Elements of System of quality control" in SQC 1.
4. Refer to heading of "Leadership responsibilities for quality on audits" under SA 220.
5. In the given case, issues relating to independence and ethical requirements have arisen during the audit engagement. As per SA 220, the Engagement Partner is responsible for forming a conclusion on compliance with relevant ethical requirements, including independence.

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.

In the present case, financial interest held by the spouse of a team member, provision of consultancy services, and offer of advisory position may create self-interest, self-review, and familiarity threats. The Engagement Partner must evaluate whether these threats are significant and whether available safeguards (such as removal of the concerned team member, independent review, or discontinuation of non-audit services) can reduce the threats 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.

Accordingly, Mr. A must communicate these matters to the appropriate authority within the firm (such as the Ethics Partner or Managing Partner). If safeguards are not sufficient to mitigate the threats, appropriate action must be taken. This may include:

- Disposal of the financial interest,
- Removal of affected personnel from the engagement,
- Discontinuation of conflicting services, or
- Withdrawal from the audit engagement, where withdrawal is legally permitted.

In the given case, the Engagement Partner is duty-bound under SA 220 to evaluate the identified threats to independence, ensure compliance with ethical requirements, and take appropriate corrective action. If the threats cannot be eliminated or reduced to an acceptable level through safeguards, the firm must either eliminate the underlying cause or withdraw from the engagement, as permitted by law. Failure to do so would amount to non-compliance with SA 220 and compromise the quality and credibility of the audit.

6. As per SA 210, "Agreeing the Terms of Audit Engagements", a request from the entity for the auditor to change the terms of the audit engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit as originally requested or a restriction on the scope of the audit engagement, whether imposed by management or caused by other circumstances.

The auditor considers the justification given for the request, particularly the implications of a restriction on the scope of the audit engagement.

A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of the service originally requested may be considered a reasonable basis for requesting a change in the audit engagement.

In contrast, a change may not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory. An example might be where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the entity asks for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion.

Hence Deepa Ltd.'s request for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion is not reasonable.

7. Maintaining professional skepticism throughout audit is necessary if auditor is to reduce risks of overlooking unusual circumstances and using inappropriate assumptions in determining the nature, time and extent of audit procedures and evaluating results thereof.

In the given situation, revenue from operations of the company have increased from ₹ 80 crores to ₹100 crores despite its operations being affected by fire for about two months. Further, despite loss of inventories to the tune of ₹ 5 crores, financial statements reflect increase in net profit before tax from 7.5% in year 2024-25 to 10% in year 2025-26. Thus, approach of CA D lacks professional skepticism.

In spite of these unusual circumstances, the auditor has decided to rely upon same tests of details as performed in the previous years. The nature and extent of audit procedures need to be suitably altered considering changed circumstances. He may include substantive analytical procedures to analyse variations and seek necessary explanations from management. In case of doubt about the reliability of information or indications of possible fraud, Standards on Auditing require auditor to determine what modifications or additions to audit procedures are necessary to resolve the matter. CA D, the auditor of a listed company, shall document the overall audit strategy, the audit plan and any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

8. 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. Such a letter includes, inter alia, objective and scope of audit of financial statements. The absence of such a letter leads to misunderstanding between auditor and management. As auditor has failed to send engagement letter, the governing body has formed an improper view of objective and scope of audit of financial statements.

By not following requirements of SA 210, CA H is not acting ethically. He has violated principle of professional competence and due care governing professional ethics. This principle requires an accountant to attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation and act diligently and in accordance with applicable technical and professional standards. Maintaining professional competence requires awareness of current technical and professional standards. Non sending of engagement letter shows lack of such awareness on part of CA H. Therefore, he has violated said fundamental principle governing professional ethics.

9. As per SA 210, "Agreeing the terms of audit engagements", recurring audit is an audit which is performed by an auditor over years. In case of recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.

The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

- (i) Any indication that the entity misunderstands the objective and scope of the audit.
- (ii) Any revised or special terms of the audit engagement.
- (iii) A recent change of senior management.
- (iv) A significant change in ownership.
- (v) A significant change in nature or size of the entity's business.
- (vi) A change in legal or regulatory requirements.

(vii) A change in the financial reporting framework adopted in the preparation of the financial statements.

(viii) A change in other reporting requirements.

In the given case, Taste Ltd., a food production company, has undergone a major shift in its product line by expanding into Pharmaceuticals and the company is also subject to new regulatory reporting requirements. In view of the abovementioned factors, it is appropriate to revise the terms of the audit engagement in accordance with SA 210. Thus, the viewpoint of CA Rohit regarding no need for issuance of a new engagement letter is not correct, CA Rohit is required to send the revised audit engagement letter.

10. Type of Threats to Independence

S. No.	Situation	Threat to Independence
(i)	CA J, partner of the firm, performed statutory audit as well as non- audit engagement for Take Away Private Limited.	Self-review threats
(ii)	CA M, partner of the firm, who has done income tax audit for M/s. Happy Associates where in CA M has material significant indirect financial interest.	Self-interest threats
(iii)	The costs of air travel and stay accommodation of family members. of audit team for audit Chennai was borne by the client stationed at Chennai.	Familiarity threats
(iv)	One of the clients, Chalk Limited, threatened to replace them as auditors because the audit team insisted to make provision for expected credit loss which the company was not willing to provide.	Intimidation threats
(v)	CA N, partner of the firm, who audited NM Private Limited became arbitrator for dispute between. NM Private Limited and one of its vendors.	Advocacy threats
(vi)	CA N accepted the assignment of Tax audit (on behalf of firm) of TRF Industries. Management agreed to pay him contingent fee for tax audit.	Self-interest threats

When such threats exist, the auditor should –

- (1) Either desist from the task or eliminate the threat or at the very least, put in place safeguards which reduce the threats to an acceptable level. All such safeguards' measures need to be recorded in a form that can serve as evidence of compliance with due process.
- (2) If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

11. Fundamental Principles:

- (i) **Act diligently and in accordance with applicable technical and professional standards:** In the given case, **professional competence and due care** fundamental principle is being referred to since a chartered accountant shall comply with the principle of professional competence and due care, which requires an accountant to attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and act diligently and in accordance with applicable technical and professional standards.
 - (ii) **A chartered accountant shall not knowingly be associated with reports where he believes that the information contains a materially false or misleading statement:** In the given case, **integrity** fundamental principle is being referred to, it prescribes that a chartered accountant shall comply with the principle of integrity, which requires an accountant to be straightforward and honest in all professional and business relationships. Integrity implies fair dealing and truthfulness.
- 12.** Confidentiality principle requires a chartered accountant to respect the confidentiality of information acquired as a result of professional or business relationships. Confidentiality serves the public interest because it facilitates the free flow of information from the chartered accountant's client or employing organization to the accountant with the understanding that the information will not be disclosed to a third party.

However, such confidential information may be disclosed, for example, when it is required by law, when it is permitted by law and is authorised by the client or employer or there is a professional duty or right to disclose when not prohibited by law.

In the given situation, CA P, who is a chartered accountant in service, and in terms of employment and professional relationships with the employer he is alert to the possibility of inadvertent disclosures of any information outside the employing organization. However, CA P had to divulge the information and documents as evidence in the course of legal proceedings and same was required by law. Therefore, CA P will not be held responsible for violation of fundamental principle of "Confidentiality" governing professional ethics.

13. (i) Close business relationship with an audit client would be classified as Self-interest threat.

Reason: Self-interest threats occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client.

- (ii) Auditors perform services that are themselves subject-matter of audit would be classified as Self-review threat.

Reason: Self-review threats occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement, or when a member of the audit team was previously a director or senior employee of the client.

- (iii) Auditor deals with shares or securities of the audited company would be classified as Advocacy threat.

Reason: Advocacy threats occur when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised.

- (iv) Long association between specific auditors and their specific client counterparts would be classified as Familiarity threat.

Reason: Familiarity threats are self-evident and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests.

- (v) Auditor deterred from acting objectively with an adequate degree of professional skepticism would be classified as Intimidation threat.

Reason: Intimidation threats could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees or being threatened with litigation.

- 14.** (i) In the given case, the engagement partner expects the audit team to maintain an attitude of professional skepticism throughout the audit, especially while evaluating unusual year-end sales transactions. Professional skepticism refers to an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:

- Overlooking unusual circumstances.
- Over generalising when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

- (ii) Ethical guidance may follow principles-based approach or rules-based approach. The essence of principles-based approach to ethics is that it requires compliance with spirit of ethics. It requires accountants to exercise professional judgment in every situation based upon their professional knowledge, skill and expertise. It requires that accountants should use professional judgment to evaluate every situation to arrive at conclusions.

However, rules-based approach to ethics strictly follows clearly established rules. It may lead to a narrow outlook and spirit of ethics may be overlooked while strictly adhering to rules. Further, rules-based approach is somewhat rigid as it may not be possible to deal with every practical situation relying upon rules.

Therefore, it is necessary that spirit of code is followed.

- 15.** (i) In the given case, CA Jatin's family relationship creates a conflict of interest that could unduly influence his professional judgment. This indicates that "Objectivity" principle is being violated.

The principle of objectivity requires an auditor not to compromise professional judgment because of bias, conflict of interest or undue influence of others.

It requires that a chartered accountant shall not undertake a professional activity if a circumstance or relationship unduly influences the accountant's professional judgment regarding that activity.

- (ii) In the instant case, CA Jatin did not check the latest provision of the Income-tax Act while preparing return of income-tax, which allows for a major new deduction resulting in the client overpaying income tax. This indicates "Professional competence and due care" principle is being violated. A chartered accountant shall comply with the principle of professional competence and due care, which requires an accountant to attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and act diligently and in accordance with applicable technical and professional standards.

Diligence includes responsibility to act carefully, thoroughly and on a timely basis in accordance with requirements of an assignment.

- (iii) In the given situation, CA Jatin's client instructs him to intentionally understate the sales figures to reduce the tax liability. It violates "integrity" principle. A chartered accountant shall comply with the principle of integrity, which requires an accountant to be straightforward and honest in all professional and business relationships. Integrity implies fair dealing and truthfulness.

A chartered accountant shall not knowingly be associated with reports, returns, communications or other information where the accountant believes that the information contains a materially false or misleading statement; contains statements or information provided negligently or omits or obscures required information where such omission or obscurity would be misleading.

Answers to Questions involving Test your understanding

1. Failure to reply to professional body smacks of lack of courtesy and professional responsibility. The principle of "Professional behaviour" is disregarded.
2. "Integrity" requires that a chartered accountant shall not knowingly be associated with reports, returns, communications or other information where the accountant believes that the information contains a materially false or

misleading statement; contains statements or information provided negligently or omits or obscures required information where such omission or obscurity would be misleading.

In the given case, a false certificate is knowingly issued showing misstated original cost of machinery. Therefore, fundamental principle of "integrity" is violated.

3. When threats to independence exist, the auditor should either desist from the task or eliminate the threat or at the very least, put in place safeguards which reduce the threats to an acceptable level.

Holding of shares involves financial interest in the company and is in nature of self-interest threat. He has come to hold shares due to nomination made by his distant relative before accepting the appointment. Considering above, he should take steps to eliminate the threat by selling shares immediately before accepting appointment. Holding of shares of the same company for which he is offered appointment as auditor constitutes threat to his independence.

4. Undue dependence on fees of a client constitutes a threat as there is fear of losing the client. Such threats are referred to as self-interest threats.
5. In this case, Chartered Accountant is already rendering accounting and book keeping services to an NGO. If he accepts audit, he would be involved in reviewing own work. Therefore, the same constitutes "self-review" threat.
6. In the given case, auditors have relied only upon management representation letter regarding treatment of certain tax matters under appeal by the company. No other audit procedures to verify management's treatment of such matters under appeal have been performed by auditors. It shows lack of "professional skepticism" on part of auditors.
7. Engagement letter includes reference to expected form and content of audit report. It merely states that auditor would provide opinion in this form. However, engagement letter also includes statement that the form and content of report may need to be amended in the light of audit findings. Therefore, if in light of audit findings, auditor needs to give a modified opinion, he shall do so.

8. It is necessary for management to give in writing explicitly to the auditor that it understands its responsibilities for preparation of financial statements in accordance with applicable financial reporting framework. It is a necessary precondition for an audit in accordance with SA 210.

If the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement: -

- (a) If the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable or
- (b) If the agreement of management is not obtained on matters relating to understanding of responsibility of management on preparation of financial statements, internal controls for preparation of financial statements, providing access to all information to auditor and unrestricted access to persons within the entity.

Unless required by law or regulation to do so, such a refusal on the part of auditor is necessary as management is not willing to accept its responsibility for preparation of financial statements in accordance with applicable financial reporting framework. An audit is conducted on this basic premise according to SA 210. When basic premise on which audit is conducted is not fulfilled, refusal by auditor is necessary.

9. Integrity of principal owners has to be considered before accepting an audit engagement in accordance with SA 220. In this regard, SA 220 states requirements on lines of SQC 1. SQC 1 clearly states that in cases where there are indications that the client might be involved in money laundering or other criminal activities, appointment should not be accepted.

In the instant case, there have been raids of NIA on suspected links with terror outfits which is a criminal activity. Further, raids by Enforcement Directorate also point towards money laundering. Therefore, proposed offer should not be accepted.

- 10.** SQC 1 requires that before accepting an engagement, competence (including capabilities, time and resources) to perform engagement have to be considered.

In the given case, the proposed engagements involve use of technology and data analytics. The firm has no prior experience of audits in emerging “fin-tech” sector. The firm does not have trained personnel to carry out these audits. Hence, offer for these audits should not be accepted.