Engagement and Quality Control Standards along with complete text (Formerly known as Auditing and Assurance Standards)

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## Standards on Quality Control (SQCs)

- SQC 1, "Quality Control for Firms that Perform Audit and Reviews of Historical Financial Information, and other Assurance and Related Services Engagements"

## Audits and Reviews of Historical Financial Information

- 100-999 Standards on Auditing (SAs)
- 100-199 Introductory Matters
- 200-299 General Principles and Responsibilities
  - SA 200 (AAS 1), "Basic Principles Governing an Audit"
  - SA 200A (AAS 2), "Objective and Scope of the Audit of Financial Statements"
  - SA 210 (AAS 26), "Terms of Audit Engagement"
  - SA 220 (AAS 17), "Quality Control for Audit Work"
  - SA 230 (AAS 3), "Documentation"
  - SA 230 (Revised) under the Clarity Project, "Audit Documentation"
  - SA 240 (AAS 4), "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements"
  - SA 240 (Revised) under the Clarity Project, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements"
  - SA 250 (AAS 21), "Consideration of Laws and Regulations in an Audit of Financial Statements"
  - SA 250 (Revised) under the Clarity Project, "Consideration of Laws and Regulations in an Audit of Financial Statements"
  - SA 260 (AAS 27), "Communications of Audit Matters with Those Charged with Governance"
  - SA 260 (Revised) under the Clarity Project, "Communication with Those Charged with Governance"
  - SA 299 (AAS 12), "Responsibility of Joint Auditors"
- 300-499 Risk Assessment and Response to Assessed Risks
  - SA 300 (AAS 8), "Audit Planning"
  - SA 300 (Revised) under the Clarity Project, "Planning an Audit of Financial Statements" •
  - SA 315 under the Clarity Project, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment"
  - SA 320 (AAS 13), "Audit Materiality"
  - SA 330 under the Clarity Project, "The Auditor's Responses to Assessed Risks"
  - SA 402 (AAS 24), "Audit Considerations Relating to Entities Using Service Organisations"
- 500-599 Audit Evidence

    - SA 500 (AAS 5), “Audit Evidence”
    - SA 501 (AAS 34), “Audit Evidence – Additional Considerations for Specific Items”
    - SA 505 (AAS 30), “External Confirmations”
    - SA 510 (AAS 22), “Initial Engagements – Opening Balances”
    - SA 510 (Revised) under the Clarity Project, “Initial Audit Engagements – Opening Balances”
    - SA 520 (AAS 14), “Analytical Procedures”
    - SA 530 (AAS 15), “Audit Sampling”
    - SA 530 (Revised) under the Clarity Project, “Audit Sampling”
    - SA 540 (AAS 18), “Auditing of Accounting Estimates”
    - SA 540 (Revised) under the Clarity Project, “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”
    - SA 550 (AAS 23), “Related Parties”
    - SA 550 (Revised) under the Clarity Project, “Related Parties”
    - SA 560 (AAS 19), “Subsequent Events”
    - SA 560 (Revised) under the Clarity Project, “Subsequent Events”
    - SA 570 (AAS 16), “Going Concern”
    - SA 570 (Revised) under the Clarity Project, “Going Concern”
    - SA 580 (AAS 11), “Representations by Management”
    - SA 580 (Revised) under the Clarity Project, ”Written Representations”
- 600-699 Using Work of Others
    - SA 600 (AAS 10), “Using the Work of Another Auditor”
    - SA 610 (AAS 7), “Relying Upon the Work of an Internal Auditor”
    - SA 620 (AAS 9), “Using the Work of an Expert”
- 700-799 Audit Conclusions and Reporting
    - SA 700 (AAS 28), “The Auditor’s Report on Financial Statements”
    - SA 710 (AAS 25), “Comparatives”
- 800-899 Specialized Areas
- 2000-2699 Standards on Review Engagements (SREs)
    - SRE 2400 (AAS 33), “Engagements to Review Financial Statements”

**Assurance Engagements Other Than Audits or Reviews of Historical Financial Information**

- 3000-3699 Standards on Assurance Engagements (SAEs)
- 3000-3399 Applicable to All Assurance Engagements
- 3400-3699 Subject Specific Standards
    - SAE 3400 (AAS 35), “The Examination of Prospective Financial Information”

**Related Services**

- 4000-4699 Standards on Related Services (SRSs)
    - SRS 4400 (AAS 32), “Engagements to Perform Agreed-upon Procedures

Regarding Financial Information”

- SRS 4410 (AAS 31), “Engagements to Compile Financial Information”

**General Clarifications issued**

- General Clarification (GC)-AASB/2/2004 on SA 210
- General Clarification (GC)-AASB/1/2002 on SA 620

# STANDARD ON QUALITY CONTROL (SQC) 1

## QUALITY CONTROL FOR FIRMS THAT PERFORM AUDITS AND REVIEWS OF HISTORICAL FINANCIAL INFORMATION, AND OTHER ASSURANCE AND RELATED SERVICES ENGAGEMENTS

***(Effective for all engagements relating to accounting periods beginning on or after April 1, 2009)***

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Material Modifications to the International Standard on Quality Control (ISQC) 1

The following is the text of the Standard on Quality Control (SQC) 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements. The Standard should be read in conjunction with the Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Services, issued by the Institute of Chartered Accountants of India[1].

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard on Quality Control (SQC) is to establish standards and provide guidance regarding a firm's responsibilities for its system of quality control for audits and reviews of historical financial information, and for other assurance and related services engagements. This SQC is to be read in conjunction with the requirements of the Chartered Accountants Act, 1949, the Code of Ethics and other relevant pronouncements of the Institute[2] (hereinafter referred to as "the Code").

2. Additional standards and guidance on the responsibilities of firm personnel regarding quality control procedures for specific types of engagements are set out in other pronouncements of the Auditing and Assurance Standards Board (AASB) issued under the authority of the Council. For example, Standard on Auditing (SA) 220, "Quality Control for Audit Work"[3], establishes standards and provides guidance on quality control procedures for audits of historical financial information.

3. 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[4] or engagement partner(s) are appropriate in the circumstances.

4. A system of quality control consists of policies designed to achieve the objectives set out in paragraph 3 and the procedures necessary to implement and monitor compliance with those policies.

5. This SQC applies to all firms. The nature of the policies and procedures developed by individual firms to comply with this SQC will depend on various factors such as the size and operating characteristics of the firm, and whether it is part of a network.

## Definitions

6. In this SQC, the following terms have the meanings attributed below:

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[2] Attention of the members is invited, for instance, to the Guidance Note on Independence of Auditors, issued by the Committee on Ethical Standards.

[3] Earlier known as Auditing and Assurance Standard (AAS) 17, "Quality Control for Audit Work".

[4] It is clarified that in India the reports are not issued/signed in the firm name, rather they are issued/signed on behalf of the firm by the sole practitioner, proprietor or a partner of the firm, as the case may be, in his individual name. The definition of a 'firm' has been given in paragraph 6(f) of this Standard.

(a) Engagement documentation – the record of work performed, results obtained, and conclusions the practitioner reached (terms such as "working papers" or "workpapers" are also sometimes used). The documentation for a specific engagement is assembled in an engagement file;

(b) Engagement partner – the partner or other person in the firm who is a member of the Institute of Chartered Accountants of India and is in full time practice and is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

(c) Engagement quality control review – a process designed to provide an objective evaluation, before the report is issued, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.

(d) Engagement quality control reviewer – a partner, other person[5] in the firm, suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate, before the report is issued, the significant judgments the engagement team made and the conclusions they reached in formulating the report. However, in case the review is done by a team of individuals, such team should be headed by a member of the Institute.

(e) Engagement team – all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.

(f) Firm – a sole practitioner/proprietor, partnership, or any such entity of professional accountants, as may be permitted by law.

(g) Inspection – in relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures.

(h) Listed entity – an entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are traded under the regulations of a recognized stock exchange or other equivalent

[5] Such other person should be a member of the Institute of Chartered Accountants of India.

body.

(i) Monitoring – a process comprising an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements, designed to enable the firm to obtain reasonable assurance that its system of quality control is operating effectively.

(j) Network firm– an entity under common control, ownership or management with the firm or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally or internationally.

(k) Partner – any individual with authority to bind the firm with respect to the performance of a professional services engagement.

(l) Personnel – partners and staff.

(m) Professional standards – engagement standards, as defined in the AASB's "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," and relevant ethical requirements as contained in the Code.

(n) Reasonable assurance – in the context of this SQC, a high, but not absolute, level of assurance.

(o) Staff – professionals, other than partners, including any experts which the firm employs.

(p) Suitably qualified external person – an individual outside the firm with the capabilities and competence to act as an engagement partner, for example a partner or an employee[6] (with appropriate experience) of another firm.

## Elements of a System of Quality Control

7. 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

[6] Such employee should be a member of the Institute of Chartered Accountants of India.

specific engagements.

(d) Human resources.

(e) Engagement performance.

(f) Monitoring.

8. The quality control policies and procedures should be documented and communicated to the firm's personnel. Such communication describes the quality control policies and procedures and the objectives they are designed to achieve, and includes the message that each individual has a personal responsibility for quality and is expected to comply with these policies and procedures. In addition, 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.

## Leadership Responsibilities for Quality within the Firm

9. The firm should 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 equivalent) or, if appropriate, the firm's managing partners (or equivalent), to assume ultimate responsibility for the firm's system of quality control.

10. The firm's leadership and the examples it sets significantly influence the internal culture of the firm. The promotion of a quality-oriented internal culture depends on clear, consistent and frequent actions and messages from all levels of the firm's management emphasizing the firm's quality control policies and procedures, and the requirement to:

(a) Perform work that complies with professional standards and regulatory and legal requirements; and

(b) Issue reports that are appropriate in the circumstances.

Such actions and messages encourage a culture that recognizes and rewards high quality work. They may be communicated by training seminars, meetings, formal or informal dialogue, mission statements, newsletters, or briefing memoranda. They are incorporated in the firm's internal documentation and training materials, and in partner and staff appraisal procedures such that they will support and reinforce the firm's view on the importance of quality and how,

practically, it is to be achieved.

11. Of particular importance is the need for the firm's leadership to recognize that the firm's business strategy is subject to the overriding requirement for the firm to achieve quality in all the engagements that the firm performs. Accordingly:

(a) The firm assigns its management responsibilities so that commercial considerations do not override the quality of work performed;

(b) The firm's policies and procedures addressing performance evaluation, compensation, and promotion (including incentive systems) with regard to its personnel, are designed to demonstrate the firm's overriding commitment to quality; and

(c) The firm devotes sufficient resources for the development, documentation and support of its quality control policies and procedures.

12. Any person or persons assigned operational responsibility for the firm's quality control system by the firm's chief executive officer or managing board of partners should have sufficient and appropriate experience and ability, and the necessary authority, to assume that responsibility.

13. Sufficient and appropriate experience and ability enables the responsible person or persons to identify and understand quality control issues and to develop appropriate policies and procedures. Necessary authority enables the person or persons to implement those policies and procedures.

## Ethical Requirements

14. 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.

15. Ethical requirements relating to audits and reviews of historical financial information, and other assurance and related services engagements are contained in the Code. The Code establishes the fundamental principles of professional ethics, which include:

(a) Integrity;

(b) Objectivity;

(c) Professional competence and due care;

(d) Confidentiality; and

(e) Professional behavior.

16. The Code includes a conceptual approach to independence for assurance engagements, including aspects such as threats to independence, accepted safeguards and the public interest.

17. The firm's policies and procedures should emphasize the fundamental principles, which are reinforced in particular by (a) the leadership of the firm, (b) education and training, (c) monitoring, and (d) a process for dealing with non-compliance. Independence for assurance engagements is so significant that it is addressed separately in paragraphs 18-27 below. These paragraphs need to be read in conjunction with the Code.

## Independence

18. The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and, where applicable, others subject to independence requirements (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 and, where applicable, to others subject to them; and

(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.

19. Such policies and procedures should require:

(a) Engagement partners to provide the firm with relevant information about client engagements, including the scope of services, to enable the firm to evaluate the overall impact, if any, on independence requirements;

(b) Personnel to promptly notify the firm of circumstances and relationships that create a threat to independence so that

appropriate action can be taken; and

(c) The accumulation and communication of relevant information to appropriate personnel so that:

(i) The firm and its personnel can readily determine whether they satisfy independence requirements;

(ii) The firm can maintain and update its records relating to independence; and

(iii) The firm can take appropriate action regarding identified threats to independence.

20. The firm should establish policies and procedures designed to provide it with reasonable assurance that it is notified of breaches of independence requirements, and to enable it to take appropriate actions to resolve such situations. The policies and procedures should include requirements for:

(a) All who are subject to independence requirements to promptly notify the firm of independence breaches of which they become aware;

(b) The firm to promptly communicate identified breaches of these policies and procedures to:

(i) The engagement partner who, with the firm, needs to address the breach; and

(ii) Other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action; and

(c) Prompt communication to the firm, if necessary, by the engagement partner and the other individuals referred to in subparagraph (b)(ii) of the actions taken to resolve the matter, so that the firm can determine whether it should take further action.

21. Comprehensive guidance on threats to independence and safeguards, including application to specific situations are contained in the Code.

22. A firm receiving notice of a breach of independence policies and procedures promptly communicates relevant information to engagement partners, others in the firm, as appropriate and, where applicable, experts contracted by the firm and network firm personnel, for appropriate action.

Appropriate action by the firm and the relevant engagement partner includes applying appropriate safeguards to eliminate the threats to independence or to reduce them to an acceptable level, or withdrawing from the engagement. In addition, the firm provides independence education to personnel who are required to be independent.

23. 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.

24. Written confirmation may be in paper or electronic form. By obtaining confirmation and taking appropriate action on information indicating non-compliance, the firm demonstrates the importance that it attaches to independence and makes the issue current for, and visible to, its personnel.

25. The Code discusses the familiarity threat that may be created by using the same senior personnel on an assurance engagement over a long period of time and the safeguards that might be appropriate to address such a threat. Accordingly, the firm should establish policies and procedures:

(a) Setting out criteria for determining the need for safeguards to reduce the familiarity threat to an acceptable level when using the same senior personnel on an assurance engagement over a long period of time; and

(b) For all audits of financial statements of listed entities, requiring the rotation of the engagement partner after a specified period in compliance with the Code.

26. Using the same senior personnel on assurance engagements over a prolonged period may create a familiarity threat or otherwise impair the quality of performance of the engagement. Therefore, the firm should establish criteria for determining the need for safeguards to address this threat. In determining appropriate criteria, the firm considers such matters as (a) the nature of the engagement, including the extent to which it involves a matter of public interest, and (b) the length of service of the senior personnel on the engagement. Examples of safeguards include rotating the senior personnel or requiring an engagement quality control review.

27. The familiarity threat is particularly relevant in the context of financial statement audits of listed entities. For these audits, the engagement

partner should be rotated after a pre-defined period, normally not more than seven years[7].

## Acceptance and Continuance of Client Relationships and Specific Engagements

28. The firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide it with reasonable assurance that it will undertake or continue relationships and engagements only where it:

(a) Has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity;

(b) Is competent to perform the engagement and has the capabilities, time and resources to do so; and

(c) Can comply with the 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.

29. 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

[7] The provision of rotation of partners shall not be applicable in case the audit of listed entities is being done by a sole practitioner/proprietor. However, in order to ensure that appropriate system of quality control exists in the firm and that appropriate reports are issued in the circumstances by sole practitioners/proprietors, such practice unit(s) shall be compulsorily reviewed under the process of peer review.

internal control environment.

- Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.
- Indications of an inappropriate limitation in the scope of work.
- Indications that the client might be involved in money laundering or other criminal activities.
- The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.

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

30. Information on such matters that the firm obtains may come from, for example:

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

31. In considering whether the firm has the capabilities, competence, time and resources to undertake a new engagement from a new or an existing client, the firm reviews the specific requirements of the engagement and existing partner and staff profiles at all relevant levels. Matters the firm considers include whether:

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

32. The firm also considers whether accepting an engagement from a new or an existing client may give rise to an actual or perceived conflict of interest[8]. Where a potential conflict is identified, the firm considers whether it is appropriate to accept the engagement.

33. Deciding whether to continue a client relationship includes consideration of significant matters that have arisen during the current or previous engagements, and their implications for continuing the relationship. For example, a client may have started to expand its business operations into an area where the firm does not possess the necessary knowledge or expertise.

34. Where the firm obtains information that would have caused it to decline an engagement if that information had been available 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.

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

- Discussing with the appropriate level of the client's management and those charged with its governance regarding the appropriate action that the firm might take based on the relevant facts and circumstances.
- If the firm determines that it is appropriate to withdraw, discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement or from both the

[8] Paragraph 1.4 of the Code of Ethics issued by the ICAI provides that "When in practice, an accountant should both be, and appear to be, free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity". The Guidance Note on Independence of Auditors issued by the ICAI provides that "In addition to ensuring independence during the assignment, it is also essential to avoid any situation in near future which may be interpreted as a threat to independence, as for example, he or any other partner of his firm should not accept any other assignment such as internal audit, system audit and management consultancy services within one year from the completion of audit assignment."

engagement and the client relationship, and the reasons for the withdrawal.

- Considering whether there is a professional, regulatory or legal requirement for the firm to remain in place, or for the firm to report the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities.
- Documenting significant issues, consultations, conclusions and the basis for the conclusions.

## Human Resources

36. 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.

37. Such policies and procedures address the following personnel issues:

(a) Recruitment;

(b) Performance evaluation;

(c) Capabilities;

(d) Competence;

(e) Career development;

(f) Promotion;

(g) Compensation; and

(h) Estimation of personnel needs.

Addressing these issues enables the firm to ascertain the number and characteristics of the individuals required for the firm's engagements. The firm's recruitment processes include procedures that help the firm select individuals of integrity as well as the capacity to develop the capabilities and competence necessary to perform the firm's work.

38. Capabilities and competence are developed through a variety of methods, including the following:

- Professional education.
- Continuing professional development, including training.
- Work experience.
- Coaching by more experienced staff, for example, other members of the engagement team.

39. The continuing competence of the firm's personnel depends to a significant extent on an appropriate level of continuing professional development so that personnel maintain and also enhance their knowledge and capabilities. The firm therefore emphasizes in its policies and procedures, the need for continuing training for all levels of firm personnel, and provides the necessary training resources and assistance to enable personnel to develop and maintain the required capabilities and competence. Where internal technical and training resources are unavailable, or for any other reason, the firm may use a suitably qualified external person for that purpose.

40. The firm's performance evaluation, compensation and promotion procedures give due recognition and reward to the development and maintenance of competence and commitment to ethical principles. In particular, the firm:

(a) Makes personnel aware of the firm's expectations regarding performance and ethical principles;

(b) Provides personnel with evaluation of, and counseling on, performance, progress and career development; and

(c) Helps personnel understand that advancement to positions of greater responsibility depends, among other things, upon performance quality and adherence to ethical principles, and that failure to comply with the firm's policies and procedures may result in disciplinary action.

41. The size and circumstances of the firm will influence the structure of the firm's performance evaluation process. Smaller firms, in particular, may employ less formal methods of evaluating the performance of their personnel.

## Assignment of Engagement Teams

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

engagement partner. The firm should establish policies and procedures requiring that:

(a) The identity and role of the engagement partner are communicated to key members of the client's management and those charged with governance;

(b) The engagement partner has the appropriate capabilities, competence, authority and time to perform the role; and

(c) The responsibilities of the engagement partner are clearly defined and communicated to that partner.

43. Policies and procedures include systems to monitor the workload and availability of engagement partners so as to enable these individuals to have sufficient time to adequately discharge their responsibilities.

44. The firm should also assign appropriate staff with the necessary capabilities, competence and time to perform 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.

45. The firm establishes procedures to assess its staff's capabilities and competence. The capabilities and competence considered when assigning engagement teams, and in determining the level of supervision required, include the following:

- An understanding of, and practical experience with, engagements of a similar nature and complexity through appropriate training and participation.
- An understanding of professional standards and regulatory and legal requirements.
- Appropriate technical knowledge, including knowledge of relevant information technology.
- Knowledge of the relevant industries in which the clients operate.
- Ability to apply professional judgment.
- An understanding of the firm's quality control policies and procedures.

## Engagement Performance

46. The firm should establish policies and procedures designed to

provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances.

47. Through its policies and procedures, the firm seeks to establish consistency in the quality of engagement performance. This is often accomplished through written or electronic manuals, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials. Matters addressed include the following:

- How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
- Processes for complying with applicable engagement standards.
- Processes of engagement supervision, staff training and coaching.
- Methods of reviewing the work performed, the significant judgments made and the form of report being issued.
- Appropriate documentation of the work performed and of the timing and extent of the review.
- Processes to keep all policies and procedures current.

48. It is important that all members of the engagement team understand the objectives of the work they are to perform. Appropriate team-working and training are necessary to assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

49. Supervision includes the following:

- Tracking the progress of the engagement.
- Considering the capabilities and competence of individual members of the engagement team, whether they have sufficient time to carry out their work, whether they understand their instructions and whether the work is being carried out in accordance with the planned approach to the engagement.
- Addressing significant issues arising during the engagement, considering their significance and appropriately modifying the planned approach appropriately.
- Identifying matters for consultation or consideration by more experienced engagement team members during the engagement.

50. Review responsibilities are determined on the basis that more experienced engagement team members, including the engagement partner, review work performed by less experienced team members. Reviewers consider whether:

(a) The work has been performed in accordance with professional standards and regulatory and legal requirements;

(b) Significant matters have been raised for further consideration;

(c) Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;

(d) There is a need to revise the nature, timing and extent of work performed;

(e) The work performed supports the conclusions reached and is appropriately documented;

(f) The evidence obtained is sufficient and appropriate to support the report; and

(g) The objectives of the engagement procedures have been achieved.

## Consultation

51. The firm should establish policies and procedures designed to provide it with reasonable assurance that:

(a) Appropriate consultation takes place on difficult or contentious matters;

(b) Sufficient resources are available to enable appropriate consultation to take place;

(c) The nature and scope of such consultations are documented; and

(d) Conclusions resulting from consultations are documented and implemented.

52. 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.

53. Consultation uses appropriate research resources as well as the collective experience and technical expertise of the firm. Consultation helps to promote quality and improves the application of professional judgment. The

firm seeks to establish a culture in which consultation is recognized as a strength and encourages personnel to consult on difficult or contentious matters.

54. Effective consultation with other professionals requires that those consulted be given all the relevant facts that will enable them to provide informed advice on technical, ethical or other matters. Consultation procedures require consultation with those having appropriate knowledge, seniority and experience within the firm (or, where applicable, outside the firm) on significant technical, ethical and other matters, and appropriate documentation and implementation of conclusions resulting from consultations.

55. A firm needing to consult externally, for example, a firm without appropriate internal resources, may take advantage of advisory services provided by (a) other firms, or (b) professional and regulatory bodies. Before contracting for such services, the firm considers whether the external provider is suitably qualified for that purpose.

56. The documentation of consultations with other professionals that involve difficult or contentious matters is agreed by both the individual seeking consultation and the individual consulted. The documentation is sufficiently complete and detailed to enable an understanding of:

(a) The issue on which consultation was sought; and

(b) The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.

## Differences of Opinion

57. The firm should establish policies and procedures for dealing with and resolving differences of opinion within the engagement team, with those consulted and, where applicable, between the engagement partner and the engagement quality control reviewer. Conclusions reached should be documented and implemented.

58. Such procedures encourage identification of differences of opinion at an early stage, provide clear guidelines as to the successive steps to be taken thereafter, and require documentation regarding the resolution of the differences and the implementation of the conclusions reached. The report should not be issued until the matter is resolved.

59. A firm using a suitably qualified external person(s) to conduct an

engagement quality control review recognizes that differences of opinion can occur and establishes procedures to resolve such differences, for example, by consulting with another practitioner or firm, or a professional or regulatory body.

## Engagement Quality Control Review

60. The firm should establish policies and procedures requiring, for appropriate engagements, an engagement quality control review that provides an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report. Such policies and procedures should:

(a) Require an engagement quality control review for all audits of financial statements of listed entities;

(b) Set out criteria against which all other audits and reviews of historical financial information, and other assurance and related services engagements should be evaluated to determine whether an engagement quality control review should be performed; and

(c) Require an engagement quality control review for all engagements meeting the criteria established in compliance with subparagraph (b).

61. The firm's policies and procedures should require the completion of the engagement quality control review before the report is issued.

62. Criteria that a firm considers when determining which engagements other than audits of financial statements of listed entities are to be subject to an engagement quality control review include the following:

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

63. The firm should establish policies and procedures setting out:

(a) The nature, timing and extent of an engagement quality control review;

(b) Criteria for the eligibility of engagement quality control reviewers; and

(c) Documentation requirements for an engagement quality control review.

Nature, Timing and Extent of the Engagement Quality Control Review

64. An engagement quality control review ordinarily involves discussion with the engagement partner, a review of the financial statements or other subject matter information and the report, and, in particular, consideration of whether the report is appropriate. It also involves a review of selected working papers relating to the significant judgments that the engagement team made and the conclusions they reached. 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.

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

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

Engagement quality control reviews for engagements other than audits of

financial statements of listed entities may, depending on the circumstances, include some or all of these considerations.

66. The engagement quality control reviewer conducts the review in a timely manner at appropriate stages during the engagement so that significant matters may be promptly resolved to the reviewer's satisfaction before the report is issued.

67. Where the engagement quality control reviewer makes recommendations that the engagement partner does not accept and the matter is not resolved to the reviewer's satisfaction, the report is not issued until the matter is resolved by following the firm's procedures for dealing with differences of opinion.

Criteria for the Eligibility of Engagement Quality Control Reviewers

68. The firm's policies and procedures should address the appointment of engagement quality control reviewers and establish their eligibility through:

(a) The technical qualifications required to perform the role, including the necessary experience and authority; and

(b) The degree to which an engagement quality control reviewer can be consulted on the engagement without compromising the reviewer's objectivity.

69. The firm's policies and procedures on the technical qualifications of engagement quality control reviewers address the technical expertise, experience and authority necessary to perform the role. What constitutes sufficient and appropriate technical expertise, experience and authority depends on the circumstances of the engagement. In addition, the engagement quality control reviewer for an audit of the financial statements of a listed entity is an individual with sufficient and appropriate experience and authority to act as an audit engagement partner on audits of financial statements of listed entities.

70. The firm's policies and procedures are designed to maintain the objectivity of the engagement quality control reviewer. For example, the engagement quality control reviewer:

(a) Is not selected by the engagement partner;

(b) Does not otherwise participate in the engagement during the period of

review;

(c) Does not make decisions for the engagement team; and

(d) Is not subject to other considerations that would threaten the reviewer's objectivity.

71. The engagement partner may consult the engagement quality control reviewer during the engagement. Such consultation need not compromise the engagement quality control reviewer's eligibility to perform the role. Where the nature and extent of the consultations become significant, however, care is taken by both the engagement team and the reviewer to maintain the reviewer's objectivity. Where this is not possible, another individual within the firm or a suitably qualified external person is appointed to take on the role of either the engagement quality control reviewer or the person to be consulted on the engagement. The firm's policies provide for the replacement of the engagement quality control reviewer where the ability to perform an objective review may be impaired.

72. Suitably qualified external persons may be contracted where sole practitioners or small firms identify engagements requiring engagement quality control reviews. Alternatively, some sole practitioners or small firms may wish to use other firms to facilitate engagement quality control reviews. Where the firm contracts suitably qualified external persons, the firm follows the requirements and guidance in paragraphs 69-72.

### Documentation of the Engagement Quality Control Review

73. Policies and procedures on documentation of the engagement quality control review should require documentation that:

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

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

(c) The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

## Engagement Documentation

Completion of the Assembly of Final Engagement Files

74. 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.

75. Law or regulation may prescribe the time limits by which the assembly of final engagement files for specific types of engagement should be completed. Where no such time limits are prescribed in law or regulation, the firm establishes time limits appropriate to the nature of the engagements that reflect the need to complete the assembly of final engagement files on a timely basis. In the case of an audit, for example, such a time limit is ordinarily not more than 60 days after the date of the auditor's report.

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

Confidentiality, Safe Custody, Integrity, Accessibility and Retrievability of Engagement Documentation

77. The firm should establish policies and procedures designed to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation.

78. Relevant ethical requirements establish an obligation for the firm's personnel to observe at all times the confidentiality of information contained in engagement documentation, unless specific client authority has been given to disclose information, or there is a legal or professional duty to do so. Specific laws or regulations may impose additional obligations on the firm's personnel to maintain client confidentiality, particularly where data of a personal nature are concerned.

79. Whether engagement documentation is in paper, electronic or other media, the integrity, accessibility or retrievability of the underlying data may be compromised if the documentation could be altered, added to or deleted without the firm's knowledge, or if it could be permanently lost or damaged. Accordingly, the firm designs and implements appropriate controls for

engagement documentation to:

(a) Enable the determination of when and by whom engagement documentation was created, changed or reviewed;

(b) Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties via the Internet;

(c) Prevent unauthorized changes to the engagement documentation; and

(d) Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.

80. Controls that the firm may design and implement to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation include, for example:

- The use of a password among engagement team members to restrict access to electronic engagement documentation to authorized users.
- Appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement.
- Procedures for properly distributing engagement documentation to the team members at the start of engagement, processing it during engagement, and collating it at the end of engagement.
- Procedures for restricting access to, and enabling proper distribution and confidential storage of, hardcopy engagement documentation.

81. For practical reasons, original paper documentation may be electronically scanned for inclusion in engagement files. In that case, the firm implements appropriate procedures requiring engagement teams to:

(a) Generate scanned copies that reflect the entire content of the original paper documentation, including manual signatures, cross-references and annotations;

(b) Integrate the scanned copies into the engagement files, including indexing and signing off on the scanned copies as necessary; and

(c) Enable the scanned copies to be retrieved and printed as necessary.

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

### Retention of Engagement Documentation

82. The firm should establish policies and procedures for the retention of engagement documentation for a period sufficient to meet the needs of the firm or as required by law or regulation.

83. The needs of the firm for retention of engagement documentation, and the period of such retention, will vary with the nature of the engagement and the firm's circumstances, for example, whether the engagement documentation is needed to provide a record of matters of continuing significance to future engagements. The retention period may also depend on other factors, such as whether local law or regulation prescribes specific retention periods for certain types of engagements, or whether there are generally accepted retention periods in the jurisdiction in the absence of specific legal or regulatory requirements. In the specific case of audit engagements, the retention period ordinarily is no shorter than ten years from the date of the auditor's report, or, if later, the date of the group auditor's report.

84. Procedures that the firm adopts for retention of engagement documentation include those that:

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

### Ownership of Engagement Documentation

85. 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.

## Monitoring

86. The firm should establish policies and procedures designed to provide it with reasonable assurance that the 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.

87. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

(a) Adherence to professional standards and regulatory and legal requirements;

(b) Whether the quality control system has been appropriately designed and effectively implemented; and

(c) Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.

88. The firm entrusts responsibility for the monitoring process to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility. Monitoring of the firm's system of quality control is performed by competent individuals and covers both the appropriateness of the design and the effectiveness of the operation of the system of quality control.

89. Ongoing consideration and evaluation of the system of quality control includes matters such as the following:

- Analysis of:
  - New developments in professional standards and regulatory and legal requirements, and how they are reflected in the firm's policies and procedures where appropriate;
  - Written confirmation of compliance with policies and procedures on independence;
  - Continuing professional development, including training; and
  - Decisions related to acceptance and continuance of client relationships and specific engagements.
- Determination of corrective actions to be taken and improvements to be

made in the system, including the provision of feedback into the firm's policies and procedures relating to education and training.

- Communication to appropriate firm personnel of weaknesses identified in the system, in the level of understanding of the system, or compliance with it.
- Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures.

90. The inspection of a selection of completed engagements is ordinarily performed on a cyclical basis. Engagements selected for inspection include at least one engagement for each engagement partner over an inspection cycle, which ordinarily spans no more than three years. The manner in which the inspection cycle is organized, including the timing of selection of individual engagements, depends on many factors, including the following:

- The size of the firm.
- The number and geographical location of offices.
- The results of previous monitoring procedures.
- The degree of authority both personnel and offices have (for example, whether individual offices are authorized to conduct their own inspections or whether only the head office may conduct them).
- The nature and complexity of the firm's practice and organization.
- The risks associated with the firm's clients and specific engagements.

91. The inspection process includes the selection of individual engagements, some of which may be selected without prior notification to the engagement team. Those inspecting the engagements are not involved in performing the engagement or the engagement quality control review. In determining the scope of the inspections, the firm may take into account the scope or conclusions of an independent external inspection program. However, an independent external inspection program does not act as a substitute for the firm's own internal monitoring program.

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

93. The firm should evaluate the effect of deficiencies noted as a result

of the monitoring process and should determine whether they are either:

(a) Instances that do not necessarily indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that it complies with professional standards and regulatory and legal requirements, and that the reports issued by the firm or engagement partners are appropriate in the circumstances; or

(b) Systemic, repetitive or other significant deficiencies that require prompt corrective action.

94. The firm should communicate to relevant engagement partners and other appropriate personnel deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action.

95. The firm's evaluation of each type of deficiency should result in recommendations for one or more of the following:

(a) Taking appropriate remedial action in relation to an individual engagement or member of personnel;

(b) The communication of the findings to those responsible for training and professional development;

(c) Changes to the quality control policies and procedures; and

(d) Disciplinary action against those who fail to comply with the policies and procedures of the firm, especially those who do so repeatedly.

96. Where the results of the monitoring procedures indicate that a report may be inappropriate or that procedures were omitted during the performance of the engagement, the firm should determine what further action is appropriate to comply with relevant professional standards and regulatory and legal requirements. It should also consider obtaining legal advice.

97. At least annually, the firm should communicate the results of the monitoring of its quality control system to engagement partners and other appropriate individuals within the firm, including the firm's chief executive officer or, if appropriate, its managing partner(s). Such communication should enable the firm and these individuals to take prompt and appropriate action where necessary in accordance with their defined roles and responsibilities. Information communicated should

include the following:

(a) A description of the monitoring procedures performed.

(b) The conclusions drawn from the monitoring procedures.

(c) Where relevant, a description of systemic, repetitive or other significant deficiencies and of the actions taken to resolve or amend those deficiencies.

98. The reporting of identified deficiencies to individuals other than the relevant engagement partners ordinarily does not include an identification of the specific engagements concerned, unless such identification is necessary for the proper discharge of the responsibilities of the individuals other than the engagement partners.

99. Some firms operate as part of a network and, for consistency, may implement some or all of their monitoring procedures on a network basis. Where firms within a network operate under common monitoring policies and procedures designed to comply with this SQC, and these firms place reliance on such a monitoring system:

(a) At least annually, the network communicates the overall scope, extent and results of the monitoring process to appropriate individuals within the network firms;

(b) The network communicates promptly any identified deficiencies in the quality control system to appropriate individuals within the relevant network firm or firms so that the necessary action can be taken; and

(c) Engagement partners in the network firms are entitled to rely on the results of the monitoring process implemented within the network, unless the firms or the network advises otherwise.

100. Appropriate documentation relating to monitoring:

(a) Sets out monitoring procedures, including the procedure for selecting completed engagements to be inspected;

(b) Records the evaluation of:

(i) Adherence to professional standards and regulatory and legal requirements;

(ii) Whether the quality control system has been appropriately designed and effectively implemented; and

(iii) Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by

the firm or engagement partners are appropriate in the circumstances; and

(c) Identifies the deficiencies noted, evaluates their effect, and sets out the basis for determining whether and what further action is necessary.

### Complaints and Allegations

101. The firm should establish policies and procedures designed to provide it with reasonable assurance that it deals appropriately with:

(a) Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements; and

(b) Allegations of non-compliance with the firm's system of quality control.

102. Complaints and allegations (which do not include those that are clearly frivolous) may originate from within or outside the firm. They may be made by firm personnel, clients or other third parties. They may be received by engagement team members or other firm personnel.

103. As part of this process, the firm establishes clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisals.

104. The firm investigates such complaints and allegations in accordance with established policies and procedures. The investigation is supervised by a partner with sufficient and appropriate experience and authority within the firm but who is not otherwise involved in the engagement, and includes involving legal counsel as necessary. Small firms and sole practitioners may use the services of a suitably qualified external person or another firm to carry out the investigation. Complaints, allegations and the responses to them are documented.

105. Where the results of the investigations indicate deficiencies in the design or operation of the firm's quality control policies and procedures, or non-compliance with the firm's system of quality control by an individual or individuals, the firm takes appropriate action as discussed in paragraph 95.

## Documentation

106. The firm should establish policies and procedures requiring appropriate documentation to provide evidence of the operation of each

element of its system of quality control.

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

108. Factors to consider when determining the form and content of documentation evidencing the operation of each of the elements of the system of quality control include the following:

- The size of the firm and the number of offices.
- The degree of authority both personnel and offices have.
- The nature and complexity of the firm's practice and organization.

109. The firm retains this documentation 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.

## Effective Date

110. This Standard on Quality Control is recommendatory for all engagements relating to accounting periods beginning on or after April 1, 2008 and is mandatory for all engagements relating to accounting periods beginning on or after April 1, 2009.

## Material Modifications to the International Standard on Quality Control (ISQC) 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance Related Services Engagements

### Additions

1. Paragraph 6(d) of the ISQC 1, dealing with the definition of "engagement quality control reviewer" mentions that "other person in the firm" with sufficient and appropriate experience and authority can also act as quality control

reviewer. The SQC 1 has retained this concept subject to the condition that such "other person in the firm" should also be a member of the Institute of Chartered Accountants of India.

2. Paragraph 6(d) of the ISQC 1, while defining the "engagement quality control reviewer" provides that the review can be done by a team of individuals comprising the partner, other person in the firm and/or the suitably qualified external person. The SQC 1 has retained this concept subject to the condition that in case of review by a team of individuals, such team should be headed by a member of the Institute.

3. Paragraph 6(f) of the ISQC 1 defines "firm" as "a sole practitioner, partnership, corporation or other entity of professional accountants". Since in India an individual can practice in his individual name and also in the name of the firm as proprietor of that firm, accordingly, the term 'Proprietor' has been added to the definition of the firm.

4. Paragraph 83 of the ISQC 1 prescribes the minimum period of engagement documentation as five years. The SQC 1 prescribes the minimum period of retention of engagement documentation as ten years since, as per the provisions of the Chartered Accountants Act, 1949, including regulations therein, prescribes the minimum period of retention of working papers as ten years.

Deletions

1. Paragraph 6(f) of the ISQC 1 defines "firm" as "a sole practitioner, partnership, corporation or other entity of professional accountants". Since in India, the practitioners establish any corporate entity for practice, the word 'Corporation' has been deleted from the definition.

2. In terms of paragraph 6(p) of the ISQC 1, defining a "suitably qualified external person" as a partner of another firm, or an employee (with appropriate experience) of either a professional accountancy body whose members may perform audits and reviews of historical financial information, or other assurance or related services engagements, or of an organisation that provides relevant quality control services. Since, in India only the Institute of Chartered Accountants of India is the professional body whose members can carry out an audit or a review of historical financial information or other assurance engagement, a specific reference to this fact appearing in the context of "partner of another firm or an employee" has been deleted from the definition of "suitably qualified external person".

3. Paragraph 6(p) lays down that "an organisation that provides relevant quality control services" can also act as a suitably qualified person. The SQC does not include any such requirement since it is felt that a review of a firm of accountants should be done by a similar firm of accountants only.

4. Paragraph 27 of the ISQC 1 requires that in all engagements of audit of listed companies, the engagement partner of the firm should be rotated within a period of seven years in order to avoid the familiarity threat. The SQC 1 does not mandate such a provision in the audit engagements of the listed entities that are audited by the sole practitioners/proprietors as it is not possible to apply the provision in such cases. However, the SQC 1 provides for peer review of those firms in order to mitigate familiarity threat.

5. The ISQC 1 also deals with the public sector perspective. However, since the Standards, Statements, General Clarifications and Guidance Notes issued by the ICAI are equally applicable in case of all engagements, irrespective of the form, nature and size of the entity, this Standard does not specifically mention that aspect.

# SA 200 (AAS 1)

## BASIC PRINCIPLES GOVERNING AN AUDIT

***(Effective for all audits relating to accounting periods beginning on or after April 1, 1985)***

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Standard on Auditing (SA) 200*, "Basic Principles Governing an Audit" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1] , which sets out the authority of SAs.

* Issued in April, 1985.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. This Standard describes the basic principles which govern the auditor's professional responsibilities and which should be complied with whenever an audit is carried out.

2. An audit is the 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[2]. In this Standard, the term "financial information" encompasses financial statements.

3. Other Standards on Auditing to be issued by the Institute will elaborate on the principles set out herein to give guidance on auditing procedures and reporting practices.

4. Compliance with the basic principles requires the application of auditing procedures and reporting practices appropriate to the particular circumstances.

## Integrity, Objectivity and Independence

5. The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity.

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[2] .Para 3.1 of the "Preface to the Statement on Standard Auditing Practices" issued by the Council of the Institute of Chartered Accountants of India in 1982 states as follows:

> "3.1 The SAPs will apply whenever an independent audit is carried out; that is, in the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size, or legal form (unless specified otherwise) when such an examination is conducted with a view to expressing an opinion thereon. The SAPs may also have application as appropriate, to other related functions of auditors."

The said Preface has been withdrawn pursuant to issuance of the Revised "Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced elsewhere in this Handbook.

## Confidentiality

6. The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose.

## Skills and Competence

7. The audit should be performed and the report should be prepared with due professional care by persons who have adequate training, experience and competence in auditing.

8. The auditor requires specialised skills and competence which are acquired through a combination of general education, technical knowledge obtained through study and formal courses concluded by a qualifying examination recognised for this purpose and practical experience under proper supervision. In addition, the auditor requires a continuing awareness of developments including pronouncements of ICAI on accounting and auditing matters, and relevant regulations and statutory requirements.

## Work Performed by Others

9. When the auditor delegates work to assistants or uses work performed by other auditors and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. In the case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, such as in the case of the work of branch auditors appointed under the Companies Act, 1956, the auditor's report should expressly state the fact of such reliance.

10. The auditor should carefully direct, supervise and review work delegated to assistants. The auditor should obtain reasonable assurance that work performed by other auditors or experts is adequate for his purpose.

## Documentation

11. The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles.

## Planning

12. 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 a knowledge of the client's business.

13. Plans should be made to cover, among other things:

(a) acquiring knowledge of the client's accounting system, policies and internal control procedures;

(b) establishing the expected degree of reliance to be placed on internal control;

(c) determining and programming the nature, timing, and extent of the audit procedures to be performed; and

(d) coordinating the work to be performed.

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

## Audit Evidence

15. The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information.

16. Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect.

17. Substantive procedures are designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system.

They are of two types:

(i) tests of details of transactions and balances;

(ii) analysis of significant ratios and trends including the resulting enquiry of unusual fluctuations and items.

## Accounting System and Internal Control

18. 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. The auditor should reasonably assure himself that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal controls normally contribute to such assurance.

19. The auditor should gain an understanding of the accounting system and related internal controls and should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

20. Where the auditor concludes that he can rely on certain internal controls, his substantive procedures would normally be less extensive than would otherwise be required and may also differ as to their nature and timing.

## Audit Conclusions and Reporting

21. The auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information. This review and assessment involves forming an overall conclusion as to whether:

(a) the financial information has been prepared using acceptable accounting policies, which have been consistently applied;

(b) the financial information complies with relevant regulations and statutory requirements;

(c) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

22. The audit report should contain a clear written expression of opinion on the financial information and if the form or content of the report is laid down

in or prescribed under any agreement or statute or regulation, the audit report should comply with such requirements. An unqualified opinion indicates the auditor's satisfaction in all material respects with the matters dealt with in paragraph 21 or as may be laid down or prescribed under the relevant agreement or statute or regulation, as the case may be.

23. When a qualified opinion, adverse opinion or a disclaimer of opinion is to be given or reservation of opinion on any matter is to be made, the audit report should state the reasons therefor.

## Effective Date

24. This Standard on Auditing becomes operative for all audits relating to accounting periods beginning on or after April 1, 1985.

# SA 200A (AAS 2)

## OBJECTIVE AND SCOPE OF THE AUDIT OF FINANCIAL STATEMENTS

***(Effective for all audits relating to accounting periods beginning on or after April 1, 1985)***

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Standard on Auditing (SA) 200A*, "Objective and Scope of the Audit of Financial Statements" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in April, 1985.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. This Standard describes the overall objective and scope of the audit of general purpose financial statements of an enterprise by an independent auditor. According to para 3.3 of the Preface to the Statements of Accounting Standards[2] issued by the Institute of Chartered Accountants of India, "the term 'General Purpose Financial Statements' includes balance sheet, statement of profit and loss and other statements and explanatory notes which form part thereof, issued for the use of shareholders/members, creditors, employees and public at large." References to financial statements in this Standard should be construed to refer to general purpose financial statements.

## Objective of an Audit

2. The objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements.

3. The auditor's opinion helps determination of the true and fair view of the financial position and operating results of an enterprise. The user, however, should not assume that the auditor's opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise.

## Responsibility for the Financial Statements

4. While the auditor is responsible for forming and expressing his opinion on the financial statements, the responsibility for their preparation is that of the management of the enterprise. Management's responsibilities include the maintenance of adequate accounting records and internal controls, the selection and application of accounting policies and the safeguarding of the assets of the enterprise. The audit of the financial statements does not relieve management of its responsibilities.

## Scope of an Audit

5. The scope of an audit of financial statements will be determined by the

[2] The Preface to Statements of Accounting Standards issued in 1979 has been withdrawn pursuant to issuance of Revised Preface issued in 2004. The aspects relating to para 3.3. of original Preface are dealt by para 3.4 of the said Revised Preface, according to which General Purpose Financial Statements also includes Cash Flow Statements.

auditor having regard to the terms of the engagement, the requirements of relevant legislation and the pronouncements of the Institute. The terms of engagement cannot, however, restrict the scope of an audit in relation to matters which are prescribed by legislation or by the pronouncements of the Institute.

6. The audit should be organised to cover adequately all aspects of the enterprise as far as they are relevant to the financial statements being audited. To form an opinion on the financial statements, the auditor should be reasonably satisfied as to whether the information contained in the underlying accounting records and other source data is reliable and sufficient as the basis for the preparation of the financial statements. In forming his opinion, the auditor should also decide whether the relevant information is properly disclosed in the financial statements subject to statutory requirements, where applicable.

7. The auditor assesses the reliability and sufficiency of the information contained in the underlying accounting records and other source data by:

(a) making a study and evaluation of accounting systems and internal controls on which he wishes to rely and testing those internal controls to determine the nature, extent and timing of other auditing procedures; and

(b) carrying out such other tests, enquiries and other verification procedures of accounting transactions and account balances as he considers appropriate in the particular circumstances.

8. The auditor determines whether the relevant information is properly disclosed in the financial statements by:

(a) comparing the financial statements with the underlying accounting records and other source data to see whether they properly summarise the transactions and events recorded therein; and

(b) considering the judgements that management has made in preparing the financial statements; accordingly, the auditor assesses the selection and consistent application of accounting policies, the manner in which the information has been classified, and the adequacy of disclosure.

9. The auditor's work involves exercise of judgement, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgements and estimates made by management in preparing the financial statements. Furthermore, much of the evidence available to the auditor can enable him to draw only reasonable conclusions therefrom. Because of these factors, absolute certainty in auditing is rarely attainable.

10. In forming his opinion on the financial statements, the auditor follows procedures designed to satisfy himself that the financial statements reflect a true and fair view of the financial position and operating results of the enterprise. The auditor recognises that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any system of internal control, there is an unavoidable risk that some material misstatement may remain undiscovered. While in many situations the discovery of a material misstatement by management may often arise during the conduct of the audit, such discovery is not the main objective of audit nor is the auditor's programme of work specifically designed for such discovery. The audit cannot, therefore, be relied upon to ensure the discovery of all frauds or errors but where the auditor has any indication that some fraud or error may have occurred which could result in material misstatement, the auditor should extend his procedures to confirm or dispel his suspicions.

11. The auditor is primarily concerned with items which either individually or as a group are material in relation to the affairs of an enterprise. However, it is difficult to lay down any definite standard by which materiality can be judged. Material items are those which might influence the decisions of the user of the financial statements[3]. It is a matter in which a decision is arrived at on the basis of the auditor's professional experience and judgement.

12. The auditor is not expected to perform duties which fall outside the scope of his competence. For example, the professional skill required of an auditor does not include that of a technical expert for determining physical condition of certain assets.

13. Constraints on the scope of the audit of financial statements that impair the auditor's ability to express an unqualified opinion on such financial statements should be set out in his report, and a qualified opinion or disclaimer of opinion should be expressed, as appropriate.

## Effective Date

14. This Standard on Auditing becomes operative for all audits relating to accounting periods beginning on or after April 1, 1985.

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[3] Accounting Standard (AS) 1, "Disclosure of Accounting Policies" issued by the Council of the Institute of Chartered Accountants of India.

# SA 210 (AAS 26)

## TERMS OF AUDIT ENGAGEMENT

***(Effective for all audits relating to accounting periods beginning on or after April 1, 2003)***

## Contents


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Standard on Auditing (SA) 210*, "Terms of Audit Engagement" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs. From the date this Standard on Auditing becomes effective, the Guidance Note on Audit Engagement Letters issued by the Institute shall stand withdrawn.

* Issued in January, 2003.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard on Auditing (SA) is to establish standards on:

   (a) agreeing the terms of the engagement with the client; and
   (b) the auditor's response to a request by a client to change the terms of an engagement to one that provides a lower level of assurance[2].

2. The auditor and the client should agree on the terms of the engagement. The agreed terms would need to be recorded in an audit engagement letter or other suitable form of contract.

3. This SA is intended to assist the auditor in the preparation of engagement letters relating to audits of financial statements. The Standard is also applicable to related services. When other services such as tax, accounting, or management consultancy and other services[3] are to be provided, separate letters may be appropriate.

4. Though the objective and scope of an audit and the auditor's obligations are, normally, laid down in the applicable statute or regulations and the pronouncements of the Institute of Chartered Accountants of India, the audit engagement letters would be informative for the clients.

## Audit Engagement Letters

5. In the interest of both client and auditor, the auditor should send an engagement letter, preferably before the commencement of the engagement, to help avoid any misunderstandings with respect to the engagement. The engagement letter documents and confirms the auditor's acceptance of the appointment, the objective and scope of the audit and the extent of the auditor's responsibilities to the client.

### Principal Contents

6. The form and content of audit engagement letter may vary for each

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[2] Refer to Framework of Statements on Standard Auditing Practices and Guidance Notes on Related Services issued in July, 2001 for the meaning of the term "assurance" and the type of engagements that provide a lower level of assurance than an audit.
(The readers may note that the Framework issued in 2001 has been withdrawn pursuant to the issuance of the "Framework for Assurance Engagements", by the Institute of Chartered Accountants of India, in July, 2007. The Revised Framework is applicable from April 1, 2008. The text of the Revised Framework is reproduced elsewhere in this Handbook.)

[3] Code of Ethics issued by the Institute of Chartered Accountants of India defines the term "management consultancy and other services".

client, but it would generally include reference to:

- The objective of the audit of financial statements.
- Management's responsibility for the financial statements.
- Management's responsibility for selection and consistent application of appropriate accounting policies, including implementation of the applicable accounting standards alongwith proper explanation relating to material departures from those accounting standards.
- Management's responsibility for preparation of the financial statements on a going concern basis.
- Management's 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.
- Management's responsibility for the maintenance of adequate accounting records and internal controls for safeguarding the assets of the company and for preventing and detecting fraud or other irregularities.
- The scope of the audit, including reference to the applicable legislation, regulations, and the pronouncements of the Institute of Chartered Accountants of India.
- The fact that having regard to the test nature of an audit, persuasive rather than conclusive nature of audit evidence together with inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements, resulting from fraud, and to a lesser extent error, if either exists, may remain undetected.
- Unrestricted access to whatever records, documentation and other information requested in connection with the audit.
- The fact that the audit process may be subjected to a peer review under the Chartered Accountants Act, 1949.

7. The auditor may also include the following matters in the engagement letter:

- Arrangements regarding the planning of the audit.
- Expectation of receiving from management written confirmation concerning representations made in connection with the audit.
- Request for the client to confirm the terms of the engagement by acknowledging receipt of the engagement letter.

- Description of any other letters or reports the auditor expects to issue to the client.
- Basis on which fees are computed and any billing arrangements.

8. When relevant, the following points could also be included in the engagement letter:

- Arrangements concerning the involvement of other auditors and experts in some aspects of the audit.
- Arrangements concerning the involvement of internal auditors and other staff of the client.
- Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit, i.e., when the financial statements for the preceding period were audited by another auditor.
- Any restriction of the auditor's liability when such possibility exists.
- A reference to any further agreements between the auditor and the client.

An example of an engagement letter for audit under a statute is set out in the Appendix [4].

### Audit of Components

9. When the auditor of a parent entity is also the auditor of its subsidiary, branch or division (component), the factors that influence the decision whether to send a separate engagement letter to the component include:

- Who appoints the auditor of the component?
- Whether a separate audit report is to be issued on the component.
- Legal requirements.
- The extent of any work performed by other auditors.
- Degree of ownership by parent.
- Degree of independence of the management of the component.

## Recurring Audits

10. On recurring audits, the auditor should consider whether

[4] The formats of the engagement letters to be issued in case of compilation, agreed upon procedures or review are given in the Standard on Related Services (SRS) 4410, "Engagements to Compile Financial Information"; SRS 4400, "Engagements to Perform Agreed Upon Procedures Regarding Financial Information", and Standard on Review Engagements (SRE) 2400, "Engagements to Review Financial Statements", respectively.

circumstances require the terms of the engagement to be revised and whether there is a need to remind the client of the existing terms of the engagement.

11. The auditor may decide not to send a new engagement letter each period. However, the following factors may make it appropriate to send a new letter:

- Any indication that the client misunderstands the objective and scope of the audit.
- Any revised or special terms of the engagement.
- A recent change of senior management, board of directors or ownership.
- A significant change in nature or size of the client's business.
- Legal requirements or pronouncements of the Institute of Chartered Accountants of India, or changes in the existing ones.

## Acceptance of a Change in Engagement

12. An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.

13. A request from the client for the auditor to change the engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit or related service originally requested or a restriction on the scope of the engagement, whether imposed by management or caused by circumstances. The auditor would consider carefully the reason given for the request, particularly the implications of a restriction on the scope of the engagement.

14. A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of service originally requested would ordinarily be considered a reasonable basis for requesting a change in the engagement. In contrast, a change would not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory.

15. Before agreeing to change an audit engagement to a related service, an auditor who was engaged to perform an audit in accordance with SAs would consider, in addition to the above matters, any legal or contractual implications of the change.

16. If the auditor concludes that there is reasonable justification to change the engagement and if the audit work performed complies with the SAs applicable to the changed engagement, the report issued would be that appropriate for the revised terms of engagement. In order to avoid confusion, the report would not include reference to:

(a) the original engagement; or

(b) any procedures that may have been performed in the original engagement, except where the 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.

17. Where the terms of the engagement are changed, the auditor and the client should agree on the new terms.

18. The auditor should not agree to a change of engagement where there is no reasonable justification for doing so. An example might be an audit engagement where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the client asks for the engagement to be changed to a review engagement to avoid a qualified, adverse or a disclaimer of opinion.

19. If the auditor is unable to agree to a change of the engagement and is not permitted to continue the original engagement, the auditor should withdraw and consider whether there is any obligation, either contractual or otherwise, to report the circumstances necessitating the withdrawal to other parties, such as the board of directors or shareholders.

## Effective Date

20. This Standard on Auditing becomes operative for all audits relating to accounting periods beginning on or after 1st April, 2003.

## Compatibility with International Standard on Auditing (ISA) 210

The auditing standards established in this SA are generally consistent in all material respects with those set out in ISA 210 “Terms of Audit Engagements".

# Appendix

## Example of an Engagement Letter for an Audit under a Statute[5]

{The following letter is for use as a guide in conjunction with the considerations outlined in this SA and will need to be varied according to individual requirements and circumstances relevant to the engagement. This Appendix does not form part of the Standard.}

To the Board of Directors (or the appropriate representative of senior management).

You have requested that we audit the balance sheet of (Name of the Company) as at 31st March, 2XXX and the related profit and loss account and the (cash flow statement)[6] for the year ended on that date. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.

We will conduct our audit in accordance with the auditing standards generally accepted in India and with the requirements of the Companies Act, 1956. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

However, having regard to the test nature of an audit, persuasive rather than conclusive nature of audit evidence together with inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements of financial statements, resulting from fraud, and to a lesser extent error, if either exists, may remain undetected.

In addition to our report on the financial statements, we expect to provide you with a separate letter concerning any material weaknesses in accounting and internal control systems which might come to our notice.

The responsibility for the preparation of financial statements on a going concern basis is that of the management. The management is also responsible for selection and consistent application of appropriate accounting policies, including implementation of applicable accounting standards along

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[5] In this illustration, the Companies Act, 1956.

[6] Only in cases where relevant.

with proper explanation relating to any material departures from those accounting standards. The management is also responsible 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.

The responsibility of the management also includes the maintenance of adequate accounting records and internal controls for safeguarding of the assets of the company and for the preventing and detecting fraud or other irregularities. As part of our audit process, we will request from management written confirmation concerning representations made to us in connection with the audit.

We also wish to invite your attention to the fact that our audit process is subject to 'peer review' under the Chartered Accountants Act, 1949. The reviewer may examine our working papers during the course of the peer review.

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records; documentation and other information are requested in connection with our audit.

Our fees will be billed as the work progresses.

This letter will be effective for future years unless it is terminated, amended or superseded.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our audit of the financial statements.

XYZ & Co.
Chartered Accountants
……
(Signature)
(Name of the Member)
(Designation[7])

Date :
Place :

Acknowledged on behalf of
ABC Company by
……

(Signature)
Name and Designation
Date

[7] Partner or proprietor, as the case may be.

# GENERAL CLARIFICATION (GC)–AASB/2/2004 ON SA 210

## Standard on Auditing (SA) 210, "Terms of Audit Engagement"

{The following is the General Clarification (GC)–AASB/2/2004 issued by the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India on Standard on Auditing (SA) 210, "Terms of Audit Engagement."}

1. The Standard on Auditing (SA) 210, "Terms of Audit Engagement" was issued with a view to establish standards on:

(a) agreeing the terms of the engagement with the client; and

(b) the auditor's response to a request by a client to change the terms of an engagement to one that provides a lower level of assurance.

2. A question that arises is whether it is necessary that the engagement letter issued by the auditor should be acknowledged by addressee and returned to the auditor to indicate that the client's understanding of the terms of the engagement is in accordance with the engagement letter issued by the auditor and to establish that the auditor has complied with the requirements of the Standard in so far as they are related to sending the audit engagement letter.

3. Paragraphs 2 through 4 of SA 210 provide as follows:

> "2. The auditor and the client should agree on the terms of the engagement. The agreed terms would need to be recorded in an audit engagement letter or other suitable form of contract.
>
> 3. This SA is intended to assist the auditor in the preparation of engagement letters relating to audits of financial statements. The Standard is also applicable to related services. When other services such as tax, accounting, or management consultancy and other services are to be provided, separate letters may be appropriate.
>
> 4. Though the objective and scope of an audit and the auditor's obligations are, normally, laid down in the applicable statute or regulations and the pronouncements of the Institute of Chartered Accountants of India, the audit engagement letters would be informative for the clients."

4. From the above it is clear that the basic purpose of issuing an engagement letter is that the auditor and the client should agree on the terms of the engagement. The auditor and the client are normally considered to be agreeing on the terms of the engagement if the objective and scope of an audit and the auditor's obligations are laid down in the statute or regulations governing the engagement. Examples of such engagements include audit under section 227 of the Companies Act, 1956, audit of public sector banks, etc. In such cases, it is not necessary that the engagement letter sent by the auditor in accordance with paragraph 5 of SA 210 is acknowledged by the addressee and returned to the auditor to establish that the client's understanding of the terms of the engagement is in accordance with the engagement letter issued by the auditor. It shall be sufficient compliance with the requirements related to sending the audit engagement letter, if an engagement letter is appropriately delivered to the client and the auditor retains the evidence for such delivery. In such cases, the audit engagement letters would be informative for the clients.

5. If, however, the client seeks any further explanations or clarification in regard to any terms, conditions or other contents of the engagement letter issued, it might indicate that there exists a difference in understanding of the terms of audit engagement either on the part of the client or on the part of the auditor. The auditor, in such cases, should take necessary steps to resolve the issues, for example by appropriately replying to the issues raised by the client. It is also desirable that the auditor documents the evidence indicating that the issues are settled and the client and auditor agree on the terms of the engagement.

6. There may be certain engagements where the objective and scope of the engagement and the auditor's obligations are not laid down in the applicable statute or regulations. In such situations, the auditor should request the client that a copy of the engagement letter be acknowledged by the addressee and returned to the auditor to establish:

(a) that the client's understanding of the arrangements for the engagement is in accordance with the engagement letter issued by the auditor; and

(b) that the auditor has complied with the requirements of the standard in so far as they are related to sending the audit engagement letter.

# SA 220 (AAS 17)

## QUALITY CONTROL FOR AUDIT WORK

***(Effective for all audits relating to accounting periods beginning on or after April 1, 1999)***

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Standard on Auditing (SA) 220*, "Quality Control for Audit Work" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs. From the date this Standard on Auditing becomes effective, the "Guidance Note on Control of the Quality of Audit Work" issued by the Institute shall stand withdrawn.

* Issued in July, 1999.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard on Auditing (SA) is to establish standards on the quality control:

(a) policies and procedures of an audit firm regarding audit work generally; and

(b) procedures regarding the work delegated to assistants on an individual audit.

2. Quality control policies and procedures should be implemented at both the level of the audit firm and on individual audits.

3. In this SA, the following terms have the meaning attributed below:

(a) "the auditor" means the person with final responsibility for the audit;

(b) "audit firm" means either the partners of a firm providing audit services or a sole practitioner providing audit services, as appropriate;

(c) "personnel" means all partners and professional staff engaged in the audit practice of the firm; and

(d) "assistants" means personnel involved in an individual audit other than the auditor.

## Audit Firm

4. The audit firm should implement quality control policies and procedures designed to ensure that all audits are conducted in accordance with Standards on Auditing (SAs).

5. Compliance with Standards on Auditing (SAs) is essential whenever an audit is carried out and requires the application of auditing procedures and reporting practices appropriate to the particular circumstances. An audit firm needs to implement appropriate quality control policies and procedures to ensure that all audits are carried out in accordance with Standards on Auditing (SAs).

6. The objectives of the quality control policies to be adopted by an audit firm will ordinarily incorporate the following:

(a) Professional Requirements: Personnel in the firm are to adhere to the principles of Independence, Integrity, Objectivity, Confidentiality and Professional Behavior.

(b) Skills and Competence[2]: The firm is to be staffed by personnel who have attained and maintain the Technical Standards and Professional Competence required to enable them to fulfil their responsibilities with Due Care.

(c) Assignment: Audit work is to be assigned to personnel who have the degree of technical training and proficiency required in the circumstances.

(d) Delegation: There is to be sufficient direction, supervision and review of work at all levels to provide reasonable assurance that the work performed meets appropriate standards of quality.

(e) Consultation: Whenever necessary, consultation within or outside the firm is to occur with those who have appropriate expertise.

(f) Acceptance and Retention of Clients: An evaluation of prospective clients and a review, on an ongoing basis, of existing clients is to be conducted. In making a decision to accept or retain a client, the firm's independence and ability to serve the client properly are to be considered.

(g) Monitoring: The continued adequacy and operational effectiveness of quality control policies and procedures is to be monitored.

7. The firm's general quality control policies and procedures should be communicated to its personnel in a manner that provides reasonable assurance that the policies and procedures are understood and implemented.

## Individual Audits

8. The auditor should implement those quality control procedures which are, in the context of the policies and procedures of the firm, appropriate to the individual audit.

9. The auditor, and assistants with supervisory responsibilities, will consider the professional competence of assistants performing work delegated to them when deciding the extent of direction, supervision and review appropriate for each assistant.

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[2]Refer to SA 200, "Basic Principles Governing an Audit".

10. Any delegation of work to assistants would be in a manner that provides reasonable assurance that such work will be performed with due care by persons having the degree of professional competence required in the circumstances.

### Direction

11. Assistants to whom work is delegated need appropriate direction. Direction involves informing assistants of their responsibilities and the objectives of the procedures they are to perform. It also involves informing them of matters, such as the nature of the entity's business and possible accounting or auditing problems that may affect the nature, timing and extent of audit procedures with which they are involved.

12. The audit programme is an important tool for the communication of audit directions. Time budgets and the overall audit plan are also helpful in communicating audit directions.

### Supervision

13. Supervision is closely related to both direction and review and may involve elements of both.

14. Personnel carrying out supervisory responsibilities perform the following functions during the audit:

(a) monitor the progress of the audit to consider whether:

  (i) assistants have the necessary skills and competence to carry out their assigned tasks;

  (ii) assistants understand the audit directions; and

  (iii) the work is being carried out in accordance with the overall audit plan and the audit programme;

(b) become informed of and address significant accounting and auditing questions raised during the audit, by assessing their significance and modifying the overall audit plan and the audit programme as appropriate; and

(c) resolve any differences of professional judgement between personnel and consider the level of consultation that is appropriate.

Review

15. The work performed by each assistant needs to be reviewed by personnel of at least equal competence to consider whether:

(a) the work has been performed in accordance with the audit programme;

(b) the work performed and the results obtained have been adequately documented;

(c) all significant audit matters have been resolved or are reflected in audit conclusions;

(d) the objectives of the audit procedures have been achieved; and

(e) the conclusions expressed are consistent with the results of the work performed and support the audit opinion.

16. The following need to be reviewed on a timely basis:

(a) overall audit plan and the audit programme;

(b) assessments of inherent and control risks, including the results of tests of control and the modifications, if any, made to the overall audit plan and the audit programme as a result of tests of control;

(c) documentation of the audit evidence obtained from substantive procedures and the conclusions drawn therefrom, including the results of consultations; and

(d) financial statements, proposed adjustments in financial statements arising out of the auditor's examination, and the auditor's proposed observations/report.

17. The process of reviewing an audit may include, particularly in the case of large complex audits, requesting personnel not otherwise involved in the audit to perform certain additional procedures before issuing the auditor's report.

## Effective Date

18. This Standard on Auditing becomes operative for all audits relating to accounting periods beginning on or after April 1, 1999.

# SA 230 (AAS 3)

## DOCUMENTATION

***(Effective for all audits relating to accounting periods beginning on or after July 1, 1985)***

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Standard on Auditing (SA) 230*, "Documentation" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in July, 1985.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. Standard on Auditing (SA) 200, "Basic Principles Governing an Audit" (Paragraph 11), states, "The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles." The purpose of this Standard is to amplify the basic principle outlined above.

2. Documentation, for purposes of this Standard, refers to the working papers prepared or obtained by the auditor and retained by him, in connection with the performance of his audit.

3. Working papers:

- ♦ aid in the planning and performance of the audit;
- ♦ aid in the supervision and review of the audit work; and
- ♦ provide evidence of the audit work performed to support the auditor's opinion.

## Form and Content

4. Working papers should record the audit plan, the nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained.

5. The form and content of working papers are affected by matters such as:

- ♦ The nature of the engagement.
- ♦ The form of the auditor's report.
- ♦ The nature and complexity of the client's business.
- ♦ The nature and condition of the client's records and degree of reliance on internal controls.
- ♦ The needs in particular circumstances for direction, supervision and review of work performed by assistants.

6. Working papers should be designed and properly organised to meet the circumstances of each audit and the auditor's needs in respect thereof. The standardisation of working papers (for example, checklists, specimen letters,

standard organisation of working papers) improves the efficiency with which they are prepared and reviewed. It also facilitates the delegation of work while providing a means to control its quality.

7. Working papers should be sufficiently complete and detailed for an auditor to obtain an overall understanding of the audit. The extent of documentation is a matter of professional judgement since it is neither necessary nor practical that every observation, consideration or conclusion is documented by the auditor in his working papers.

8. All significant matters which require the exercise of judgement, together with the auditor's conclusion thereon, should be included in the working papers.

9. To improve audit efficiency, the auditor normally obtains and utilises schedules, analyses and other working papers prepared by the client. In such circumstances, the auditor should satisfy himself that these working papers have been properly prepared. Examples of such working papers are detailed analyses of important revenue accounts, receivables, etc.

10. In the case of recurring audits, some working paper files may be classified as permanent audit files, which are updated currently with information of continuing importance to succeeding audits, as distinct from current audit files, which contain information relating primarily to the audit of a single period.

11. A permanent audit file normally includes:

- Information concerning the legal and organisational structure of the entity. In the case of a company, this includes the Memorandum and Articles of Association. In the case of a statutory corporation, this includes the Act and Regulations under which the corporation functions.
- Extracts or copies of important legal documents, agreements and minutes relevant to the audit.
- A record of the study and evaluation of the internal controls related to the accounting system. This might be in the form of narrative descriptions, questionnaires or flow charts, or some combination thereof.
- Copies of audited financial statements for previous years.

- Analysis of significant ratios and trends.
- Copies of management letters issued by the auditor, if any.
- Record of communication with the retiring auditor, if any, before acceptance of the appointment as auditor.
- Notes regarding significant accounting policies.
- Significant audit observations of earlier years.

12. The current file normally includes:

- Correspondence relating to acceptance of annual reappointment.
- Extracts of important matters in the minutes of Board Meetings and General Meetings, as are relevant to the audit.
- Evidence of the planning process of the audit and audit programme.
- Analysis of transactions and balances.
- A record of the nature, timing and extent of auditing procedures performed, and the results of such procedures.
- Evidence that the work performed by assistants was supervised and reviewed.
- Copies of communications with other auditors, experts and other third parties.
- Copies of letters or notes concerning audit matters communicated to or discussed with the client, including the terms of the engagement and material weaknesses in relevant internal controls.
- Letters of representation or confirmation received from the client.
- Conclusions reached by the auditor concerning significant aspects of the audit, including the manner in which exceptions and unusual matters, if any, disclosed by the auditor's procedures were resolved or treated.
- Copies of the financial information being reported on and the related audit reports.

## Ownership and Custody of Working Papers

13. Working papers are the property of the auditor. The auditor may, at his discretion, make portions of or extracts from his working papers available to his client.

14. The auditor should adopt reasonable procedures for custody and confidentiality of his working papers and should retain them for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirements of record retention.

## Effective Date

15. This Standard on Auditing becomes operative for all audits relating to accounting periods beginning on or after July 1, 1985.

# Standard on Auditing (SA) 230[1] (Revised)
# Audit Documentation

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Material Modifications to ISA 230, "Audit Documentation"


Standard on Auditing (SA) 230 (Revised), "Audit Documentation" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services[2]", which sets out the authority of SAs.

[1] Earlier known as Auditing and Assurance Standard (AAS) 3, "Documentation".

[2] Published in July, 2007 issue of the Journal.

# Introduction

## Scope of this SA

1. This Standard on Auditing (SA) 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.

### Nature and Purposes of Audit Documentation

2. Audit documentation that meets the requirements of this SA and the specific documentation requirements of other relevant SAs provides:

(a) Evidence of the auditor's basis for a conclusion about the achievement of the overall objective of the auditor; and

(b) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

3. Audit documentation serves a number of additional purposes, including the following:

- Assisting the engagement team to plan and perform the audit.
- Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with Proposed SA 220 (Revised)[3].
- Enabling the engagement team to be accountable for its work.
- Retaining a record of matters of continuing significance to future audits.
- Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.

[3] SA 220 (AAS 17), paragraphs 11-17. Proposed SA 220 (Revised), "Quality Control for an Audit of Financial Statements", is being revised in the light of the corresponding International Standard.

- Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

### Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

## Objective

5. 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.

## Definitions

6. For purposes of the SAs, the following terms have the meanings attributed below:

(a) Audit documentation – The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "workpapers" are also sometimes used).

(b) Audit file – 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.

(c) Experienced auditor – An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of:

(i) Audit processes;

(ii) SAs and applicable legal and regulatory requirements;

(iii) The business environment in which the entity operates; and

(iv) Auditing and financial reporting issues relevant to the entity's industry.

## Requirements

### Timely Preparation of Audit Documentation

7. The auditor shall prepare audit documentation on a timely basis. (Ref: Para. A1)

### Documentation of the Audit Procedures Performed and Audit Evidence Obtained

#### Form, Content and Extent of Audit Documentation

8. The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: (Ref: Para. A2-A5, A16- A17)

(a) The nature, timing, and extent of the audit procedures performed to comply with the SAs and applicable legal and regulatory requirements; (Ref: Para. A6-A7)

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

(c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. (Ref: Para. A8- A11)

9. 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; (Ref: Para. A12)

(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. (Ref: Para. A13)

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. (Ref: Para. A14)

11. 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. (Ref: Para. A15)

### Departure from a Relevant Requirement

12. If, in exceptional circumstances, the auditor judges it necessary to depart from a relevant requirement in a SA, the auditor shall document how the alternative audit procedures performed achieve the aim of that requirement, and the reasons for the departure. (Ref: Para. A18-A19)

### Matters Arising after the Date of the Auditor's Report

13. If, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor shall document: (Ref: Para. A20)

(a) The circumstances encountered;

(b) The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and

(c) When and by whom the resulting changes to audit documentation were made and reviewed.

## Assembly of the Final Audit File

14. 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. (Ref: Para. A21-A22)

15. 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. (Ref: Para. A23)

16. In circumstances other than those envisaged in paragraph 13 where the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit file has been completed, the auditor shall, regardless of the nature of the modifications or additions, document: (Ref: Para. A24 -A25)

(a) The specific reasons for making them; and

(b) When and by whom they were made and reviewed.

***

## Application and Other Explanatory Material

### Timely Preparation of Audit Documentation (Ref: Para. 7)

A1. 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.

### Documentation of the Audit Procedures Performed and Audit Evidence Obtained

#### Form, Content and Extent of Audit Documentation (Ref: Para. 8)

A2. The form, content and extent of audit documentation depend on factors such as:

- The size and complexity of the entity.
- The nature of the audit procedures to be performed.

- The identified risks of material misstatement.
- The significance of the audit evidence obtained.
- The nature and extent of exceptions identified.
- 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.
- The audit methodology and tools used.

A3. Audit documentation may be recorded on paper or on electronic or other media. Examples of audit documentation include:

- Audit programmes.
- Analyses.
- Issues memoranda.
- Summaries of significant matters.
- Letters of confirmation and representation.
- Checklists.
- Correspondence (including e-mail) concerning significant matters.

The auditor may include abstracts or copies of the entity's records (for example, significant and specific contracts and agreements) as part of audit documentation. Audit documentation, however, is not a substitute for the entity's accounting records.

A4. 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.

A5. Oral explanations by the auditor, on their own, do not represent adequate support for the work auditor performed or conclusions the auditor reached, but

may be used to explain or clarify information contained in the audit documentation.

Documentation of Compliance with SAs (Ref: Para. 8(a))

A6. In principle, compliance with the requirements of this SA will result in the audit documentation being sufficient and appropriate in the circumstances. Other SAs contain specific documentation requirements that are intended to clarify the application of this SA in the particular circumstances of those SAs. The specific documentation requirements of other SAs do not limit the application of this SA. Furthermore, the absence of a documentation requirement in any particular SA is not intended to suggest that there is no documentation that will be prepared as a result of complying with that SA.

A7. Audit documentation provides evidence that the audit complies with SAs. However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit. Further, it is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file. For example:

- The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.
- The existence of a signed engagement letter in the audit file demonstrates that the auditor has agreed the terms of the audit engagement with management, or where appropriate, those charged with governance.
- An auditor's report containing an appropriately qualified opinion demonstrates that the auditor has complied with the requirement to express a qualified opinion under the circumstances specified in the SAs.
- In relation to requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file:
  - For example, there may be no single way in which the

auditor's professional skepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor's exercise of professional skepticism in accordance with SAs. Such evidence may include specific procedures performed to corroborate management's responses to the auditor's inquiries.

- Similarly, that the engagement partner has taken responsibility for the direction, supervision and performance of the audit in compliance with the SAs may be evidenced in a number of ways within the audit documentation. This may include documentation of the engagement partner's timely involvement in aspects of the audit, such as participation in the team discussion required by SA 315[4].

Documentation of Significant Matters and Related Significant Professional Judgments (Ref: Para. 8(c))

A8. 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 (as defined in SA 315)[5].
- 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.

A9. An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results. Documentation of

[4] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 10.

[5] SA 315, paragraph 4(e).

the professional judgments made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment. 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).

A10. Some examples of circumstances in which, in accordance with paragraph 8, it is appropriate to prepare audit documentation relating to the use of professional judgment include, where the matters and judgments 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 judgments (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.

A11. 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, or that includes cross- references to other relevant supporting audit documentation that provides such information. Such a summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist the auditor's consideration of the significant matters. It may also help the auditor to consider whether, in light of the audit procedures performed and conclusions reached, there is any individual

relevant SA objective that the auditor has not met or is unable to meet that would prevent the auditor from achieving the auditor's overall objective.

Identification of Specific Items or Matters Tested, and of the Preparer and Reviewer (Ref: Para. 9)

A12. Recording the identifying characteristics serves a number of purposes. For example, it enables the engagement team to be accountable for its work and facilitates the investigation of exceptions or inconsistencies. Identifying characteristics will vary with the nature of the audit procedure and the item or matter tested. For example:

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

A13. Proposed SA 220[6] (Revised) requires the auditor to review the audit work performed through review of the audit documentation. The requirement to document who reviewed the audit work performed does not imply a need for each specific working paper to include evidence of review. The requirement, however, means documenting what audit work was reviewed, who reviewed such work, and when it was reviewed.

Documentation of Discussions of Significant Matters with Management, Those Charged with Governance, and Others (Ref: Para. 10)

A14. The documentation is not limited to records prepared by the auditor but may include other appropriate records such as minutes of meetings prepared by the entity's personnel and agreed by the auditor. Others with whom the auditor may discuss significant matters may include other personnel within the entity, and external parties, such as persons providing professional advice to the entity.

Documentation of How Inconsistencies have been addressed (Ref: Para. 11)

A15. The requirement to document how the auditor addressed inconsistencies in information does not imply that the auditor needs to retain documentation that is incorrect or superseded.

Considerations Specific to Smaller Entities (Ref: Para. 8)

A16. The audit documentation for the audit of a smaller entity is generally less extensive than that for the audit of a larger entity. Further, in the case of an audit where the engagement partner performs all the audit work, the documentation will not include matters that might have to be documented solely to inform or instruct members of an engagement team, or to provide evidence of review by other members of the team (for example, there will be no matters to document relating to team discussions or supervision). Nevertheless, the engagement partner complies with the overriding requirement in paragraph 8 to prepare audit documentation that can be understood by an experienced auditor, as the audit documentation may be subject to review by external parties for regulatory or

[6] Hitherto known as AAS 17, refer paragraph 15.

other purposes.

A17. When preparing audit documentation, the auditor of a smaller entity may also find it helpful and efficient to record various aspects of the audit together in a single document, with cross references to supporting working papers as appropriate. Examples of matters that may be documented together in the audit of a smaller entity include the understanding of the entity and its internal control, the overall audit strategy and audit plan, materiality, assessed risks, significant matters noted during the audit, and conclusions reached.

Departure from a Relevant Requirement (Ref: Para. 12)

A18. The objectives and requirements in SAs are designed to support the achievement of the overall objective of the auditor.[7] Accordingly, other than in exceptional circumstances, the SAs call for compliance with each requirement that is relevant in the circumstances of the audit.

A19. The documentation requirement applies only to requirements that are relevant in the circumstances. A requirement is not relevant[8] only in the cases where:

(a) The SA is not relevant [for example, in a continuing engagement, nothing in Proposed SA 510 (Revised)[9] is relevant]; or

(b) The circumstances envisioned do not apply because the requirement is conditional and the condition does not exist (for example, the requirement to modify the auditor's opinion where there is an inability to obtain sufficient appropriate audit evidence, and there is no such inability).

Matters Arising after the Date of the Auditor's Report (Ref: Para. 13)

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[7] Refer paragraph 23-24 of ISA 200 (Revised and Redrafted). SA 200 (AAS 1), "Basic Principles Governing an Audit" and SA 200A (AAS 2), "Objective and Scope of the Audit of Financial Statements". The Standards are being revised in the light of the corresponding International Standard.

[8] Refer paragraph 22- 23 of ISA 200 (Revised and Redrafted).

[9] The Exposure Draft of SA 510 (Revised), "Initial Audit Engagements—Opening Balances", has been published in the October, 2008 issue of the Journal.

A20. Examples of exceptional circumstances include facts which become known to the auditor after the date of the auditor's report but which existed at that date and which, if known at that date, might have caused the financial statements to be amended or the auditor to modify the opinion in the auditor's report.[10] The resulting changes to the audit documentation are reviewed in accordance with the review responsibilities set out in Proposed SA 220 (Revised)[11], with the engagement partner taking final responsibility for the changes.

## Assembly of the Final Audit File (Ref: Para. 14-16)

A21. SQC 1 requires firms to establish policies and procedures for the timely completion of the assembly of audit files.[12] 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.[13]

A22. 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.

A23. SQC 1 requires firms to establish policies and procedures for the retention

[10] SA 560 (Revised), "Subsequent Events", paragraph 13.
[11] Refer footnote 3.
[12] Refer para 74 of SQC 1.
[13] Refer para 75 of SQC 1.

of engagement documentation.[14] The retention period for audit engagements ordinarily is no shorter than ten years from the date of the auditor's report, or, if later, the date of the group auditor's report.[15]

A24. An example of a circumstance in which the auditor may find it necessary to modify existing audit documentation or add new audit documentation after file assembly has been completed is the need to clarify existing audit documentation arising from comments received during monitoring inspections performed by internal or external parties.

### Ownership of Audit Documentation

A25. Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", issued by the Institute, 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.

## Material Modifications to ISA 230, "Audit Documentation"

### Additions

1. Paragraph A23 of ISA 230 prescribes the minimum period of engagement documentation as five years. The SA 230 prescribes the minimum period of retention of engagement documentation as ten years since, as per the provisions of the Chartered Accountants Act, 1949, and regulations made there under, prescribe the minimum period of retention of working papers as ten years.
2. An additional paragraph A25 has been added from SQC 1, giving provisions regarding Ownership of Audit Documentation.

[14] Refer para 82 of SQC 1.
[15] Refer para 83 of SQC 1.

# SA 240 (AAS 4)

## THE AUDITOR'S RESPONSIBILITY TO CONSIDER FRAUD AND ERROR IN AN AUDIT OF FINANCIAL STATEMENTS

***(Effective for all audits relating to accounting periods commencing on or after 1st April 2003)***

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Standard on Auditing (SA) 240*, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1] , which sets out the authority of SAs.

* Issued in January, 2003. This Standard was originally issued in June, 1987 and was titled, "Fraud and Error". The date Standard on Auditing (SA) 240 (Revised) comes into effect, this Standard on Auditing shall stand withdrawn. SA 240 (Revised) is effective for audits of Financial Statements for periods beginning on or after April 1, 2009.

[1] Published in the July, 2007issue of the Journal.

## Introduction

1. The purpose of this Standard on Auditing (SA) is to establish standards on the auditor's responsibility to consider fraud and error in an audit of financial statements. While this SA focuses on the auditor's responsibilities with respect to fraud and error, the primary responsibility for the prevention and detection of fraud and error rests with both those charged with governance and the management of an entity. In this Standard, the term 'financial information' encompasses 'financial statements'. In some circumstances, specific legislations and regulations may require the auditor to undertake procedures additional to those set out in this SA.

2. When planning and performing audit procedures and evaluating and reporting the results thereof, the auditor should consider the risk of material misstatements in the financial statements resulting from fraud or error.

## Fraud and Error and Their Characteristics

3. Misstatements in the financial statements can arise from fraud or error. The term "error" refers to an unintentional misstatement in the financial statements, including the omission of an amount or a disclosure, such as:

- A mistake in gathering or processing data from which financial statements are prepared.
- An incorrect accounting estimate arising from oversight or misinterpretation of facts.
- A mistake in the application of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.

4. The term "fraud" refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Although fraud is a broad legal concept, the auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements. Misstatement of the financial statements may not be the objective of some frauds. Auditors do not make legal determinations of whether fraud has actually occurred. Fraud involving one or more members of management or those charged with governance is referred to as "management fraud"; fraud involving only employees of the entity is referred

to as "employee fraud". In either case, there may be collusion with third parties outside the entity.

5. Two types of intentional misstatements are relevant to the auditor's consideration of fraud-misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

6. Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may involve:

- Deception such as manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared.
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.
- Intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.

7. Misappropriation of assets involves the theft of an entity's assets. Misappropriation of assets can be accomplished in a variety of ways (including embezzling receipts, stealing physical or intangible assets, or causing an entity to pay for goods and services not received); it is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing.

8. Fraud involves motivation to commit fraud and a perceived opportunity to do so. Individuals might be motivated to misappropriate assets, for example, because the individuals are living beyond their means. Fraudulent financial reporting may be committed because management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target particularly when the consequences to management of failing to meet financial goals can be significant. A perceived opportunity for fraudulent financial reporting or misappropriation of assets may exist when an individual believes internal control could be circumvented, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in the internal control system.

9. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement in the financial statements is intentional or unintentional. Unlike error, fraud is intentional and usually

involves deliberate concealment of the facts. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult, if not impossible, for the auditor to determine intent, particularly in matters involving management judgment, such as accounting estimates and the appropriate application of accounting principles.

## Responsibility of Those Charged With Governance and of Management

10. The primary responsibility for the prevention and detection of fraud and error rests with both those charged with the governance and the management of an entity. The respective responsibilities of those charged with governance and management may vary from entity to entity. Management, with the oversight of those charged with governance, needs to set the proper tone, create and maintain a culture of honesty and high ethics, and establish appropriate controls to prevent and detect fraud and error within the entity.

11. It is the responsibility of those charged with governance of an entity to ensure, through oversight of management, the integrity of an entity's accounting and financial reporting systems and that appropriate controls are in place, including those for monitoring risk, financial control and compliance with the laws and regulations.

12. It is the responsibility of the management of an entity to establish a control environment and maintain policies and procedures to assist in achieving the objective of ensuring, as far as possible, the orderly and efficient conduct of the entity's business. This responsibility includes implementing and ensuring the continued operation of accounting and internal control systems, which are designed to prevent and detect fraud and error. Such systems reduce but do not eliminate the risk of misstatements, whether caused by fraud or error. Accordingly, management assumes responsibility for any remaining risk.

## Responsibilities of the Auditor

13. As described in SA 200A, "Objective and Scope of the Audit of Financial Statements", the objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion

on such financial statements. An audit conducted in accordance with the auditing standards generally accepted in India[2] is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The fact that an audit is carried out may act as a deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error.

## Inherent Limitations of an Audit

14. An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the auditing standards generally accepted in India. An audit does not guarantee that all material misstatements will be detected because of such factors as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature. For these reasons, the auditor is able to obtain only a reasonable assurance that material misstatements in the financial statements will be detected.

15. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement resulting from error because fraud, generally, involves sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those involved. Audit procedures that are effective for detecting an error may be ineffective for detecting fraud.

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[2] Paragraph 15 of SA 700, "The Auditor's Report on Financial Statements" describes the standards generally accepted in India.

16. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because those charged with governance and management are often in a position that assumes their integrity and enables them to override the formally established control procedures. Certain levels of management may be in a position to override control procedures designed to prevent similar frauds by other employees, for example, by directing subordinates to record transactions incorrectly or to conceal them. Given its position of authority within an entity, management has the ability to either direct employees to do something or solicit their help to assist management in carrying out a fraud, with or without the employees' knowledge.

17. The auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance; hence, in an audit, the auditor does not guarantee that material misstatements, whether from fraud or error, will be detected. Therefore, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not, in and of itself, indicate:

(a) failure to obtain reasonable assurance,
(b) inadequate planning, performance or judgment,
(c) absence of professional competence and due care, or,
(d) failure to comply with auditing standards generally accepted in India.

This is particularly the case for certain kinds of intentional misstatements, since auditing procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion between or among one or more individuals among management, those charged with governance, employees, or third parties, or involves falsified documentation. Whether the auditor has performed an audit in accordance with auditing standards generally accepted in India is determined by the adequacy of the audit procedures performed in the circumstances and the suitability of the auditor's report based on the result of these procedures.

## Professional Skepticism

18. The auditor plans and performs an audit with an attitude of professional skepticism. Such an attitude is necessary for the auditor to identify and properly evaluate, for example:

- Matters that increase the risk of a material misstatement in the financial statements resulting from fraud or error (for instance, management's characteristics and influence over the control environment, industry conditions, and operating characteristics and financial stability).
- Circumstances that make the auditor suspect that the financial statements are materially misstated.
- Evidence obtained (including the auditor's knowledge from previous audits) that brings into question the reliability of management representations.

19. However, unless the audit reveals evidence to the contrary, the auditor is entitled to accept records and documents as genuine. Accordingly, an audit performed in accordance with auditing standards generally accepted in India rarely contemplate authentication of documentation, nor are auditors trained as, or expected to be, experts in such authentication.

Planning Discussions

20. In planning the audit, the auditor should discuss with other members of the audit team, the susceptibility of the entity to material misstatements in the financial statements resulting from fraud or error.

21. Such discussions would involve considering, for example, in the context of the particular entity, where errors may be more likely to occur or how fraud might be perpetrated. Based on these discussions, members of the audit team may gain a better understanding of the potential for material misstatements in the financial statements resulting from fraud or error in the specific areas of the audit assigned to them, and how the results of the audit procedures that they perform may affect other aspects of the audit. Decisions may also be made as to which members of the audit team will conduct certain inquiries or audit procedures, and how the results of those inquiries and procedures will be shared.

Inquiries of Management

22. When planning the audit, the auditor should make inquiries of management:

(a) to obtain an understanding of:

  (i) management's assessment of the risk that the financial statements may be materially misstated as a result of fraud; and

(ii) the accounting and internal control systems management has put in place to address such risk;

(b) to obtain knowledge of management's understanding regarding the accounting and internal control systems in place to prevent and detect error;

(c) to determine whether management is aware of any known fraud that has affected the entity or suspected fraud that the entity is investigating; and

(d) to determine whether management has discovered any material errors.

23. The auditor supplements his own knowledge of the entity's business by making inquiries of management regarding management's own assessment of the risk of fraud and the systems in place to prevent and detect it. In addition, the auditor makes inquiries of management regarding the accounting and internal control systems in place to prevent and detect error. Since management is responsible for the entity's accounting and internal control systems and for the preparation of the financial statements, it is appropriate for the auditor to inquire of management how it is discharging these responsibilities. Matters that might be discussed as part of these inquiries include:

(a) whether there are particular subsidiary locations, business segments, types of transactions, account balances or financial statement categories where the possibility of error may be high, or where fraud risk factors may exist, and how they are being addressed by management;

(b) the work of the entity's internal audit function and whether internal audit has identified fraud or any serious weaknesses in the system of internal control; and

(c) how management communicates to employees its view on responsible business practices and ethical behaviour, such as through ethics policies or codes of conduct.

24. The nature, extent and frequency of management's assessment of such systems and risk vary from entity to entity. In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In other entities, management's assessment may be less formal

and less frequent. The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may be indicative of the lack of importance that management places on internal control.

25. It is also important that the auditor obtains an understanding of the design of the accounting and internal control systems within the entity. In designing such systems, management makes informed judgments on the nature and extent of the control procedures it chooses to implement and the nature and extent of the risks it chooses to assume. As a result of making these inquiries of management, the auditor may learn, for example, that management has consciously chosen to accept the risk associated with a lack of segregation of duties. Information from these inquiries may also be useful in identifying fraud risk factors that may affect the auditor's assessment of the risk that the financial statements may contain material misstatements caused by fraud.

26. It is also important for the auditor to inquire about management's knowledge of frauds that have affected the entity, suspected frauds that are being investigated, and material errors that have been discovered. Such inquiries might indicate possible weaknesses in control procedures if, for example, a number of errors have been found in certain areas. Alternatively, such inquiries might indicate that control procedures are operating effectively because anomalies are being identified and investigated promptly.

27. Although the auditor's inquiries of management may provide useful information concerning the risk of material misstatements in the financial statements resulting from employee fraud, such inquiries are unlikely to provide useful information regarding the risk of material misstatements in the financial statements resulting from management fraud. Accordingly, the auditor's follow-up of fraud risk factors, as discussed in paragraph 39, is of particular relevance in relation to management fraud.

### Discussions with Those Charged with Governance

28. Those charged with governance of an entity have oversight responsibility for systems for monitoring risk, financial control and compliance with the law. In case of clients whose corporate governance practices are well developed and those charged with governance play an active role in oversight of how management has discharged its

responsibilities, auditors are encouraged to seek the views of those charged with governance on the adequacy of accounting and internal control systems in place to prevent and detect fraud and error, the risk of fraud and error, and the competence and integrity of management. Such inquiries may, for example, provide insights regarding the susceptibility of the entity to management fraud. The auditor may have an opportunity to seek the views of those charged with governance during, for example, a meeting with the audit committee to discuss the general approach and overall scope of the audit and eliciting views of independent directors. This discussion may also provide those charged with governance with the opportunity to bring matters of concern to the auditor's attention.

29. Since the responsibilities of those charged with governance and management may vary by entity, it is important that the auditor understands the nature of these responsibilities within an entity to ensure that the inquiries and communications described above are directed to the appropriate individuals[3].

30. In addition, following the inquiries of management described in paragraphs 22-27, the auditor considers whether there are any matters of governance interest to be discussed with those charged with governance of the entity[4]. Such matters may include for example:

- Concerns about the nature, extent and frequency of management's assessments of the accounting and control systems in place to prevent and detect fraud and error, and of the risk that the financial statements may be misstated.
- A failure by management to address appropriately material weaknesses in internal control identified during the prior period's audit.
- The auditor's evaluation of the entity's control environment, including questions regarding management's competence and integrity.
- The effect of any matters, such as those above, on the general approach and overall scope of the audit, including additional procedures that the auditor may need to perform.

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[3] SA 260, "Communications of Audit Matters with Those Charged with Governance", paragraph 8, discusses with whom the auditor communicates when the entity's governance structure is not well defined.

[4] For a discussion of these matters, see SA 260, "Communications of Audit Matters with Those Charged with Governance," paragraphs 11-14.

Audit Risk

31. SA 400 (Revised), "Risk Assessments and Internal Control," paragraph 3, states that "audit risk" is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Such misstatements can result from either fraud or error. SA 400 (Revised) identifies the three components of audit risk i.e., inherent risk, control risk and detection risk, and also provides guidance on how to assess these risks.

Inherent Risk and Control Risk

32. When assessing inherent risk and control risk in accordance with SA 400 (Revised), "Risk Assessments and Internal Control", the auditor should consider how the financial statements might be materially misstated as a result of fraud or error. In considering the risk of material misstatement resulting from fraud, the auditor should consider whether fraud risk factors are present that indicate the possibility of either fraudulent financial reporting or misappropriation of assets.

33. SA 400 (Revised), "Risk Assessments and Internal Control", describes the auditor's assessment of inherent risk and control risk, and how those assessments affect the nature, timing and extent of the audit procedures. In making those assessments, the auditor considers how the financial statements might be materially misstated as a result of fraud or error.

34. The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, using the auditor's knowledge of the business, the auditor may identify events or conditions that provide an opportunity, a motive or a means to commit fraud, or indicate that fraud may already have occurred. Such events or conditions are referred to as "fraud risk factors". For example, a document may be missing, a general ledger may be out of balance, or an analytical procedure may not make sense. However, these conditions may be the result of circumstances other than fraud. Therefore, fraud risk factors do not necessarily indicate the existence of fraud, however, they often have been present in circumstances where frauds have occurred. The presence of fraud risk factors may affect the auditor's assessment of inherent risk or control risk. Examples of fraud risk factors are set out in Appendix 1 to this SA.

35. Fraud risk factors cannot easily be ranked in order of importance or combined into effective predictive models. The significance of fraud risk

factors varies widely. Some of these factors will be present in entities where the specific conditions do not present a risk of material misstatement. Accordingly, the auditor exercises professional judgment when considering fraud risk factors individually or in combination and whether there are specific controls that mitigate the risk.

36. Although the fraud risk factors described in Appendix 1 cover a broad range of situations typically faced by auditors, they are only examples. Moreover, not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size, with different ownership characteristics, in different industries, or because of other differing characteristics or circumstances. Accordingly, the auditor uses professional judgment when assessing the significance and relevance of fraud risk factors and determining the appropriate audit response.

37. The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example, in the case of a large entity, the auditor ordinarily considers factors that generally constrain improper conduct by management, such as the effectiveness of those charged with governance, and the internal audit function. The auditor also considers what steps have been taken to enforce a formal code of conduct, and the effectiveness of the budgeting system. In the case of a small entity, some or all of these considerations may be inapplicable or less important. For example, a smaller entity might not have a written code of conduct but, instead, may have developed a culture that emphasises the importance of integrity and ethical behaviour through oral communication and by management example. Domination of management by a single individual in a small entity does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. Furthermore, fraud risk factors considered at a business segment operating level may provide different insights than the consideration thereof at an entity-wide level.

38. The presence of fraud risk factors may indicate that the auditor will be unable to assess control risk at less than high for certain financial statement assertions. On the other hand, the auditor may be able to identify internal controls designed to mitigate those fraud risk factors that the auditor can test to support a control risk assessment below high.

Detection Risk

39. Based on the auditor's assessment of inherent and control risks (including the results of any tests of controls), the auditor should design substantive procedures to reduce to an acceptably low level the risk that misstatements resulting from fraud and error that are material to the financial statements taken as a whole will not be detected. In designing the substantive procedures, the auditor should address the fraud risk factors that the auditor has identified as being present.

40. SA 400 (Revised) "Risk Assessments and Internal Control", explains that the auditor's control risk assessment, together with the inherent risk assessment, influences the nature, timing and extent of substantive procedures to be performed to reduce detection risk to an acceptably low level. In designing substantive procedures, the auditor addresses fraud risk factors that the auditor has identified as being present. The auditor's response to those factors is influenced by their nature and significance. In some cases, even though fraud risk factors have been identified as being present, the auditor's judgment may be that the audit procedures, including both tests of control, and substantive procedures, already planned, are sufficient to respond to the fraud risk factors.

41. In other circumstances, the auditor may conclude that there is a need to modify the nature, timing and extent of substantive procedures to address fraud risk factors present. In these circumstances, the auditor considers whether the assessment of the risk of material misstatement calls for an overall response, a response that is specific to a particular account balance, class of transactions or assertion, or both types of response. The auditor considers whether changing the nature of audit procedures, rather than the extent of them, may be more effective in responding to identified fraud risk factors. Examples of response procedures are set out in Appendix 2 to this SA, including examples of responses to the auditor's assessment of the risk of material misstatement resulting from both fraudulent financial reporting and misappropriation of assets.

## Procedures when Circumstances Indicate a Possible Misstatement

42. When the auditor encounters circumstances that may indicate that there is a material misstatement in the financial statements resulting

from fraud or error, the auditor should perform procedures to determine whether the financial statements are materially misstated.

43. During the course of the audit, the auditor may encounter circumstances that indicate that the financial statements may contain a material misstatement resulting from fraud or error. Examples of such circumstances that, individually or in combination, may make the auditor suspect that such a misstatement exists are set out in Appendix 3 to this SA.

44. When the auditor encounters such circumstances, the nature, timing and extent of the procedures to be performed depends on the auditor's judgment as to the type of fraud or error indicated, the likelihood of its occurrence, and the likelihood that a particular type of fraud or error could have a material effect on the financial statements. Ordinarily, the auditor is able to perform sufficient procedures to confirm or dispel a suspicion that the financial statements are materially misstated resulting from fraud or error. If not, the auditor considers the effect on the auditor's report, as discussed in paragraph 48.

45. The auditor cannot assume that an instance of fraud or error is an isolated occurrence and therefore, before the conclusion of the audit, the auditor considers whether the assessment of the components of audit risk made during the planning of the audit may need to be revised and whether the nature, timing and extent of the auditor's other procedures may need to be reconsidered. {See SA 400 (Revised), "Risk Assessments and Internal Control," paragraphs 40 and 47} For example, the auditor would consider:

- The nature, timing and extent of substantive procedures.
- The assessment of the effectiveness of internal controls if control risk was assessed below high.
- The assignment of audit team members that may be appropriate in the circumstances.

## Considering Whether an Identified Misstatement may be Indicative of Fraud

46. When the auditor identifies a misstatement, the auditor should consider whether such a misstatement may be indicative of fraud and if there is such an indication, the auditor should consider the implications

of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations.

47. If the auditor has determined that a misstatement is, or may be, the result of fraud, the auditor evaluates the implications, especially those dealing with the organizational position of the person or persons involved. For example, fraud involving misappropriations of cash from a small petty cash fund is ordinarily of little significance to the auditor in assessing the risk of material misstatement due to fraud. This is because both the manner of operating the fund and its size tend to establish a limit on the amount of potential loss, and the custodianship of such funds is ordinarily entrusted to an employee with a low level of authority. Conversely, when the matter involves management with a higher level of authority, even though the amount itself is not material to the financial statement, it may be indicative of a more pervasive problem. In such circumstances, the auditor reconsiders the reliability of evidence previously obtained since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. The auditor also considers the possibility of collusion involving employees, management or third parties when reconsidering the reliability of evidence. If management, particularly at the highest level, is involved in fraud, the auditor may not be able to obtain the evidence necessary to complete the audit and report on the financial statements.

## Evaluation and Disposition of Misstatements, and the Effect on the Auditor's Report

48. When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud or error, the auditor should consider the implications for the audit. SA 320, "Audit Materiality," paragraphs 12-16, and SA 700, "The Auditor's Report on Financial Statements", paragraphs 37-47, provide guidance on the evaluation and disposition of misstatements and the effect on the auditor's report. Where a significant fraud has occurred or the fraud is committed by those charged with governance, the auditor should consider the necessity for a disclosure of the fraud in the financial statements. If adequate disclosure is not made the auditor should consider the necessity for a suitable disclosure in his report.

## Documentation

49. The auditor should document fraud risk factors identified as being present during the auditor's assessment process (see paragraph 32) and document the auditor's response to any such factors (see paragraph 39). If during the performance of the audit, fraud risk factors are identified that cause the auditor to believe that additional audit procedures are necessary, the auditor should document the presence of such risk factors and the auditor's response to them.

50. The auditor must document matters which are important in providing evidence to support the audit opinion, and the working papers must include the auditor's reasoning on all significant matters which require the auditor's judgment, together with the auditor's conclusion thereon. Because of the importance of fraud risk factors in the assessment of the inherent or control risk of material misstatement, the auditor documents fraud risk factors identified and the response considered appropriate by the auditor. (Reference may also be had to SA 230, "Documentation").

## Management Representations

51. The auditor should obtain written representations from management that:

(a) it acknowledges its responsibility for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error;

(b) it believes the effects of those uncorrected financial statement misstatements aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representation;

(c) it has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity; and

(d) it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.

52. SA 580, "Representations by Management" provides guidance on obtaining appropriate representations from management in the audit. In addition to acknowledging its responsibility for the financial statements, it is important that management acknowledges its responsibility for the accounting and internal control systems designed to prevent and detect fraud and error.

53. Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that the auditor obtains written representation from management that any uncorrected misstatements resulting from either fraud or error are, in management's opinion, immaterial, both individually and in the aggregate. Such representations are not a substitute for obtaining sufficient appropriate audit evidence. In some circumstances, management may not believe that certain of the uncorrected financial statement misstatements aggregated by the auditor during the audit are misstatements. For that reason, management may want to add to their written representation words such as, "We do not agree that items ..... and ..... constitute misstatements because [description of reasons]."

54. The auditor may designate an amount below which misstatements need not be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. In so doing, the auditor considers the fact that the determination of materiality involves qualitative as well as quantitative considerations and that misstatements of a relatively small amount could nevertheless have a material effect on the financial statements. The summary of uncorrected misstatements included in or attached to the written representation need not include such misstatements.

55. Because of the nature of fraud and the difficulties encountered by auditors in detecting material misstatements in the financial statements resulting from fraud, it is important that the auditor obtains a written representation from management confirming that it has disclosed to the auditor all facts relating to any frauds or suspected frauds that it is aware of that may have affected the entity, and that management has disclosed to the auditor the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud.

## Communication

56. When the auditor identifies a misstatement resulting from fraud, or a suspected fraud, or error, the auditor should consider the auditor's responsibility to communicate that information to management, those charged with governance and, in some circumstances, when so required by the laws and regulations, to regulatory and enforcement authorities also.

57. Communication of a misstatement resulting from fraud, or a suspected fraud, or error to the appropriate level of management on a timely basis is important because it enables management to take necessary action. The determination of which level of management is the appropriate one is a matter of professional judgment and is affected by such factors as the nature, magnitude and frequency of the misstatement or suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the misstatement or suspected fraud.

58. The determination of which matters are to be communicated by the auditor to those charged with governance is a matter of professional judgment and is also affected by any understanding between the parties as to which matters are to be communicated. Ordinarily, such matters include:

- Questions regarding management competence and integrity.
- Fraud involving management.
- Other frauds which result in a material misstatement of the financial statements.
- Material misstatements resulting from error.
- Misstatements that indicate material weaknesses in internal control, including the design or operation of the entity's financial reporting process.
- Misstatements that may cause future financial statements to be materially misstated.

## Communication of Misstatements Resulting From Error to Management and to Those Charged With Governance

59. If the auditor has identified a material misstatement resulting from error, the auditor should communicate the misstatement to the appropriate level of management on a timely basis, and consider the need to report it to those charged with governance.

60. The auditor should inform those charged with governance of those uncorrected misstatements aggregated by the auditor during the audit that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

61. As noted in paragraph 54, the uncorrected misstatements communicated to those charged with governance need not include the misstatements below a designated amount.

## Communication of Misstatements Resulting From Fraud to Management and to Those Charged with Governance

62. If the auditor has:

(a) identified a fraud, whether or not it results in a material misstatement in the financial statements; or

(b) obtained evidence that indicates that fraud may exist (even if the potential effect on the financial statements would not be material);

the auditor should communicate these matters to the appropriate level of management on a timely basis, and consider the need to report such matters to those charged with governance.

63. When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter is brought to the attention of an appropriate level of management. This is so even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity's organization). The determination of which level of management is the appropriate one is also affected in these circumstances by the likelihood of collusion or the involvement of a member of management.

64. If the auditor has determined that the misstatement is, or may be, the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor:

(a) discusses the matter and the approach to further investigation with an appropriate level of management that is at least one level above those involved, and with management at the highest level; and

(b) if appropriate, suggests that management consult legal counsel.

### Communication of Material Weaknesses in Internal Control

65. The auditor should communicate to management any material weaknesses in internal control related to the prevention or detection of fraud and error, which have come to the auditor's attention as a result of the performance of the audit. The auditor should also be satisfied that those charged with governance have been informed of any material weaknesses in internal control related to the prevention and detection of fraud that either have been brought to the auditor's attention by management or have been identified by the auditor during the audit.

66. When the auditor has identified any material weaknesses in internal control related to the prevention or detection of fraud or error, the auditor communicates these material weaknesses in internal control to management. Because of the serious implications of material weaknesses in internal control related to the prevention and detection of fraud, it is also important that such deficiencies be brought to the attention of those charged with governance.

67. If the integrity or honesty of management or those charged with governance are doubted, the auditor ordinarily considers seeking legal advice to assist in the determination of the appropriate course of action.

### Communication to Regulatory and Enforcement Authorities

68. The auditor's professional duty to maintain the confidentiality of client information ordinarily precludes reporting fraud and error to a party outside the client entity. However, the auditor's legal responsibilities may vary and in certain circumstances, statute, the law or courts of law may override the duty of confidentiality. For example, under the regulatory framework for Non-Banking Financial Companies, an obligation is cast upon the auditor to report

to the Reserve Bank of India any adverse or unfavourable remarks in his report. In such circumstances, the auditor may consider seeking legal advice.

## Auditor Unable to Complete the Engagement

69. If the auditor concludes that it is not possible to continue performing the audit as a result of a misstatement resulting from fraud or suspected fraud, the auditor should:

(a) consider the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) consider the possibility of withdrawing from the engagement; and

(c) if the auditor withdraws:

  (i) discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

  (ii) consider whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

70. The auditor may encounter exceptional circumstances that bring into question the auditor's ability to continue performing the audit, for example, in circumstances where:

(a) the entity does not take the remedial action regarding fraud that the auditor considers necessary in the circumstances, even when the fraud is not material to the financial statements;

(b) the auditor's consideration of the risk of material misstatement resulting from fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or

(c) the auditor has significant concern about the competence or integrity of management or those charged with governance.

71. Because of the variety of the circumstances that may arise, it is not possible to describe definitively when withdrawal from an engagement is appropriate. Factors that affect the auditor's conclusion include the implications of the involvement of a member of management or of those charged with governance (which may affect the reliability of management representations) and the effects on the auditor of continuing association with the entity.

72. The auditor has professional and legal responsibilities in such circumstances and these responsibilities may vary in different circumstances. For example, the auditor may be entitled to, or required to, make a statement or report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities. Given the exceptional nature of the circumstances and the need to consider the legal requirements, the auditor considers seeking legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action.

Communication with an Incoming Auditor

73. Clause 8 of Part I of the First Schedule to the Chartered Accountants Act, 1949 lays down that a Chartered Accountant in practice would be guilty of professional misconduct if he accepts a position as an auditor, previously held by another chartered accountant without first communicating to him in writing. On receipt of an inquiry from a incoming auditor, the existing auditor should advise whether there are any professional reasons why the incoming auditor should not accept the appointment. If the client denies the existing auditor permission to discuss its affairs with the incoming auditor or limits what the existing auditor may say, that fact should be disclosed to the incoming auditor.

74. The auditor may be contacted by an incoming auditor inquiring whether there are any professional reasons why the incoming auditor should not accept the appointment. The responsibilities of existing and incoming auditor are set out in the Code of Ethics, issued by the Institute of Chartered Accountants of India.

75. The extent to which an existing auditor can discuss the affairs of a client with an incoming auditor will depend on whether the existing auditor has obtained the client's permission to do so, and on the professional and legal responsibilities relating to such disclosure. Subject to any constraints arising

from these responsibilities, the existing auditor advises the incoming auditor whether there are any professional reasons not to accept the appointment, providing details of the information and discussing freely with the incoming auditor all matters relevant to the appointment. If fraud or suspected fraud was a factor in the existing auditor's withdrawal from the engagement, it is important that the existing auditor take care to state only the facts (not his or her conclusions) relating to these matters.

## Effective Date

76. This Standard on Auditing becomes operative for all audits relating to accounting periods commencing on or after 1st April 2003.

## Compatibility with International Standard on Auditing (ISA) 240

The auditing standards established in this Standard on Auditing are generally consistent in all material respects with those set out in International Standard on Auditing (ISA) 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements".

## Appendix 1

### Examples of Risk Factors Relating to Misstatements Resulting from Fraud

The fraud risk factors identified in this Appendix are examples of such factors typically faced by auditors in a broad range of situations. However, the fraud risk factors listed below are only examples; not all of these factors are likely to be present in all audits, nor is the list necessarily complete. Furthermore, the auditor exercises professional judgment when considering fraud risk factors individually or in combination and whether there are specific controls that mitigate the risk. Fraud risk factors are discussed in paragraphs 34-38.

### Fraud Risk Factors Relating to Misstatements Resulting from Fraudulent Financial Reporting

Fraud risk factors that relate to misstatements resulting from fraudulent financial reporting may be grouped in the following three categories:

1. Management's Characteristics and Influence over the Control Environment.
2. Industry Conditions.
3. Operating Characteristics and Financial Stability.

For each of these three categories, examples of fraud risk factors relating to misstatements arising from fraudulent financial reporting are set out below:

1. Fraud Risk Factors Relating to Management's Characteristics and Influence over the Control Environment

A. These fraud risk factors pertain to management's abilities, pressures, style, and attitude relating to internal control and the financial reporting process.

- ♦ There is motivation for management to engage in fraudulent financial reporting. Specific indicators might include the following:
  - ✓ A significant portion of management's compensation is represented by bonuses, stock options or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position or cash flow.

- ✓ There is excessive interest by management in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices.
- ✓ Management commits to analysts, creditors and other third parties to achieving what appear to be unduly aggressive or clearly unrealistic forecasts.
- ✓ Management has an interest in pursuing inappropriate means to minimize reported earnings for tax-motivated reasons.

B. There is a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. Specific indicators might include the following:

- ♦ Management does not effectively communicate and support the entity's values or ethics, or management communicates inappropriate values or ethics.
- ♦ Management is dominated by a single person or a small group without compensating controls such as effective oversight by those charged with governance.
- ♦ Management does not monitor significant controls adequately.
- ♦ Management fails to correct known material weaknesses in internal control on a timely basis.
- ♦ Management sets unduly aggressive financial targets and expectations for operating personnel.
- ♦ Management displays a significant disregard for regulatory authorities.
- ♦ Management continues to employ ineffective accounting, information technology or internal auditing staff.
- ♦ Non-financial management participates excessively in, or is preoccupied with, the selection of accounting principles or the determination of significant estimates.
- ♦ There is a high turnover of management, counsel or board members.

- There is a strained relationship between management and the current or predecessor auditor. Specific indicators might include the following:
  - ✓ Frequent disputes with the current or a predecessor auditor on accounting, auditing or reporting matters.
  - ✓ Unreasonable demands on the auditor, including unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report.
  - ✓ Formal or informal restrictions on the auditor that inappropriately limit the auditor's access to people or information, or limit the auditor's ability to communicate effectively with those charged with governance.
  - ✓ Domineering management behaviour in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work.
- There is a history of securities law violations, or claims against the entity or its management alleging fraud or violations of securities laws.
- The corporate governance structure is weak or ineffective, which may be evidenced by, for example:
  - ✓ A lack of members who are independent of management.
  - ✓ Little attention being paid to financial reporting matters and to the accounting and internal control systems by those charged with governance.

2. Fraud Risk Factors Relating to Industry Conditions

These fraud risk factors involve the economic and regulatory environment in which the entity operates.

- New accounting, statutory or regulatory requirements that could impair the financial stability or profitability of the entity.
- A high degree of competition or market saturation, accompanied by declining margins.
- A declining industry with increasing business failures and significant declines in customer demand.

- Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.

3. Fraud Risk Factors Relating to Operating Characteristics and Financial Stability

These fraud risk factors pertain to the nature and complexity of the entity and its transactions, the entity's financial condition, and its profitability.

- Inability to generate cash flows from operations while reporting earnings and earnings growth.
- Significant pressure to obtain additional capital necessary to stay competitive, considering the financial position of the entity (including a need for funds to finance major research and development or capital expenditures).
- Assets, liabilities, revenues or expenses based on significant estimates that involve unusually subjective judgments or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the entity (for example, the ultimate collectibility of receivables, the timing of revenue recognition, the realisability of financial instruments based on highly-subjective valuation of collateral or difficult-to-assess repayment sources, or a significant deferral of costs).
- Significant related party transactions which are not in the ordinary course of business.
- Significant related party transactions which are not audited or are audited by another firm.
- Significant, unusual or highly complex transactions (especially those close to year-end) that pose difficult questions concerning substance over form.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.
- An overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority or contractual arrangements without apparent business purpose.

- Difficulty in determining the organization or person (or persons) controlling the entity.
- Unusually rapid growth or profitability, especially compared with that of other companies in the same industry.
- Especially high vulnerability to changes in interest rates.
- Unusually high dependence on debt, a marginal ability to meet debt repayment requirements, or debt covenants that are difficult to maintain.
- Unrealistically aggressive sales or profitability incentive programs.
- A threat of imminent bankruptcy, foreclosure or hostile takeover.
- Adverse consequences on significant pending transactions (such as a business combination or contract award) if poor financial results are reported.
- A poor or deteriorating financial position when management has personally guaranteed significant debts of the entity.

Fraud Risk Factors Relating to Misstatements Resulting from Misappropriation of Assets

Fraud risk factors that relate to misstatements resulting from misappropriation of assets may be grouped in the following two categories:

1. Susceptibility of Assets to Misappropriation.
2. Controls.

For each of these two categories, examples of fraud risk factors relating to misstatements resulting from misappropriation of assets are set out below. The extent of the auditor's consideration of the fraud risk factors in category 2 is influenced by the degree to which fraud risk factors in category 1 are present.

1. Fraud Risk Factors Relating to Susceptibility of Assets to Misappropriation

These fraud risk factors pertain to the nature of an entity's assets and the degree to which they are subject to theft.

- Large amounts of cash on hand or processed.

- Inventory characteristics, such as small size combined with high value and high demand.
- Easily convertible assets, such as bearer bonds, diamonds or computer chips.
- Fixed asset characteristics, such as small size combined with marketability and lack of ownership identification.

2. Fraud Risk Factors Relating to Controls

These fraud risk factors involve the lack of controls designed to prevent or detect misappropriation of assets.

- Lack of appropriate management oversight (for example, inadequate supervision or inadequate monitoring of remote locations).
- Lack of procedures to screen job applicants for positions where employees have access to assets susceptible to misappropriation.
- Inadequate record keeping for assets susceptible to misappropriation.
- Lack of an appropriate segregation of duties or independent checks.
- Lack of an appropriate system of authorization and approval of transactions (for example, in purchasing).
- Poor physical safeguards over cash, investments, inventory or fixed assets.
- Lack of timely and appropriate documentation for transactions (for example, credits for merchandise returns).
- Lack of mandatory vacations for employees performing key control functions.

# Appendix 2

## Examples of Modifications of Procedures in Response to the Assessment of Fraud Risk Factors in Accordance with Paragraphs 39-41

The following are examples of possible responses to the auditor's assessment of the risk of material misstatement resulting from both fraudulent financial reporting and misappropriation of assets. The auditor exercises judgment to select the most appropriate procedures in the circumstances. The procedures identified may neither be the most appropriate nor necessary in each circumstance. The auditor's response to fraud risk factors is discussed in paragraphs 40-41.

### Overall Considerations

Judgments about the risk of material misstatements resulting from fraud may affect the audit in the following ways:

i. Professional skepticism: The application of professional skepticism may include: (i) increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions, and (ii) increased recognition of the need to corroborate management explanations or representations concerning material matters.

ii. Assignment of members of the audit team: The knowledge, skill and ability of members of the audit team assigned significant audit responsibilities need to be commensurate with the auditor's assessment of the level of risk for the engagement. In addition, the extent of supervision needs to recognize the risk of material misstatement resulting from fraud and the qualifications of members of the audit team performing the work.

iii. Accounting principles and policies: The auditor may decide to consider further management's selection and application of significant accounting policies, particularly those related to revenue recognition, asset valuation or capitalizing versus expensing.

iv. Controls: The auditor's ability to assess control risk below high may be reduced. However, this does not eliminate the need for the auditor to obtain an understanding of the components of the entity's internal control sufficient to plan the audit. In fact, such an understanding may

be of particular importance in further understanding and considering any controls (or lack thereof) the entity has in place to address the fraud risk factors identified. However, this consideration also needs to include an added sensitivity to management's ability to override such controls.

The nature, timing and extent of procedures may need to be modified in the following ways:

- The nature of audit procedures performed may need to be changed to obtain evidence that is more reliable or to obtain additional corroborative information. For example, more audit evidence may be needed from independent sources outside the entity.
- The timing of substantive procedures may need to be altered to be closer to, or at, year-end. For example, if there are unusual incentives for management to engage in fraudulent financial reporting, the auditor might conclude that substantive procedures should be performed near or at year-end because it would not be possible to control the incremental audit risk associated with that fraud risk factor.
- The extent of the procedures applied will need to reflect the assessment of the risk of material misstatement resulting from fraud. For example, increased sample sizes or more extensive analytical procedures may be appropriate.

The auditor considers whether changing the nature of the audit procedures, rather than the extent of them, may be more effective in responding to identified fraud risk factors.

### Considerations at the Account Balance, Class of Transactions and Assertion Level

Specific responses to the auditor's assessment of the risk of material misstatement resulting from fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified, and the account balances, classes of transactions and assertions they may affect. If these factors or conditions indicate a particular risk applicable to specific account balances or types of transactions, audit procedures addressing these specific areas will need to be considered that will, in the auditor's judgment, limit audit risk to an appropriate level in light of the fraud risk factors or conditions identified.

The following are specific examples of responses:

- Visit locations or perform certain tests on a surprise or unannounced basis. For example, observe inventory at locations where auditor attendance has not been previously announced or count cash at a particular date on a surprise basis.
- Request that inventories be counted at a date closer to the year-end.
- Alter the audit approach in the current year. For example, contact major customers and suppliers orally in addition to sending written confirmation, send confirmation requests to a specific party within an organization, or seek more and different information.
- Perform a detailed review of the entity's quarter-end or year-end adjusting entries and investigate any entries that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year-end, investigate the possibility of related parties and the sources of financial resources supporting the transactions.
- Perform substantive analytical procedures at a detailed level. For example, compare sales and cost of sales by location and line of business to expectations developed by the auditor.
- Conduct interviews of personnel involved in areas for which there is a concern about the risk of material misstatement resulting from fraud, to obtain their insights about the risk and whether, or how, controls address the risk.
- When other auditors are auditing the financial statements of one or more subsidiaries, divisions or branches, consider discussing with them the extent of work necessary to be performed to ensure that the risk of material misstatement resulting from fraud resulting from transactions and activities among these components is adequately addressed.
- If the work of an expert becomes particularly significant with respect a financial statement item for which the risk of misstatement due to fraud is high, perform additional procedures relating to some or all of the expert's assumptions, methods or findings to determine that the findings are not unreasonable, or engage another expert for that purpose.

- Perform audit procedures to analyze selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgments, for example, an allowance for sales returns, were resolved with the benefit of hindsight.
- Perform procedures on account or other reconciliation(s) prepared by the entity, including consideration of reconciliation(s) performed at interim periods.
- Perform computer-assisted techniques, such as data mining to test for anomalies in a population.
- Test the integrity of computer-produced records and transactions.
- Seeking additional audit evidence from sources outside of the entity being audited.

Specific Responses-Misstatements Resulting from Fraudulent Financial Reporting

Examples of responses to the auditor's assessment of the risk of material misstatements resulting from fraudulent financial reporting are as follows:

- Revenue recognition: If there is a risk of material misstatement resulting from fraud that may involve or result in improper revenue recognition, it may be appropriate to confirm with customers certain relevant contract terms and the absence of side agreements, inasmuch as the appropriate accounting is often influenced by such terms or agreements.
- Inventory quantities: If there is a risk of material misstatement resulting from fraud relating to inventory quantities, reviewing the entity's inventory records may help to identify locations, areas or items for specific attention during or after the physical inventory count. Such a review may lead, for example, to a decision to observe inventory counts at certain locations on an unannounced basis, or to ask management to ensure that counts at all locations subject to count are performed on the same date.
- Non-standard journal entries: If there is a risk of material misstatements resulting from fraudulent financial reporting, performing tests of non-standard journal entries to confirm that they are adequately supported

and reflect underlying events and transactions may help in identifying fictitious entries of aggressive recognition practices. While there is not generally accepted definition of non-standard journal entries, in general, they are financial statement changes or entries made in the books and records (including computer records) of an entity that usually are initiated by management-level personnel and are not routine or associated with the normal processing of transactions.

Specific Responses - Misstatements Resulting from Misappropriations of Assets

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to a risk of material misstatement resulting from fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions.

Although some of the audit responses noted in the two categories above may apply in such circumstances, the scope of the work is to be linked to the specific information about the misappropriation risk that has been identified. For example, where a particular asset is highly susceptible to misappropriation that is potentially material to the financial statements, it may be useful for the auditor to obtain an understanding of the control procedures related to the prevention and detection of such misappropriation and to test the operating effectiveness of such controls.

# Appendix 3

## Examples of Circumstances that Indicate the Possibility of Fraud or Error

The auditor may encounter circumstances that, individually or in combination, indicate the possibility that the financial statements may contain a material misstatement resulting from fraud or error. The circumstances listed below are only examples; neither all of these circumstances are likely to be present in all audits nor is the list necessarily complete. Circumstances that indicate a possible misstatement are discussed in paragraphs 43-44.

- Unrealistic time deadlines for audit completion imposed by management.
- Reluctance by management to engage in frank communication with appropriate third parties, such as regulators and bankers.
- Limitation in audit scope imposed by management.
- Identification of important matters not previously disclosed by management.
- Significant difficult-to-audit figures in the accounts.
- Aggressive application of accounting principles.
- Conflicting or unsatisfactory evidence provided by management or employees.
- Unusual documentary evidence such as handwritten alterations to documentation, or handwritten documentation which is ordinarily electronically printed.
- Information provided unwillingly or after unreasonable delay.
- Seriously incomplete or inadequate accounting records.
- Unsupported transactions.
- Unusual transactions, by virtue of their nature, volume or complexity, particularly if such transactions occurred close to the year-end.
- Transactions not recorded in accordance with management's general or specific authorization.

- Significant unreconciled differences between control accounts and subsidiary records or between physical count and the related account balance which were not appropriately investigated and corrected on a timely basis.
- Inadequate control over computer processing (for example, too many processing errors; delays in processing results and reports).
- Significant differences from expectations disclosed by analytical procedures.
- Fewer confirmation responses than expected or significant differences revealed by confirmation responses.
- Evidence of an unduly lavish lifestyle by officers or employees.
- Unreconciled suspense accounts.
- Long outstanding account receivable balances.

# SA 240 (REVISED)[1]

## THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS

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

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[1] Issued in December, 2007. Earlier known as the Auditing and Assurance Standard (AAS) 4, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements".

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Appendices:

1. Examples of Fraud Risk Factors
2. Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatement Due to Fraud
3. Examples of Circumstances that Indicate the Possibility of Fraud

Standard on Auditing (SA) 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services[2]," which sets out the authority of SAs.

[2] Published in the July, 2007 issue of the Journal.

# Introduction

## Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities relating to fraud in an audit of financial statements. Specifically, it expands on how SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment," and SA 330, "The Auditor's Responses to Assessed Risks," are to be applied in relation to risks of material misstatement due to fraud.

### Characteristics of Fraud

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

3. Although fraud is a broad legal concept, for the purposes of the SAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements. Two types of intentional misstatements are relevant to the auditor – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred. (Ref: Para. A1-A6)

### Responsibility for the Prevention and Detection of Fraud

4. The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance. In exercising oversight responsibility, those charged with governance consider the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.

Responsibilities of the Auditor

5. 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. As described in SA 200, "Objective and General Principles Governing an Audit of Financial Statements[3]," owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.

6. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

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

8. When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting

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[3] Presently, AAS 1 (Renumbered as SA 200), "Basic Principles Governing an Internal Audit" and AAS 2 (Renumbered as SA 200A), "Objective and Scope of an Audit of Financial Statements" correspond to International Standard on Auditing (ISA) 200. Both the AASs are currently being revised in the light of the ISA 200. Post this revision, the principles covered by AAS 1 and AAS 2 will be merged into one Standard i.e., SA 200.

error may not be effective in detecting fraud. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

### Effective Date

9. This SA is effective for audits of financial statements for periods beginning on or after 1st April, 2009.

## Objectives

10. The objectives of the auditor are:

(a) To identify and assess the risks of material misstatement in the financial statements due to fraud;

(b) To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and

(c) To respond appropriately to identified or suspected fraud.

## Definitions

11. For purposes of the SAs, the following terms have the meanings attributed below:

(a) Fraud - An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

(b) Fraud risk factors - Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

## Requirements

### Professional Skepticism

12. In accordance with SA 200, the auditor shall maintain an attitude of professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. A7- A8)

13. Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be

authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. (Ref: Para. A9)

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

## Discussion Among the Engagement Team

15. SA 315 requires a discussion among the engagement team members and a determination by the engagement partner of matters which are to be communicated to those team members not involved in the discussion[4]. This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur notwithstanding the engagement team members' beliefs that management and those charged with governance are honest and have integrity. (Ref: Para. A10-A11)

## Risk Assessment Procedures and Related Activities

16. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, required by SA 315[5], the auditor shall perform the procedures in paragraphs 17-24 to obtain information for use in identifying the risks of material misstatement due to fraud.

### Management and Others within the Entity

17. The auditor shall make inquiries of management regarding:

(a) Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments; (Ref: Para. A12-A13)

(b) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist; (Ref: Para. A14)

(c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and

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[4] SA 315, paragraph 10.

[5] SA 315, paragraphs 5-23.

(d) Management's communication, if any, to employees regarding its views on business practices and ethical behavior.

18. The auditor shall make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. (Ref: Para. A15-A17)

19. For those entities that have an internal audit function, the auditor shall make inquiries of internal audit to determine whether it has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud. (Ref: Para. A18)

Those Charged with Governance

20. Unless all of those charged with governance are involved in managing the entity, the auditor shall obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks. (Ref: Para. A19-A21)

21. The auditor shall make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries of management.

Unusual or Unexpected Relationships Identified

22. The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

Other Information

23. The auditor shall consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud. (Ref: Para. A22)

Evaluation of Fraud Risk Factors

24. The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud. (Ref: Para. A23-A27)

## Identification and Assessment of the Risks of Material Misstatement Due to Fraud

25. In accordance with SA 315, the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures[6].

26. When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Paragraph 47 specifies the documentation required when the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud. (Ref: Para. A28-A30)

27. The auditor shall treat those assessed risks of material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the auditor shall obtain an understanding of the entity's related controls, including control activities, relevant to such risks. (Ref: Para. A31-A32)

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

### Overall Responses

28. In accordance with SA 330, the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level. (Ref: Para. A33)

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

(a) Assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud for the engagement; (Ref: Para. A34-A35)

(b) Evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial

[6] SA 315, Paragraph 24.

reporting resulting from management's effort to manage earnings; and

(c) Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures. (Ref: Para. A36)

### Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level

30. In accordance with SA 330, the auditor shall design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level. (Ref: Para. A37-A40)

### Audit Procedures Responsive to Risks Related to Management Override of Controls

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

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

(a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:

  (i) Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;

  (ii) Select journal entries and other adjustments made at the end of a reporting period; and

  (iii) Consider the need to test journal entries and other adjustments throughout the period. (Ref: Para. A41-A44)

(b) Review accounting estimates[7] for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the auditor shall:

(i) Evaluate whether the judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor shall re-evaluate the accounting estimates taken as a whole; and

(ii) Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year[8]. (Ref: Para. A45-A46)

(c) For significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit, the auditor shall evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. (Ref: Para. A47)

33. The auditor shall determine whether, in order to respond to the identified risks of management override of controls, the auditor needs to perform other audit procedures in addition to those specifically referred to above (i.e., when there are specific additional risks of management override that are not covered as part of the procedures performed to address the requirements in paragraph 32).

## Evaluation of Audit Evidence (Ref: Para. A48)

34. The auditor shall evaluate whether analytical procedures[9] that are performed when forming an overall conclusion as to whether the financial

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[7] Reference may be made to SA 540, "Auditing of Accounting Estimates".

[8] Accounting Standard (AS) 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires the adjustment of the prior period estimates, which may affect both the period of change in the Accounting Estimates and subsequent periods, in the subsequent years.

[9] Reference may be made to SA 520, "Analytical Procedures".

statements as a whole are consistent with the auditor's understanding of the entity and its environment indicate a previously unrecognized risk of material misstatement due to fraud. (Ref: Para. A49)

35. When the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. (Ref: Para. A50)

36. If the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor shall re-evaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained. (Ref: Para. A51)

37. When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud the auditor shall evaluate the implications for the audit. (Ref: Para. A52)

## Auditor Unable to Continue the Engagement

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

(a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and

(c) If the auditor withdraws:

  (i) Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

  (ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the

audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal. (Ref: Para. A53-A56)

## Management Representations

39. The auditor shall obtain written representations from management that:

(a) It acknowledges its responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;

(b) It has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud;

(c) It has disclosed to the auditor its knowledge of fraud or suspected fraud affecting the entity involving:

  (i) Management;

  (ii) Employees who have significant roles in internal control; or

  (iii) Others where the fraud could have a material effect on the financial statements; and

(d) It has disclosed to the auditor its knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (Ref: Para. A57-A58)

## Communications to Management and with Those Charged with Governance

40. If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. (Ref: Para. A59)

41. Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving:

(a) Management;

(b) Employees who have significant roles in internal control; or

(c) Others where the fraud results in a material misstatement in the financial statements.

The auditor shall communicate these matters to those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit. (Ref: Para. A60-A62)

42. In accordance with SA 260 (Revised), "Communication with Those Charged with Governance[10]," the auditor shall communicate with those charged with governance any other matters related to fraud that are, in the auditor's judgment, relevant to their responsibilities. (Ref: Para. A63)

## Communications to Regulatory and Enforcement Authorities

43. If the auditor has identified or suspects a fraud, the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances. (Ref: Para. A64-A66)

## Documentation

44. The auditor's documentation of the understanding of the entity and its environment and the assessment of the risks of material misstatement required by SA 315 shall include:

(a) The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and

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

45. The auditor's documentation of the responses to the assessed risks of material misstatement required by SA 330 shall include:

(a) The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and

(b) The results of the audit procedures, including those designed to

[10] Hitherto known as the Auditing and Assurance Standard (AAS) 27, "Communication of Audit Matters with Those Charged with Governance".

address the risk of management override of controls.

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

47. When the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is not applicable in the circumstances of the engagement, the auditor shall document the reasons for that conclusion.

## Application and Other Explanatory Material

### Characteristics of Fraud (Ref: Para. 3)

A1. Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. For example:

- Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome – particularly since the consequences to management for failing to meet financial goals can be significant. Similarly, individuals may have an incentive to misappropriate assets, for example, because the individuals are living beyond their means.
- A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in internal control.
- Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

A2. Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. It can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability. Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting. Such a

situation could occur when, due to pressures to meet market expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.

A3. Fraudulent financial reporting may be accomplished by the following:

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

A4. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:

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

A5. Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a

variety of ways including:

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

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

A6. The auditor may, at times, be required to by a legislation or a regulation to make a specific assertion in respect of frauds on/by the entity in his report. For example, Clause (xxi) of Paragraph 4 of the Companies (Auditor's Report) Order, 2003 requires the auditor to specifically report "whether any fraud on or by the entity has been noticed or reported during the year; if yes, the nature and amount involved is to be indicated". Similarly, in case of audit of banks, the auditors, in terms of the circular no. DBS.FGV.(F).No. BC/23.08.001/2001-02, is required to report to the Reserve Bank of India anything susceptible to fraud or fraudulent activity or act of excess power or any foul play in any transaction. Consequently, in such cases, the auditor's responsibilities may not be limited to consideration of risks of material misstatement of the financial statements, but may also include a broader responsibility to consider risks of fraud.

Professional Skepticism (Ref: Para. 12-14)

A7. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. Maintaining an attitude of professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance where relevant. Due to the characteristics of

fraud, the auditor's attitude of professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

A8. Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance, the auditor's attitude of professional skepticism is particularly important in considering the risks of material misstatement due to fraud because there may have been changes in circumstances.

A9. As explained in SA 200, an audit performed in accordance with SAs rarely involves the authentication of documents, nor is the auditor trained as or expected to be an expert in such authentication. However, when the auditor identifies conditions that cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, possible procedures to investigate further may include:

- Confirming directly with the third party.
- Using the work of an expert to assess the document's authenticity.

Discussion Among the Engagement Team (Ref: Para. 15)

A10. Discussing the susceptibility of the entity's financial statements to material misstatement due to fraud with the engagement team:

- Provides an opportunity for more experienced engagement team members to share their insights about how and where the financial statements may be susceptible to material misstatement due to fraud.
- Enables the auditor to consider an appropriate response to such susceptibility and to determine which members of the engagement team will conduct certain audit procedures.
- Permits the auditor to determine how the results of audit procedures will be shared among the engagement team and how to deal with any allegations of fraud that may come to the auditor's attention.

A11. The discussion may include such matters as:

- An exchange of ideas among engagement team members about how and where they believe the entity's financial statements may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.
- A consideration of circumstances that might be indicative of earnings

management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting.

- A consideration of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud.
- A consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation.
- A consideration of any unusual or unexplained changes in behavior or lifestyle of management or employees which have come to the attention of the engagement team.
- An emphasis on the importance of maintaining a proper state of mind throughout the audit regarding the potential for material misstatement due to fraud.
- A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud.
- A consideration of how an element of unpredictability will be incorporated into the nature, timing and extent of the audit procedures to be performed.
- A consideration of the audit procedures that might be selected to respond to the susceptibility of the entity's financial statement to material misstatement due to fraud and whether certain types of audit procedures are more effective than others.
- A consideration of any allegations of fraud that have come to the auditor's attention.
- A consideration of the risk of management override of controls.

## Risk Assessment Procedures and Related Activities

### Inquiries of Management

Management's Assessment of the Risk of Material Misstatement Due to Fraud [Ref: Para. 17(a)]

A12. Management is responsible for the entity's internal control and for the preparation of the financial statements. Accordingly, it is appropriate for the auditor to make inquiries of management regarding management's own assessment of the risk of fraud and the controls in place to prevent and detect it. The nature, extent and frequency of management's assessment of such risk and controls may vary from entity to entity. In some entities, management may make detailed assessments on an annual basis or as part

of continuous monitoring. In other entities, management's assessment may be less structured and less frequent. The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may in some circumstances be indicative of the lack of importance that management places on internal control.

Considerations specific to smaller entities

A13. In some entities, particularly smaller entities, the focus of management's assessment may be on the risks of employee fraud or misappropriation of assets.

Management's Process for Identifying and Responding to the Risks of Fraud (Ref: Para. 17(b))

A14. In the case of entities with multiple locations management's processes may include different levels of monitoring of operating locations, or business segments. Management may also have identified particular operating locations or business segments for which a risk of fraud may be more likely to exist.

Inquiry of Management and Others within the Entity (Ref: Para. 18)

A15. The auditor's inquiries of management may provide useful information concerning the risks of material misstatements in the financial statements resulting from employee fraud. However, such inquiries are unlikely to provide useful information regarding the risks of material misstatement in the financial statements resulting from management fraud. Making inquiries of others within the entity may provide individuals with an opportunity to convey information to the auditor that may not otherwise be communicated.

A16. Examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud include:

- Operating personnel not directly involved in the financial reporting process.
- Employees with different levels of authority.
- Employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees.
- In-house legal counsel.

- Chief ethics officer or equivalent person.
- The person or persons charged with dealing with allegations of fraud.

A17. Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information.

Inquiry of Internal Audit (Ref: Para. 19)

A18. SA 610, "Considering the Work of Internal Audit[11]", establishes requirements and provides guidance in audits of those entities that have an internal audit function. In carrying out the requirement of SA 610 in the context of fraud, the auditor may inquire about specific internal audit activities including, for example:

- The procedures performed, if any, by the internal auditors during the year to detect fraud.
- Whether management has satisfactorily responded to any findings resulting from those procedures.

Obtaining an Understanding of Oversight Exercised by Those Charged With Governance (Ref: Para. 20)

A19. Those charged with governance of an entity have oversight responsibility for systems for monitoring risk, financial control and compliance with the law. In many entities, corporate governance practices are well developed and those charged with governance play an active role in oversight of the entity's assessment of the risks of fraud and of the relevant internal control. Since the responsibilities of those charged with governance and management may vary by entity, it is important that the auditor understands their respective responsibilities to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals.[12]

A20. An understanding of the oversight exercised by those charged with governance may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of internal control over risks of fraud, and the competency and integrity of management. The auditor may obtain this understanding in a number of ways, such as by attending meetings where

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[11] Hitherto known as Auditing and Assurance Standard (AAS) 7, "Relying Upon the Work of an Internal Auditor".

[12] SA 260 (Revised), "Communication with Those Charged with Governance", discusses with whom the auditor communicates when the entity's governance structure is not well defined.

such discussions take place, reading the minutes from such meetings or making inquiries of those charged with governance.

Considerations Specific to Smaller Entities

A21. In some cases, all of those charged with governance are involved in managing the entity. This may be the case in a small entity where a single owner manages the entity and no one else has a governance role. In these cases, there is ordinarily no action on the part of the auditor because there is no oversight separate from management.

Consideration of Other Information (Ref: Para. 23)

A22. In addition to information obtained from applying analytical procedures, other information obtained about the entity and its environment may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members may provide information that is helpful in identifying such risks. In addition, information obtained from the auditor's client acceptance and retention processes, and experience gained on other engagements performed for the entity, for example engagements to review interim financial information, may be relevant in the identification of the risks of material misstatement due to fraud.

Evaluation of Fraud Risk Factors (Ref: Para. 24)

A23. The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, the auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud (fraud risk factors). For example:

- The need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud;
- The granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; and
- A control environment that is not effective may create an opportunity to commit fraud.

A24. Fraud risk factors cannot easily be ranked in order of importance. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present risks of material misstatement. Accordingly, the determination of whether a fraud risk factor is present and whether it is to be considered in assessing the risks of material misstatement of the financial statements due to fraud requires the exercise of professional judgment.

A25. Examples of fraud risk factors related to fraudulent financial reporting

and misappropriation of assets are presented in Appendix 1. These illustrative risk factors are classified based on the three conditions that are generally present when fraud exists:

- An incentive or pressure to commit fraud;
- A perceived opportunity to commit fraud; and
- An ability to rationalize the fraudulent action.

  Risk factors reflective of an attitude that permits rationalization of the fraudulent action may not be susceptible to observation by the auditor. Nevertheless, the auditor may become aware of the existence of such information. Although the fraud risk factors described in Appendix 1 cover a broad range of situations that may be faced by auditors, they are only examples and other risk factors may exist.

A26. The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example, in the case of a large entity, there may be factors that generally constrain improper conduct by management, such as:

- Effective oversight by those charged with governance.
- An effective internal audit function.
- The existence and enforcement of a written code of conduct.

Furthermore, fraud risk factors considered at a business segment operating level may provide different insights when compared with those obtained when considered at an entity-wide level.

Considerations Specific to Smaller Entities

A27. In the case of a small entity, some or all of these considerations may be inapplicable or less relevant. For example, a smaller entity may not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Domination of management by a single individual in a small entity does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In some entities, the need for management authorization can compensate for otherwise weak controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential weakness since

there is an opportunity for management override of controls.

## Identification and Assessment of the Risks of Material Misstatement Due to Fraud

### Risks of Fraud in Revenue Recognition (Ref: Para. 26)

A28. Material misstatement due to fraudulent financial reporting relating to revenue recognition often results from an overstatement of revenues through, for example, premature revenue recognition or recording fictitious revenues. It may result also from an understatement of revenues through, for example, improperly shifting revenues to a later period.

A29. The risks of fraud in revenue recognition may be greater in some entities than others. For example, there may be pressures or incentives on management to commit fraudulent financial reporting through inappropriate revenue recognition in the case of listed entities when, for example, performance is measured in terms of year-over-year revenue growth or profit. Similarly, for example, there may be greater risks of fraud in revenue recognition in the case of entities that generate a substantial portion of revenues through cash sales.

A30. The presumption that there are risks of fraud in revenue recognition may be rebutted. For example, the auditor may conclude that there is no risk of material misstatement due to fraud relating to revenue recognition in the case where there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property.

### Identifying and Assessing the Risks of Material Misstatement Due to Fraud and Understanding the Entity's Related Controls (Ref: Para. 27)

A31. As explained in SA 315 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. In determining which controls to implement to prevent and detect fraud, management considers the risks that the financial statements may be materially misstated as a result of fraud. As part of this consideration, management may conclude that it is not cost effective to implement and maintain a particular control in relation to the reduction in the risks of material misstatement due to fraud to be achieved.

A32. It is therefore important for the auditor to obtain an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud. In doing so, the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. Information from obtaining this understanding may also be useful in identifying fraud risks factors that may

affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

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

### Overall Responses (Ref: Para. 28)

A33. Determining overall responses to address the assessed risks of material misstatement due to fraud generally includes the consideration of how the overall conduct of the audit can reflect increased professional skepticism, for example, through:

- Increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions.
- Increased recognition of the need to corroborate management explanations or representations concerning material matters.

  It also involves more general considerations apart from the specific procedures otherwise planned; these considerations include the matters listed in paragraph 29, which are discussed below.

### Assignment and Supervision of Personnel (Ref: Para. 29(a))

A34. The auditor may respond to identified risks of material misstatement due to fraud by, for example, assigning additional individuals with specialized skill and knowledge, such as forensic and IT experts, or by assigning more experienced individuals to the engagement.

A35. The extent of supervision reflects the auditor's assessment of risks of material misstatement due to fraud and the competencies of the engagement team members performing the work.

### Unpredictability in the Selection of Audit Procedures (Ref: Para. 29(c))

A36. Incorporating an element of unpredictability in the selection of the nature, timing and extent of audit procedures to be performed is important as individuals within the entity who are familiar with the audit procedures normally performed on engagements may be more able to conceal fraudulent financial reporting. This can be achieved by, for example:

- Performing substantive procedures on selected account balances and assertions not otherwise tested due to their materiality or risk.
- Adjusting the timing of audit procedures from that otherwise expected.
- Using different sampling methods.

- Performing audit procedures at different locations or at locations on an unannounced basis.

Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level (Ref: Para. 30)

A37. The auditor's responses to address the assessed risks of material misstatement due to fraud at the assertion level may include changing the nature, timing, and extent of audit procedures in the following ways:

- The nature of audit procedures to be performed may need to be changed to obtain audit evidence that is more reliable and relevant or to obtain additional corroborative information. This may affect both the type of audit procedures to be performed and their combination. For example:
    - Physical observation or inspection of certain assets may become more important or the auditor may choose to use computer-assisted audit techniques to gather more evidence about data contained in significant accounts or electronic transaction files.
    - The auditor may design procedures to obtain additional corroborative information. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a related risk that management is inflating sales by entering into sales agreements that include terms that preclude revenue recognition or by invoicing sales before delivery. In these circumstances, the auditor may, for example, design external confirmations not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor might find it effective to supplement such external confirmations with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.
- The timing of substantive procedures may need to be modified. The auditor may conclude that performing substantive testing at or near the period end better addresses an assessed risk of material misstatement due to fraud. The auditor may conclude that, given the assessed risks of intentional misstatement or manipulation, audit procedures to extend audit conclusions from an interim date to the period end would not be effective. In contrast, because an intentional misstatement—for example, a misstatement involving improper revenue recognition—may

have been initiated in an interim period, the auditor may elect to apply substantive procedures to transactions occurring earlier in or throughout the reporting period.

- The extent of the procedures applied reflects the assessment of the risks of material misstatement due to fraud. For example, increasing sample sizes or performing analytical procedures at a more detailed level may be appropriate. Also, computer-assisted audit techniques may enable more extensive testing of electronic transactions and account files. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

A38. If the auditor identifies a risk of material misstatement due to fraud that affects inventory quantities, examining the entity's inventory records may help to identify locations or items that require specific attention during or after the physical inventory count. Such a review may lead to a decision to observe inventory counts at certain locations on an unannounced basis or to conduct inventory counts at all locations on the same date.

A39. The auditor may identify a risk of material misstatement due to fraud affecting a number of accounts and assertions. These may include asset valuation, estimates relating to specific transactions (such as acquisitions, restructurings, or disposals of a segment of the business), and other significant accrued liabilities (such as pension and other post-employment benefit obligations, or environmental remediation liabilities). The risk may also relate to significant changes in assumptions relating to recurring estimates. Information gathered through obtaining an understanding of the entity and its environment may assist the auditor in evaluating the reasonableness of such management estimates and underlying judgments and assumptions. A retrospective review of similar management judgments and assumptions applied in prior periods may also provide insight about the reasonableness of judgments and assumptions supporting management estimates.

A40. Examples of possible audit procedures to address the assessed risks of material misstatement due to fraud, including those that illustrate the incorporation of an element of unpredictability, are presented in Appendix 2. The appendix includes examples of responses to the auditor's assessment of the risks of material misstatement resulting from both fraudulent financial reporting, including fraudulent financial reporting resulting from revenue recognition, and misappropriation of assets.

Audit Procedures Responsive to Risks Related to Management Override of Controls

Journal Entries and Other Adjustments (Ref: Para. 32(a))

A41. Material misstatement of financial statements due to fraud often involve the manipulation of the financial reporting process by recording inappropriate or unauthorized journal entries. This may occur throughout the year or at period end, or by management making adjustments to amounts reported in the financial statements that are not reflected in journal entries, such as through consolidating adjustments and reclassifications.

A42. Further, the auditor's consideration of the risks of material misstatement associated with inappropriate override of controls over journal entries is important since automated processes and controls may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or to the financial reporting system. Furthermore, when IT is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information systems.

A43. When identifying and selecting journal entries and other adjustments for testing and determining the appropriate method of examining the underlying support for the items selected, the following matters are of relevance:

- The assessment of the risks of material misstatement due to fraud – the presence of fraud risk factors and other information obtained during the auditor's assessment of the risks of material misstatement due to fraud may assist the auditor to identify specific classes of journal entries and other adjustments for testing.
- Controls that have been implemented over journal entries and other adjustments – effective controls over the preparation and posting of journal entries and other adjustments may reduce the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of the controls.
- The entity's financial reporting process and the nature of evidence that can be obtained – for many entities routine processing of transactions involves a combination of manual and automated steps and procedures. Similarly, the processing of journal entries and other adjustments may involve both manual and automated procedures and controls. When information technology is used in the financial reporting process, journal

entries and other adjustments may exist only in electronic form.

- The characteristics of fraudulent journal entries or other adjustments – inappropriate journal entries or other adjustments often have unique identifying characteristics. Such characteristics may include entries (a) made to unrelated, unusual, or seldom-used accounts, (b) made by individuals who typically do not make journal entries, (c) recorded at the end of the period or as post-closing entries that have little or no explanation or description, (d) made either before or during the preparation of the financial statements that do not have account numbers, or (e) containing round numbers or consistent ending numbers.
- The nature and complexity of the accounts – inappropriate journal entries or adjustments may be applied to accounts that (a) contain transactions that are complex or unusual in nature, (b) contain significant estimates and period-end adjustments, (c) have been prone to misstatements in the past, (d) have not been reconciled on a timely basis or contain unreconciled differences, (e) contain inter-company transactions, or (f) are otherwise associated with an identified risk of material misstatement due to fraud. In audits of entities that have several locations or components, consideration is given to the need to select journal entries from multiple locations.
- Journal entries or other adjustments processed outside the normal course of business – non standard journal entries may not be subject to the same level of internal control as those journal entries used on a recurring basis to record transactions such as monthly sales, purchases and cash disbursements.

A44. The auditor uses professional judgment in determining the nature, timing and extent of testing of journal entries and other adjustments. However, because fraudulent journal entries and other adjustments are often made at the end of a reporting period, paragraph 32(a)(ii) requires the auditor to select the journal entries and other adjustments made at that time. Further, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how the fraud is accomplished, paragraph 32(a)(iii) requires the auditor to consider whether there is also a need to test journal entries and other adjustments throughout the period.

Accounting Estimates (Ref: Para. 32(b))

A45. In preparing financial statements, management is responsible for making a number of judgments or assumptions that affect significant

accounting estimates and for monitoring the reasonableness of such estimates on an ongoing basis. Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates. This may be achieved by, for example, understating or overstating all provisions or reserves in the same fashion so as to be designed either to smooth earnings over two or more accounting periods, or to achieve a designated earnings level in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.

A46. The purpose of performing a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year is to determine whether there is an indication of a possible bias on the part of management. It is not intended to call into question the auditor's professional judgments made in the prior year that were based on information available at the time.

Business Rationale for Significant Transactions (Ref: Para. 32(c))

A47. Indicators that may suggest that significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual, may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets include:

- The form of such transactions appears overly complex (for example, the transaction involves multiple entities within a consolidated group or multiple unrelated third parties).
- Management has not discussed the nature of and accounting for such transactions with those charged with governance of the entity, and there is inadequate documentation.
- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- Transactions that involve non-consolidated related parties, including special purpose entities, have not been properly reviewed or approved by those charged with governance of the entity.
- The transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.

Evaluation of Audit Evidence (Ref: Para. 34-37)

A48. SA 330 requires the auditor, based on the audit procedures performed and the audit evidence obtained, to evaluate whether the

assessments of the risks of material misstatement at the assertion level remain appropriate. This evaluation is primarily a qualitative matter based on the auditor's judgment. Such an evaluation may provide further insight about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures. Appendix 3 contains examples of circumstances that may indicate the possibility of fraud.

Analytical Procedures Performed in the Overall Review of the Financial Statements (Ref: Para. 34)

A49. Determining which particular trends and relationships may indicate a risk of material misstatement due to fraud requires professional judgment. Unusual relationships involving year-end revenue and income are particularly relevant. These might include, for example: uncharacteristically large amounts of income being reported in the last few weeks of the reporting period or unusual transactions; or income that is inconsistent with trends in cash flow from operations.

Consideration of Identified Misstatements (Ref: Para. 35-37)

A50. Since fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so or some rationalization of the act, an instance of fraud is unlikely to be an isolated occurrence. Accordingly, misstatements, such as numerous misstatements at a specific location even though the cumulative effect is not material, may be indicative of a risk of material misstatement due to fraud.

A51. The implications of identified fraud depend on the circumstances. For example, an otherwise insignificant fraud may be significant if it involves senior management. In such circumstances, the reliability of evidence previously obtained may be called into question, since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. There may also be a possibility of collusion involving employees, management or third parties.

A52. SA 450, "Evaluation of Misstatements Identified during the Audit[13]", and SA 700, "The Independent Auditor's Report on General Purpose

[13] The Auditing and Assurance Standards Board will issue an Exposure Draft of the proposed new Standard based on the corresponding International Standard on Auditing in the near future.

Financial Statements[14]", establish requirements and provide guidance on the evaluation and disposition of misstatements and the effect on the auditor's opinion in the auditor's report.

## Auditor Unable to Continue the Engagement (Ref: Para. 38)

A53. Examples of exceptional circumstances that may arise and that may bring into question the auditor's ability to continue performing the audit include:

(a) The entity does not take the appropriate action regarding fraud that the auditor considers necessary in the circumstances, even when the fraud is not material to the financial statements;

(b) The auditor's consideration of the risks of material misstatement due to fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or

(c) The auditor has significant concern about the competence or integrity of management or those charged with governance.

A54. Because of the variety of the circumstances that may arise, it is not possible to describe definitively when withdrawal from an engagement is appropriate. Factors that affect the auditor's conclusion include the implications of the involvement of a member of management or of those charged with governance (which may affect the reliability of management representations) and the effects on the auditor of a continuing association with the entity.

A55. The auditor has professional and legal responsibilities in such circumstances and these responsibilities may vary under different legislations and regulations and, accordingly, the clients. Under some legislations/ regulations, for example, the auditor may be entitled to, or required to, make a statement or report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities. Given the exceptional nature of the circumstances and the need to consider the legal requirements, the auditor may consider it appropriate to seek legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action, including the possibility of reporting to shareholders, regulators or others[15].

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[14] Hitherto known as the Auditing and Assurance Standard (AAS) 28, "The Auditor's Report on Financial Statements".

[15] The Code of Ethics issued by the Institute of Chartered Accountants of India contains guidance on communication between the outgoing and incoming auditor.

A56. In some cases, the option of withdrawing from the engagement may not be available to the auditor due to the nature of the terms of appointment or public interest considerations.

### Management Representations (Ref: Para. 39)

A57. SA 580, "Management Representations[16]", establishes requirements and provides guidance on obtaining appropriate representations from management in the audit. In addition to acknowledging its responsibility for the financial statements, it is important that, irrespective of the size of the entity, management acknowledge its responsibility for internal control designed, implemented and maintained to prevent and detect fraud.

A58. Because of the nature of fraud and the difficulties encountered by auditors in detecting material misstatements in the financial statements resulting from fraud, it is important that the auditor obtain a written representation from management confirming that it has disclosed to the auditor:

(a) The results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud; and

(b) Its knowledge of actual, suspected or alleged fraud affecting the entity.

## Communications to Management and with Those Charged with Governance

### Communication to Management (Ref: Para. 40)

A59. When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of the appropriate level of management as soon as practicable. This is so even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity's organization). The determination of which level of management is the appropriate one is a matter of professional judgment and is affected by such factors as the likelihood of collusion and the nature and magnitude of the suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the suspected fraud.

### Communication with Those Charged with Governance (Ref: Para. 41)

A60. The auditor's communication with those charged with governance

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[16] Hitherto known as the Auditing and Assurance Standard (AAS) 11, "Management Representations".

may be made orally or in writing. SA 260 (Revised) identifies factors the auditor considers in determining whether to communicate orally or in writing. Due to the nature and sensitivity of fraud involving senior management, or fraud that results in a material misstatement in the financial statements, the auditor reports such matters on a timely basis and may consider it necessary to also report such matters in writing.

A61. In some cases, the auditor may consider it appropriate to communicate with those charged with governance when the auditor becomes aware of fraud involving employees other than management that does not result in a material misstatement. Similarly, those charged with governance may wish to be informed of such circumstances. The communication process is assisted if the auditor and those charged with governance agree at an early stage in the audit about the nature and extent of the auditor's communications in this regard.

A62. In the exceptional circumstances where the auditor has doubts about the integrity or honesty of management or those charged with governance, the auditor may consider it appropriate to obtain legal advice to assist in determining the appropriate course of action.

Other Matters Related to Fraud (Ref: Para. 42)

A63. Other matters related to fraud to be discussed with those charged with governance of the entity may include, for example:

- Concerns about the nature, extent and frequency of management's assessments of the controls in place to prevent and detect fraud and of the risk that the financial statements may be misstated.
- A failure by management to appropriately address identified material weaknesses in internal control, or to appropriately respond to an identified fraud.
- The auditor's evaluation of the entity's control environment, including questions regarding the competence and integrity of management.
- Actions by management that may be indicative of fraudulent financial reporting, such as management's selection and application of accounting policies that may be indicative of management's effort to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.
- Concerns about the adequacy and completeness of the authorization of transactions that appear to be outside the normal course of business.

### Communications to Regulatory and Enforcement Authorities (Ref: Para. 43)

A64. The auditor's professional duty to maintain the confidentiality of client information may preclude reporting fraud to a party outside the client entity. However, the auditor's legal responsibilities vary by law & statute and, in certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law. In some entities, for example, in case of audit of banks, the auditor has a statutory duty to report the occurrence of fraud to the supervisory authorities, i.e., the Reserve Bank of India, in terms of the latter's circular no. DBS.FGV.(F).No. BC/23.08.001/2001-02. Also, in some entities the auditor may have a duty to report misstatements to authorities in those cases where management and those charged with governance fail to take corrective action.

A65. The auditor may consider it appropriate to obtain legal advice to determine the appropriate course of action in the circumstances, the purpose of which is to ascertain the steps necessary in considering the public interest aspects of identified fraud.

A66. In some clients, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related legislation.

## Material Modifications to ISA 240, The Auditor's Responsibility relating to Fraud in an Audit of Financial Statements

### Additions

1. In paragraph A64, the guidance has been made more entity specific, in the context of Indian legal requirement, by way of an example.

### Deletions

1. Paragraph A6 of the Application Section of ISA 240 dealt with the application of the requirements of ISA 240 to the audits of public sector entities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific reporting requirement may also exist in case of non public sector entities pursuant to a requirement

under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A6, highlighting the fact that in some cases, the auditors may be required by the legislature or the regulator to specifically report on the instances of actual/suspected fraud in the client entity, has been retained and examples of such situations have also been added.

2. Paragraph A56 of the Application Section of ISA 240 dealt with the considerations specific to public sector entities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that option of withdrawal may not be available in case of non public sector entities pursuant to a requirement under the statute or terms of appointment of the auditor. Accordingly, the spirit of erstwhile A56, highlighting that in some cases, the auditors may not be having an option to withdraw from the engagement has been retained.

3. Paragraph A66 of the Application Section of ISA 240 dealt with the application of the requirements of ISA 240 to the audits of public sector entities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific reporting requirement may also exist in case of non public sector entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of A66 as given ISA 240, highlighting the fact that in some cases, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related legislation or regulation, has been retained.

## Appendix 1

(Ref: Para. A25)

## Examples of Fraud Risk Factors

The fraud risk factors identified in this Appendix are examples of such factors that may be faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor's consideration, i.e., fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (a) incentives/pressures, (b) opportunities, and (c) attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

### Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting

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

#### Incentives/Pressures

Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

- High degree of competition or market saturation, accompanied by declining margins.
- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
- Significant declines in customer demand and increasing business failures in either the industry or overall economy.
- Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent.
- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.
- Rapid growth or unusual profitability especially compared to that of other companies in the same industry.

- New accounting, statutory, or regulatory requirements.

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

- Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages.
- Need to obtain additional debt or equity financing to stay competitive—including financing of major research and development or capital expenditures.
- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements.
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.

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

- Significant financial interests in the entity.
- Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow.[17]
- Personal guarantees of debts of the entity.
- There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.

Opportunities

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

- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- A strong financial presence or ability to dominate a certain industry

[17] Management incentive plans may be contingent upon achieving targets relating only to certain accounts or selected activities of the entity, even though the related accounts or activities may not be material to the entity as a whole.

sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions.

- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.
- Use of business intermediaries for which there appears to be no clear business justification.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

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

- Domination of management by a single person or small group (in a non owner-managed business) without compensating controls.
- Oversight by those charged with governance over the financial reporting process and internal control is not effective.

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

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

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

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

Attitudes/Rationalizations

- Communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective.
- Non-financial management's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates.
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations.
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
- The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.
- Management failing to correct known material weaknesses in internal control on a timely basis.
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
- Low morale among senior management.
- The owner-manager makes no distinction between personal and business transactions.
- Dispute between shareholders in a closely held entity.
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
    - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
    - Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report.
    - Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.
    - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel

assigned to or consulted on the audit engagement.

### Risk Factors Arising from Misstatements Arising from Misappropriation of Assets

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalization. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, monitoring of management and weaknesses in internal control that is not effective may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

#### Incentives/Pressures

Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

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

#### Opportunities

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

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

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

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

Attitudes/Rationalizations

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

## Appendix 2

(Ref: Para. A40)

## Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatement Due to Fraud

The following are examples of possible audit procedures to address the assessed risks of material misstatement due to fraud resulting from both fraudulent financial reporting and misappropriation of assets. Although these procedures cover a broad range of situations, they are only examples and, accordingly they may not be the most appropriate nor necessary in each circumstance. Also the order of the procedures provided is not intended to reflect their relative importance.

### Consideration at the Assertion Level

Specific responses to the auditor's assessment of the risks of material misstatement due to fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified, and the classes of transactions, account balances, disclosures and assertions they may affect.

The following are specific examples of responses:

- Visiting locations or performing certain tests on a surprise or unannounced basis. For example, observing inventory at locations where auditor attendance has not been previously announced or counting cash at a particular date on a surprise basis.
- Requesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period.
- Altering the audit approach in the current year. For example, contacting major customers and suppliers orally in addition to sending written confirmation, sending confirmation requests to a specific party within an organization, or seeking more or different information.
- Performing a detailed review of the entity's quarter-end or year-end adjusting entries and investigating any that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year-end, investigating the possibility of related parties and the sources of financial resources supporting the transactions.
- Performing substantive analytical procedures using disaggregated data. For example, comparing sales and cost of sales by location, line of business or month to expectations developed by the auditor.

- Conducting interviews of personnel involved in areas where a risk of material misstatement due to fraud has been identified, to obtain their insights about the risk and whether, or how, controls address the risk.
- When other independent auditors are auditing the financial statements of one or more subsidiaries, divisions or branches, discussing with them the extent of work necessary to be performed to address the assessed risk of material misstatement due to fraud resulting from transactions and activities among these components.
- If the work of an expert becomes particularly significant with respect to a financial statement item for which the assessed risk of misstatement due to fraud is high, performing additional procedures relating to some or all of the expert's assumptions, methods or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose.
- Performing audit procedures to analyze selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgments, for example, an allowance for sales returns, were resolved with the benefit of hindsight.
- Performing procedures on account or other reconciliations prepared by the entity, including considering reconciliations performed at interim periods.
- Performing computer-assisted techniques, such as data mining to test for anomalies in a population.
- Testing the integrity of computer-produced records and transactions.
- Seeking additional audit evidence from sources outside of the entity being audited.

### Specific Responses—Misstatement Resulting from Fraudulent Financial Reporting

Examples of responses to the auditor's assessment of the risks of material misstatement due to fraudulent financial reporting are as follows:

#### Revenue Recognition

- Performing substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods. Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.
- Confirming with customers certain relevant contract terms and the

absence of side agreements, because the appropriate accounting often is influenced by such terms or agreements and basis for rebates or the period to which they relate are often poorly documented. For example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances.

- Inquiring of the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions.
- Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cut-off procedures.
- For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded.

Inventory Quantities

- Examining the entity's inventory records to identify locations or items that require specific attention during or after the physical inventory count.
- Observing inventory counts at certain locations on an unannounced basis or conducting inventory counts at all locations on the same date.
- Conducting inventory counts at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period.
- Performing additional procedures during the observation of the count, for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labeled, and the quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals. Using the work of an expert may be helpful in this regard.
- Comparing the quantities for the current period with prior periods by class or category of inventory, location or other criteria, or comparison of quantities counted with perpetual records.
- Using computer-assisted audit techniques to further test the compilation of the physical inventory counts—for example, sorting by tag number to test tag controls or by item serial number to test the possibility of item

omission or duplication.

Management Estimates

- Using an expert to develop an independent estimate for comparison to management's estimate.
- Extending inquiries to individuals outside of management and the accounting department to corroborate management's ability and intent to carry out plans that are relevant to developing the estimate.

### Specific Responses—Misstatements Due to Misappropriation of Assets

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to an assessed risk of material misstatement due to fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions. Although some of the audit responses noted in the two categories above may apply in such circumstances, the scope of the work is to be linked to the specific information about the misappropriation risk that has been identified.

Examples of responses to the auditor's assessment of the risk of material misstatements due to misappropriation of assets are as follows:

- Counting cash or securities at or near year-end.
- Confirming directly with customers the account activity (including credit memo and sales return activity as well as dates payments were made) for the period under audit.
- Analyzing recoveries of written-off accounts.
- Analyzing inventory shortages by location or product type.
- Comparing key inventory ratios to industry norm.
- Reviewing supporting documentation for reductions to the perpetual inventory records.
- Performing a computerized match of the vendor list with a list of employees to identify matches of addresses or phone numbers.
- Performing a computerized search of payroll records to identify duplicate addresses, employee identification or taxing authority numbers or bank accounts.
- Reviewing personnel files for those that contain little or no evidence of activity, for example, lack of performance evaluations.
- Analyzing sales discounts and returns for unusual patterns or trends.
- Confirming specific terms of contracts with third parties.
- Obtaining evidence that contracts are being carried out in accordance

with their terms.

- Reviewing the propriety of large and unusual expenses.
- Reviewing the authorization and carrying value of senior management and related party loans.
- Reviewing the level and propriety of expense reports submitted by senior management.

# Appendix 3

(Ref: Para. A48)

## Examples of Circumstances that Indicate the Possibility of Fraud

The following are examples of circumstances that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud.

Discrepancies in the accounting records, including:

- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.
- Unsupported or unauthorized balances or transactions.
- Last-minute adjustments that significantly affect financial results.
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties.
- Tips or complaints to the auditor about alleged fraud.

Conflicting or missing evidence, including:

- Missing documents.
- Documents that appear to have been altered.
- Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist.
- Significant unexplained items on reconciliations.
- Unusual balance sheet changes, or changes in trends or important financial statement ratios or relationships, for example, receivables growing faster than revenues.
- Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures.
- Unusual discrepancies between the entity's records and confirmation replies.
- Large numbers of credit entries and other adjustments made to accounts receivable records.
- Unexplained or inadequately explained differences between the accounts receivable sub-ledger and the control account, or between the customer statements and the accounts receivable sub-ledger.
- Missing or non-existent cancelled checks in circumstances where cancelled checks are ordinarily returned to the entity with the bank

statement.

- Missing inventory or physical assets of significant magnitude.
- Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies.
- Fewer responses to confirmations than anticipated or a greater number of responses than anticipated.
- Inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments.

Problematic or unusual relationships between the auditor and management, including:

- Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.
- Undue time pressures imposed by management to resolve complex or contentious issues.
- Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management.
- Unusual delays by the entity in providing requested information.
- Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.
- Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel.
- An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable.
- An unwillingness to address identified weaknesses in internal control on a timely basis.

Other

- Unwillingness by management to permit the auditor to meet privately with those charged with governance.
- Accounting policies that appear to be at variance with industry norms.
- Frequent changes in accounting estimates that do not appear to result from changed circumstances.
- Tolerance of violations of the entity's Code of Conduct.

# SA 250 (AAS 21)

## CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS

***(Effective for all audits commencing on or after July 1, 2001)***

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***Appendix***


Standard on Auditing (SA) 250*, "Consideration of Laws and Regulations in an Audit of Financial Statements" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in July, 2001

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard on Auditing (SA) is to establish standards on the auditor's responsibility regarding consideration of laws and regulations in an audit of financial statements.

2. When planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that non-compliance by the entity with laws and regulations may materially affect the financial statements. However, an audit cannot be expected to detect non-compliance with all laws and regulations. Detection of non-compliance, regardless of materiality, requires consideration of the implications for the integrity of management or employees and the possible effect on other aspects of the audit.

3. The term "non-compliance" as used in this SA refers to acts of omission or commission by the entity being audited, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity or on its behalf by its management or employees. For the purpose of this SA, non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by the entity's management or employees.

4. Whether an act constitutes non-compliance is a legal determination that is ordinarily beyond the auditor's professional competence. The auditor's training, experience and understanding of the entity and its industry may provide a basis for recognition that some acts coming to the auditor's attention may constitute non-compliance with laws and regulations. The determination as to whether a particular act constitutes or is likely to constitute non-compliance is generally based on the advice of an informed expert qualified to practice law but ultimately can only be determined by a court of law.

5. Laws and regulations vary considerably in their relation to the financial statements. Some laws or regulations determine the form or content of an entity's financial statements or the amounts to be recorded or disclosures to be made in financial statements. Other laws or regulations are to be complied with by management or prescribe the provisions under which the entity is allowed to conduct its business. Some entities operate in heavily regulated industries (such as banks, sugar and pharmaceuticals industries). Others are only subject to the many laws and regulations that generally relate to the operating aspects of the business (such as those related to

occupational safety and health). Non-compliance with laws and regulations could result in financial consequences for the entity such as fines, litigation, etc. Generally, the further removed non-compliance is from the events and transactions ordinarily reflected in financial statements, the less likely the auditor is to become aware of it or to recognize its possible non-compliance.

6. This SA applies to audits of financial statements and does not apply to other engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.

7. The auditor's responsibility to consider fraud and errors in an audit of financial statements is provided in SA 240, "The Auditor's Responsibilities to Consider Fraud & Error in on Audit of Financial Statements[2]".

## Responsibility of Management for the Compliance with Laws and Regulations

8. It is management's responsibility to ensure that the entity's operations are conducted in accordance with laws and regulations. The responsibility for the prevention and detection of non-compliance rests with management.

9. The following policies and procedures, among others, may assist management in discharging its responsibilities for the prevention and detection of non-compliance with laws and regulations:

- Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
- Instituting and operating appropriate systems of internal control.
- Developing, publicising and following a Code of Conduct[3].
- Ensuring employees are properly trained and understand the Code of Conduct.
- Monitoring compliance with the Code of Conduct and acting appropriately to discipline employees who fail to comply with it.

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[2] Standard on Auditing (SA) 240 was issued as AAS 4, "Fraud and Error" in June, 1987. This Standard was revised in 2003 and titled as "The Auditor's Responsibilities to Consider Fraud and Error in on Audit of Financial Statements". The Standard has further been revised under the Clarity Project and titled as "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements". The Revised Standard is effective for audit of financial statements for periods beginning on or after April 1, 2009.

[3] Code of Conduct in this context means a document containing standard instructions to be following by employees for ensuring compliance with laws and regulations.

- Establishing a legal department and/or engaging legal advisors to assist in monitoring legal requirements.
- Maintaining a register of significant laws with which the entity has to comply within its particular industry and a record of complaints in respect of non-compliance.
- In larger entities, these policies and procedures may be supplemented by assigning appropriate responsibilities to:
  - An internal audit function
  - An audit committee

## The Auditor's Consideration of Compliance with Laws and Regulations

10. The auditor is not, and cannot be held responsible for preventing non-compliance. The fact that an audit is carried out may, however, act as a deterrent.

11. An audit is subject to the unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with SAs and other generally accepted audit procedures. This risk is higher with regard to material misstatements resulting from non-compliance with laws and regulations due to factors such as:

- Existence of laws and regulations, relating to the operating aspects of the entity, that do not have a material effect on the financial statements and are not captured by the accounting and internal control systems.
- The inherent limitations of the accounting and internal control systems and the testing procedures.
- Persuasive rather than conclusive nature of audit evidence, in general.
- Deliberate designs, such as collusion, forgery, deliberate failure to record transactions, senior management override of controls or intentional misrepresentations being made to the auditor, to conceal non-compliance.

12. The auditor should plan and perform the audit recognising that the audit may reveal conditions or events that would lead to questioning whether an entity is complying with laws and regulations.

13. In accordance with specific statutory requirements, the auditor may be specifically required to report as part of the audit of the financial statements whether the entity complies with certain provisions of laws or regulations. In these circumstances, the auditor would plan to test for compliance with these provisions of the laws and regulations.

14. In order to plan the audit, the auditor should obtain a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.

15. In obtaining this general understanding, the auditor would particularly recognise that non-compliance of some laws and regulations may have a fundamental effect on the operations of the entity and may even cause the entity to cease operations, or call into question the entity's continuance as a going concern. For example, a Non-Banking Financial Company might have to cease to carry on the business of a non-banking financial institution if it fails to obtain a certificate of registration issued under Chapter III B of the Reserve Bank of India Act, 1934 and if its Net Owned Funds are less than the amount specified by the RBI in this regard.

16. To obtain the general understanding of laws and regulations, the auditor would ordinarily:

- Use the existing knowledge of the entity's industry and business.
- Inquire of management as to the laws or regulations that may be expected to have a fundamental effect on the operations of the entity.
- Inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations.
- Discuss with management the policies or procedures adopted for identifying, evaluating and accounting for litigation claims and assessments.

17. After obtaining the general understanding, the auditor should perform procedures to identify instances of non-compliance with those laws and regulations where non-compliance should be considered when preparing financial statements, specifically:

- Inquiring of management as to whether the entity is in compliance with such laws and regulations.
- Inspecting correspondence with the relevant licensing or regulatory

authorities.

18. Further, the auditor should obtain sufficient appropriate audit evidence about compliance with those laws and regulations generally recognised by the auditor to have an effect on the determination of material amounts and disclosures in financial statements. The auditor should have a sufficient understanding of these laws and regulations in order to consider them when auditing the assertions related to the determination of the amounts to be recorded and the disclosures to be made.

19. Such laws and regulations would be well established and known to the entity and within the industry; they would be considered on a recurring basis each time financial statements are issued. These laws and regulations may relate, for example, to the form and content of financial statements, including industry specific requirements or the accrual or recognition of expenses for retirement benefits, etc.

20. Other than as described in paragraphs 17, 18 and 19, the auditor need not test or perform other procedures on the entity's compliance with laws and regulations since this would be outside the scope of an audit of financial statements.

21. The auditor should be conscious that procedures applied for the purpose of forming an opinion on the financial statements may bring instances of possible non-compliance with laws and regulations to the auditor's attention. For example, such procedures include reading minutes; inquiring of the entity's management and legal counsel concerning litigation, claims and assessments; and performing substantive tests of details of transactions or balances.

22. The auditor should obtain written representations that management has disclosed to the auditor all known actual or possible non-compliance with laws and regulations whose effects should be considered when preparing financial statements.

23. In the absence of evidence to the contrary, the auditor is entitled to assume the entity is in compliance with these laws and regulations.

## Procedures when Non-compliance is Discovered

24. The Appendix to this SA sets out examples of the type of information that might come to the auditor's attention that may indicate non-compliance.

25. When the auditor becomes aware of information concerning a possible instance of non-compliance, the auditor should obtain an understanding of the nature of the act and the circumstances in which it has occurred, and sufficient other information to evaluate the possible effect on the financial statements.

26. When evaluating the possible effect on the financial statements, the auditor considers:

- The potential financial consequences, such as fines, penalties, damages, litigation, threat of expropriation of assets and enforced discontinuation of operations, including violation of the going concern assumption.
- Whether the potential financial consequences require disclosure.
- Whether the potential financial consequences are so serious as to call into question the true and fair view given by the financial statements.

27. When the auditor believes there may be non-compliance, the auditor should document the findings and discuss them with management. Documentation of findings would include copies of records and documents and making minutes of conversations, if appropriate.

28. If management does not provide satisfactory information that it is in fact in compliance, the auditor would consult with the entity's lawyer about the application of the laws and regulations to the circumstances and the possible effects on the financial statements. When it is not considered appropriate to consult with the entity's lawyer or when the auditor is not satisfied with the opinion, the auditor would consider consulting some other lawyer as to whether a violation of a law or regulation is involved, the possible legal consequences and what further action, if any, the auditor would take.

29. When adequate information about the suspected non-compliance cannot be obtained, the auditor should consider the effect of the lack of audit evidence on the auditor's report.

30. The auditor should consider the implications of non-compliance in relation to other aspects of the audit, particularly the reliability of management representations. In this regard, the auditor reconsiders the risk assessment and the validity of management representations, in case of non-compliance not detected by internal controls or not included in management representations. The implications of particular instances of non-

compliance discovered by the auditor will depend on the relationship of the perpetration and concealment, if any, of the act to specific control procedures and the level of management or employees involved.

## Communication/Reporting of Non-compliance

### To Management

31. The auditor should, as soon as practicable, either communicate with the audit committee, the board of directors and senior management, or obtain evidence that they are appropriately informed, regarding non-compliance that comes to the auditor's attention. However, the auditor need not do so for matters that are clearly inconsequential or trivial and may reach agreement in advance on the nature of such matters to be communicated.

32. If in the auditor's judgement, the non-compliance is believed to be intentional and/or material, the auditor should communicate the finding without delay.

33. If the auditor suspects that members of senior management, including members of the board of directors, are involved in non-compliance, the auditor should communicate the matter to the next higher level of authority at the entity, such as an audit committee or board of directors. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor may consider seeking legal advice.

### To the Users of the Auditor's Report on the Financial Statements

34. If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been properly reflected in the financial statements, the auditor should express a qualified or an adverse opinion.

35. If the auditor is precluded by the entity from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor should express a qualified opinion or a disclaimer of opinion on the financial statements on the basis of a limitation on the scope of the audit.

36. If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by the entity, the auditor should consider the effect on the auditor's report.

To Regulatory and Enforcement Authorities

37. The auditor's duty of confidentiality would ordinarily preclude reporting non-compliance to a third party. However, in certain circumstances, that duty of confidentiality is overridden by statute, law or by courts of law (for example, the auditor is required to report certain matters of non-compliance to the Reserve Bank of India as per the requirements of Non Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 1988, issued by the Reserve Bank of India).

## Withdrawal from the Engagement

38. The auditor may conclude that withdrawal from the engagement is necessary when the entity does not take the remedial action that the auditor considers necessary in the circumstances, even when the non-compliance is not material to the financial statements. Factors that would affect the auditor's conclusion include the implications of the involvement of the highest authority within the entity which may affect the reliability of management representations, and the effects on the auditor of continuing association with the entity. In appropriate circumstances, the auditor may consider seeking legal advice.

39. An outgoing auditor, on receiving communication from the incoming auditor, should send a reply to him as soon as possible, setting out in detail the reasons, which according to him had given rise to the attendant circumstances but without disclosing any information as regards the affairs of the client which he is not competent to do. However, with the permission of the client he may disclose information regarding affairs of the client to the incoming auditor.

## Effective Date

40. This Standard on Auditing becomes operative for all audits commencing on or after 1st July, 2001.

# Appendix

## Indications That Non-compliance May Have Occurred

Examples of the type of information that may come to the auditor's attention that may indicate that non-compliance with laws or regulations has occurred are listed below:

- Investigation by government departments or payment of fines, additional taxes or penalties.
- Payments for unspecified services or loans to consultants, related parties, employees or government employees.
- Sales commission or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
- Purchases at prices significantly above or below market price.
- Unusual payments in cash and other unusual transactions.
- Unusual transactions with companies registered in tax havens.
- Payments for goods or services made other than to the country from which the goods or services originated.
- Payments without proper exchange control documentation.
- Existence of an accounting system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- Unauthorised transactions or improperly recorded transactions.
- Media comment.

# Standard on Auditing (SA) 250 (Revised) Consideration of Laws and Regulations in an Audit of Financial Statements[1]

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Material Modifications to ISA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements"


Standard on Auditing (SA) 250 (Revised), "Consideration of Laws and Regulations in an Audit of Financial Statements", should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services[2]", which sets out the authority of SAs.

[1] Earlier known as Auditing and Assurance Standard (AAS) 21, "Consideration of Laws and Regulations in an Audit of Financial Statements".

[2] Published in the July, 2007 issue of the Journal.

# Introduction

## Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to consider laws and regulations when performing an audit of financial statements. This SA does not apply to other assurance engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.

## Effect of Laws and Regulations

2. The effect on the financial statements of laws and regulations varies considerably. Those laws and regulations to which an entity is subject constitute the legal and regulatory framework. The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity's financial statements. Other laws or regulations are to be complied with by management or set the provisions under which the entity is allowed to conduct its business but do not have a direct effect on an entity's financial statements. Some entities operate in heavily regulated industries (such as banks and chemical companies). Others are subject only to the many laws and regulations that relate generally to the operating aspects of the business (such as those related to occupational safety and health). Non-compliance with laws and regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements.

## Responsibility of Management for Compliance with Laws and Regulations

3. It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements. (Ref: Para. A1-A2)

Responsibility of the Auditor (Ref: Para. A3-A6)

4. The requirements in this SA are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with laws and regulations. However, the auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

5. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error.[3] In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.[4] In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

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

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[3] Attention is invited to SA 200, "Basic Principles Governing an Audit" and SA 200A, "Objective and Scope of the Audit of Financial Statements". Both the SAs are being revised in the light of the Revised ISA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with International Standards on Auditing".

[4] See footnote 3.

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

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

(a) The provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and labour laws. (see paragraph 13); and

(b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties (for example, compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations); non-compliance with such laws and regulations may therefore have a material effect on the financial statements (see paragraph 14).

7. In this SA, differing requirements are specified for each of the above categories of laws and regulations. For the category referred to in paragraph 6(a), the auditor's responsibility is to obtain sufficient appropriate audit evidence about compliance with the provisions of those laws and regulations. For the category referred to in paragraph 6(b), the auditor's responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

8. The auditor is required by this SA to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on financial statements may bring instances of identified or suspected non-compliance to the auditor's attention. Maintaining an attitude of professional skepticism throughout

the audit, as required by proposed SA 200 (Revised),[5] is important in this context, given the extent of laws and regulations that affect the entity.

### Effective Date

9. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

## Objectives

10. The objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements;

(b) To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and

(c) To respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit.

## Definition

11. For the purposes of this SA, the following term has the meaning attributed below:

> Non-compliance – Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management or employees of the entity.

[5] See footnote 3.

## Requirements

### The Auditor's Consideration of Compliance with Laws and Regulations

12. As part of obtaining an understanding of the entity and its environment in accordance with SA 315,[6] the auditor shall obtain a general understanding of:

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

(b) How the entity is complying with that framework. (Ref: Para. A7)

13. The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements. (Ref: Para. A8)

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

(a) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and

(b) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities. (Ref: Para. A9-A10)

15. During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. (Ref: Para. A11)

16. The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known

[6] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 11.

instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor. (Ref: Para. A12)

17. In the absence of identified or suspected non-compliance, the auditor is not required to perform audit procedures regarding the entity's compliance with laws and regulations, other than those set out in paragraphs 12-16.

## Audit Procedures When Non-Compliance is Identified or Suspected

18. If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain: (Ref: Para. A13)

(a) An understanding of the nature of the act and the circumstances in which it has occurred; and

(b) Further information to evaluate the possible effect on the financial statements. (Ref: Para. A14)

19. If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice. (Ref: Para. A15-A16)

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

21. The auditor shall evaluate the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations, and take appropriate action. (Ref: Para. A17-A18)

## Reporting of Identified or Suspected Non-Compliance

### Reporting Non-Compliance to Those Charged with Governance

22. Unless all of those charged with governance are involved in management of the entity, and therefore are aware of matters involving identified or suspected non-compliance already communicated by the auditor,[7] the auditor shall communicate with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor's attention during the course of the audit, other than when the matters are clearly inconsequential.

23. If, in the auditor's judgment, the non-compliance referred to in paragraph 22 is believed to be intentional and material, the auditor shall communicate the matter to those charged with governance as soon as practicable.

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

### Reporting Non-Compliance in the Auditor's Report on the Financial Statements

25. If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall, in accordance with Proposed SA 705[8], express a qualified or adverse opinion on the financial statements.

26. If the auditor is precluded by management or those charged with

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[7] Revised SA 260, "Communication with Those Charged with Governance", paragraph 9.

[8] Proposed SA 705, "Modifications to the Opinion in the Independent Auditor's Report". The Standard is being formulated in the light of the corresponding International Standard. Presently, the concept of modified opinion is dealt within SA 700, "The Auditor's Report on Financial Statements".

governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with Proposed SA 705.

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

### Reporting Non-Compliance to Regulatory and Enforcement Authorities

28. If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity. (Ref: Para. A19-A20)

### Documentation

29. The auditor shall document identified or suspected non-compliance with laws and regulations and the results of discussion with management and, where applicable, those charged with governance and other parties outside the entity. (Ref: Para. A21)

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## Application and Other Explanatory Material

### Responsibility for Compliance with Laws and Regulations

#### Responsibility of Management for Compliance with Laws and Regulations (Ref: Para. 3)

A1. Management, with the oversight of those charged with governance, is responsible for ensuring that the entity's operations are conducted in accordance with laws and regulations. Laws and regulations may affect an entity's financial

statements in different ways: for example, most directly, they may affect specific disclosures required of the entity in the financial statements or they may prescribe the applicable financial reporting framework[9]. They may also establish certain legal rights and obligations of the entity, some of which will be recognised in the entity's financial statements. In addition, laws and regulations may impose penalties in cases of non-compliance.

A2. The following are examples of the types of policies and procedures an entity may implement to assist in the prevention and detection of non-compliance with laws and regulations:

- Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
- Instituting and operating appropriate systems of internal control.
- Developing, publicising and following a code of conduct.
- Ensuring employees are properly trained and understand the code of conduct.
- Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it.

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[9] Revised ISA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with International Standards on Auditing", paragraph 13 (a) defines the applicable financial reporting framework as "The financial reporting framework adopted by management and, where appropriate, those charged with governance 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. 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".

- Engaging legal advisors to assist in monitoring legal requirements.
- Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints.

In larger entities, these policies and procedures may be supplemented by assigning appropriate responsibilities to the following:

- An internal audit function.
- An audit committee.
- A compliance function.

Responsibility of the Auditor (Ref: Para. 4-8)

A3. Non-compliance by the entity with laws and regulations may result in a material misstatement of the financial statements. Detection of non-compliance, regardless of materiality, may affect other aspects of the audit including, for example, the auditor's consideration of the integrity of management or employees.

A4. Whether an act constitutes non-compliance with laws and regulations is a matter for legal determination, which is ordinarily beyond the auditor's professional competence to determine. Nevertheless, the auditor's training, experience and understanding of the entity and its industry or sector may provide a basis to recognise that some acts, coming to the auditor's attention, may constitute non-compliance with laws and regulations.

A5. In accordance with specific statutory requirements, the auditor may be specifically required to report, as part of the audit of the financial statements, on whether the entity complies with certain provisions of laws or regulations. In these circumstances, proposed SA 700 (Revised)[10] or proposed SA 800[11] deal

[10] Hitherto known as AAS 28. Proposed SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements", is under revision.

[11] Proposed SA 800, "Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks".

with how these audit responsibilities are addressed in the auditor's report. Furthermore, where there are specific statutory reporting requirements, it may be necessary for the audit plan to include appropriate tests for compliance with those provisions of the laws and regulations.

A6. In some audit engagements, specially those relating to audit of government ventures and undertakings, etc., there may be additional audit responsibilities with respect to the consideration of laws and regulations which may relate to the audit of financial statements or may extend to other aspects of the entity's operations.

## The Auditor's Consideration of Compliance with Laws and Regulations

### Obtaining an Understanding of the Legal and Regulatory Framework (Ref: Para. 12)

A7. To obtain a general understanding of the legal and regulatory framework, and how the entity complies with that framework, the auditor may, for example:

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

### Laws and Regulations Generally Recognised to have a Direct Effect on the

Determination of Material Amounts and Disclosures in the Financial Statements (Ref: Para. 13)

A8. Certain laws and regulations are well-established, known to the entity and within the entity's industry or sector, and relevant to the entity's financial statements (as described in paragraph 6(a)). They could include those that relate to, for example:

- The form and content of financial statements;
- Industry-specific financial reporting issues;
- Accounting for transactions under government contracts; or
- The accrual or recognition of expenses for income tax or retirement benefits.

Some matters may be relevant to specific assertions (for example, the completeness of income tax provisions), while others may be relevant to the financial statements as a whole (for example, the required statements constituting a complete set of financial statements). Non-compliance with other laws and regulations may result in fines, litigation or other consequences for the entity, the costs of which may need to be provided for in the financial statements, but are not considered to have a direct effect on the financial statements as described in paragraph 6(a).

Procedures to Identify Instances of Non-Compliance – Other Laws and Regulations (Ref: Para. 14)

A9. Certain other laws and regulations may need particular attention by the auditor because they have a fundamental effect on the operations of the entity (as described in paragraph 6(b)). Non-compliance with laws and regulations that have a fundamental effect on the operations of the entity may cause the entity to cease operations, or call into question the entity's continuance as a going concern. For example, non-compliance with the requirements of the entity's license or other entitlement to perform its operations could have such an impact (for example, for a bank, non-compliance with capital or investment requirements). To illustrate further, a Non Banking Financial Company might have to cease to carry on the business of a non-banking financial institution if it

fails to obtain a certificate of registration issued under Chapter III B of the Reserve Bank of India Act, 1934 and if its Net Owned Funds are less than the amount specified by the RBI in this regard. There are also many laws and regulations relating principally to the operating aspects of the entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.

A10. As the financial reporting consequences of other laws and regulations can vary depending on the entity's operations, the audit procedures required by paragraph 14 are directed to bringing to the auditor's attention instances of non-compliance with laws and regulations that may have a material effect on the financial statements.

Non-Compliance brought to the Auditor's Attention by Other Audit Procedures (Ref: Para. 15)

A11. Audit procedures applied to form an opinion on the financial statements may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. For example, such audit procedures may include:

- Reading minutes;
- Inquiring of the entity's management and in-house legal counsel or external legal counsel concerning litigation, claims and assessments; and
- Performing substantive tests of details of classes of transactions, account balances or disclosures.

Written Representations (Ref: Para. 16)

A12. Because the effect on financial statements of laws and regulations can vary considerably, written representations provide necessary audit evidence about management's knowledge of identified or suspected non-compliance with laws and regulations, whose effects may have a material effect on the financial statements. However, written representations do not provide sufficient appropriate audit evidence on their own and, accordingly, do not affect the

nature and extent of other audit evidence that is to be obtained by the auditor.[12]

## Audit Procedures When Non-Compliance is Identified or Suspected

### Indications of Non-Compliance with Laws and Regulations (Ref: Para. 18)

A13. When the auditor becomes aware of the existence of, or information about, the following matters, it may be an indication of non-compliance with laws and regulations:

- Investigations by regulatory organisations and government departments or payment of fines or penalties.
- Payments for unspecified services or loans to consultants, related parties, employees or government employees.
- Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
- Purchasing at prices significantly above or below market price.
- Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.
- Unusual payments towards legal and retainership fees.
- Unusual transactions with companies registered in tax havens.
- Payments for goods or services made other than to the country from which the goods or services originated.
- Payments without proper exchange control documentation.
- Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- Unauthorised transactions or improperly recorded transactions.
- Adverse media comment.

### Matters Relevant to the Auditor's Evaluation (Ref: Para. 18(b))

[12] SA 580 (Revised), "Written Representations", paragraph 3.

A14. Matters relevant to the auditor's evaluation of the possible effect on the financial statements include:

- The potential financial consequences of non-compliance with laws and regulations on the financial statements including, for example, the imposition of fines, penalties, damages, threat of expropriation of assets, enforced discontinuation of operations, and litigation.
- Whether the potential financial consequences require disclosure.
- Whether the potential financial consequences are so serious as to call into question the fair presentation of the financial statements, or otherwise make the financial statements misleading.

Audit Procedures (Ref: Para. 19)

A15. The auditor may discuss the findings with those charged with governance where they may be able to provide additional audit evidence. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to transactions or events that have led to the possibility of non-compliance with laws and regulations.

A16. If management or, as appropriate, those charged with governance do not provide sufficient information to the auditor that the entity is in fact in compliance with laws and regulations, the auditor may consider it appropriate to consult with the entity's in-house legal counsel or external legal counsel about the application of the laws and regulations to the circumstances, including the possibility of fraud, and the possible effects on the financial statements. When it is not considered appropriate to consult with the entity's legal counsel or when the auditor is not satisfied with the legal counsel's opinion, the auditor may consider it appropriate to consult the auditor's own legal counsel as to whether a contravention of a law or regulation is involved, the possible legal consequences, including the possibility of fraud, and what further action, if any, the auditor would take.

Evaluating the Implications of Non-Compliance (Ref: Para. 21)

A17. As required by paragraph 21, the auditor evaluates the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations. The implications of particular instances of non-compliance identified by the auditor will depend on the relationship of the perpetration and concealment, if any, of the act to specific control activities and the level of management or employees involved, especially implications arising from the involvement of the highest authority within the entity.

A18. In exceptional cases, the auditor may consider whether, unless prohibited by law or regulation, withdrawal from the engagement is necessary when management or those charged with governance do not take the remedial action that the auditor considers appropriate in the circumstances, even when the non-compliance is not material to the financial statements. When deciding whether withdrawal from the engagement is necessary, the auditor may consider seeking legal advice. If withdrawal from the engagement is prohibited, the auditor may consider alternative actions, including describing the non-compliance in an Other Matter(s) paragraph in the auditor's report.[13]

## Reporting of Identified or Suspected Non-Compliance

### Reporting Non-Compliance to Regulatory and Enforcement Authorities (Ref: Para. 28)

A19. The auditor's professional duty to maintain the confidentiality of client information may preclude reporting identified or suspected non-compliance with laws and regulations to a party outside the entity. However, the auditor's legal responsibilities vary under different laws and regulations and, in certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law. Under the present legal and regulatory framework for financial institutions in India, their auditor has a statutory duty to report the occurrence, or suspected occurrence, of non-compliance with laws and regulations to supervisory authorities. For example, the auditor is required to report certain

[13] Proposed SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report". The Standard is being formulated in the light of the corresponding International Standard.

matters of non-compliance to the Reserve Bank of India as per the requirements of Non Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 1988, issued by the Reserve Bank of India. Also, some laws or regulations require the auditor to report misstatements to authorities in those cases where management and, where applicable, those charged with governance fail to take corrective action. The auditor may consider it appropriate to obtain legal advice to determine the appropriate course of action.

A20. In case of certain entities, such as national governments, regional (for example, state, provincial, territorial) governments, local (for example, city, town) governments and related governmental entities (for example, agencies, boards, commissions and enterprises), the auditor may be obliged to report on instances of non-compliance to governing authorities or to report them in the auditor's report.

### Documentation (Ref: Para. 29)

A21. The auditor's documentation of findings regarding identified or suspected non-compliance with laws and regulations may include, for example:

- Copies of records or documents.
- Minutes of discussions held with management, those charged with governance or parties outside the entity.

## Material Modifications to ISA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements"

### Deletions

1. Paragraph A6 of the Application Section of ISA 250 deals with the application of the requirements of ISA 250 to the audits of public sector entities regarding the additional audit responsibilities with respect to the consideration of laws and regulations. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific

reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, there may be additional audit responsibilities with respect to the consideration of laws and regulations which may relate to the audit of financial statements or may extend to other aspects of the entity's operations. Accordingly, the spirit of erstwhile A6, highlighting the fact that in case of certain entities, there may be additional audit responsibilities with respect to the consideration of laws and regulations, has been retained.

2. Paragraph A20 of the Application Section of ISA 250 deals with the application of the requirements of ISA 250 to the audits of public sector entities regarding the obligation to report on instances of non-compliance to governing authorities or to report them in the auditor's report. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, the auditor may be obliged to report on instances of non-compliance to governing authorities or to report them in the auditor's report. Accordingly, the spirit of erstwhile A20, highlighting the fact that in case of certain entities, there may be instances of reporting non-compliance to governing authorities or to report them in the auditor's report, has been retained.

# SA 260 (AAS 27)

## COMMUNICATIONS OF AUDIT MATTERS WITH THOSE CHARGED WITH GOVERNANCE

***(Effective for all audits relating to accounting periods beginning on or after April 1, 2003)***

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Standard on Auditing (SA) 260*,"Communications of Audit Matters with Those Charged with Governance" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in January, 2003.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard on Auditing (SA) is to establish standards on communications of audit matters arising from the audit of financial statements between the auditor and those charged with governance of an entity. These communications relate to audit matters of governance interest as defined in this SA. This SA does not provide guidance on communications by the auditor to parties outside the entity, for example, external regulatory or supervisory agencies.

2. The auditor should communicate audit matters of governance interest arising from the audit of financial statement with those charged with governance of an entity.

3. For the purpose of this SA, the term "governance" is used to describe the role of persons entrusted with the supervision, control and direction of an entity. Those charged with governance are, ordinarily, accountable for ensuring that the entity achieves its objectives, financial reporting, and reporting to interested parties. Those charged with governance include management only when it performs such functions.

4. For the purpose of this SA, "audit matters of governance interest" are those matters that arise from the audit of financial statements and are, in the opinion of the auditor, both important and relevant to those charged with governance in overseeing the financial reporting and disclosure process. Audit matters of governance interest include only those matters that have come to the attention of the auditor as a result of the performance of the audit. The auditor is not required, in an audit in accordance with auditing standards generally accepted in India[2], to design procedures for the specific purpose of identifying matters of governance interest.

## Relevant Persons

5. The auditor should determine the relevant persons who are charged with governance and with whom audit matters of governance interest are to be communicated.

6. The structure of governance may vary from entity to entity, depending upon size and legal constitution. For example, in case of companies, the Board of Directors and the committees constituted under the Board like the audit committee, ethics committee; in case of trusts, societies etc., the board of trustees or the management committee, etc.

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[2] Paragraph 15 of SA 700, "The Auditor's Report on Financial Statements" describes auditing standards generally accepted in India.

7. The auditor uses judgement to determine those persons with whom audit matters of governance interest are communicated, taking into account, the governance structure of the entity, the circumstances of the engagement and relevant legislation, if any. The auditor also considers the legal responsibilities of those persons. The auditor also considers the importance and sensitivity of the audit matters of governance interest to be communicated. For example, in case of a company where the board of directors has established an audit committee under it, the auditor may decide to communicate with the audit committee, or with the whole board, depending on the importance of the audit matters of governance interest.

8. When the entity's governance structure is not well defined, or those charged with governance are not clearly identified by the circumstances of the engagement, or by legislation, the auditor comes to an agreement with the entity about with whom the audit matters of governance interest are to be communicated. Examples include some owner-managed entities, not for profit organisations, government agencies, etc.

9. To avoid misunderstandings, an audit engagement letter[3] may explain that the auditor will communicate only those matters of governance interest that come to attention as a result of the performance of an audit and that the auditor is not required to design procedures for the specific purpose of identifying matters of governance interest. The engagement letter may also:

- Describe the form in which any communication on audit matters of governance interest will be made;
- Identify the relevant persons with whom such communications will be made;
- Identify any specific audit matters of governance interest which it has been agreed are to be communicated.

10. The effectiveness of communications is enhanced by developing a constructive working relationship between the auditor and those charged with governance. This relationship is developed while maintaining an attitude of professional independence and objectivity.

## Audit Matters of Governance Interest to be Communicated

11. The auditor should consider audit matters of governance interest that arise from the audit of financial statements and communicate them with those charged with governance. Such matters may include:

[3] Refer Standard on Auditing (SA) 210, "Terms of Audit Engagement", issued by the Council of the Institute of Chartered Accountants of India.

- The general approach and overall scope of the audit, including any expected limitations thereon, or any additional requirements;
- The selection of or changes in, significant accounting policies and practices that have, or could have, a material effect on the entity's financial statements;
- The potential effect on the financial statements of any significant risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements;
- Adjustments to financial statements arising out of audit that have, or could have, a significant effect on the entity's financial statements;
- Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern;
- Disagreements with management about matters that, individually or in aggregate, could be significant to the entity's financial statements or the auditor's report. These communications include consideration of whether the matter has, or has not, been resolved and the significance of the matter;
- Expected modifications to the auditor's report;
- Other matters warranting attention by those charged with governance, such as material weaknesses in internal control, questions regarding management integrity, and fraud involving management;
- Any other matters agreed upon in the terms of the audit engagement.

12. As part of the auditor's communications, those charged with governance are informed that:

- The auditor's communications of matters include only those audit matters of governance interest that have come to the attention of the auditor as a result of the performance of the audit;
- An audit of financial statements is not designed to identify all matters that may be relevant to those charged with governance. Accordingly, the audit does not ordinarily identify all such matters.

13. The auditor should communicate audit matters of governance interest on a timely basis. This enables those charged with governance to take appropriate action.

14. In order to achieve timely communications, the auditor discusses with those charged with governance the basis and timing of such communications. In certain cases, because of the nature of the matter, the auditor may communicate that matter sooner than previously agreed.

## Forms of Communication

15. The auditor's communication with those charged with governance may be made orally or in writing. The auditor's decision whether to communicate orally or in writing is affected by factors such as:

- The size, operating structure, legal structure, and communications processes of the entity being audited;
- The nature, sensitivity and significance of the audit matters of governance interest to be communicated;
- The arrangements made with respect to periodic meetings or reporting of audit matters of governance interest;
- The amount of on-going contact and dialogue the auditor has with those charged with governance.

16. When audit matters of governance interest are communicated orally, the auditor should document in the working papers the matters communicated and any responses to those matters. This document may take the form of minutes of the auditor's discussion with those charged with governance. In certain circumstances, depending on the nature, sensitivity, and significance of the matter, it may be advisable for the auditor to confirm in writing with those charged with governance any oral communication on audit matters of governance interest.

17. Ordinarily, the auditor initially discusses audit matters of governance interest with management, except those matters relating to questions related to management's competence or integrity. In case of matters relating to questions related to management's competence or integrity, the auditor discusses the audit matters with those charged with governance. These initial discussions with management are important in order to clarify facts and issues, and to give management an opportunity to provide further information. If management agrees to communicate a matter of governance interest with those charged with governance, the auditor may not need to repeat the communications, provided that the auditor is satisfied that such communications have effectively and appropriately been made.

## Other Matters

18. If the auditor considers that having regard to the facts and circumstances of the case a modification[4] of the auditor's report on financial statements is required, as described in SA 700, "The Auditor's

[4] Paragraph 31 of SA 700, "The Auditor's Report on Financial Statements" deals with the concept of "modified audit report".

Report on Financial Statements", communications between the auditor and those charged with governance cannot be regarded as a substitute.

19. The auditor considers whether audit matters of governance interest previously communicated may have an effect on the current year's financial statements. The auditor considers whether the point continues to be a matter of governance interest and whether to communicate the matter again with those charged with governance.

## Confidentiality

20. The requirements of professional pronouncements, legislation or regulation may impose obligations of confidentiality that restrict the auditor's communications of audit matters of governance interest. The auditor refers to such requirements before communicating with those charged with governance. In some circumstances, the potential conflicts with the auditor's ethical and legal obligations of confidentiality and reporting may be complex. In these cases, the auditor may wish to consult a legal counsel.

## Laws and Regulations

21. The requirements of professional pronouncements, legislation or regulation may impose obligation on the auditor to make communications on governance related matters. For example, the requirements of regulators, such as report under Section 619 (3) of the Companies Act, 1956, in case of Public Sector Undertakings and Long Form Audit Report in the case of Public Sector Banks, may impose obligation on the auditor to make communications on governance related matters. These additional communication requirements are not covered by this SA; however, they may affect the content, form and timing of communications with those charged with governance.

## Effective Date

22. This Standard on Auditing is effective for all audits relating to accounting periods beginning on or after 1st April, 2003.

## Compatibility with International Standard on Auditing (ISA) 260

The auditing standards established in this SA are generally consistent in all material respects with those set out in ISA 260 "Communications of Audit Matters with Those Charged with Governance".

# Standard on Auditing (SA) 260 (Revised)
# Communication with Those Charged with Governance[1]

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Revised Standard on Auditing (SA) 260, "Communication with Those Charged with Governance", should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[2], which sets out the authority of SAs.

[1] Earlier known as Auditing and Assurance Standard (AAS) 27, "Communications of Audit Matters with Those Charged with Governance".

[2] Published in the July, 2007 issue of the Journal.

# Introduction

## Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to communicate with those charged with governance in relation to an audit of financial statements. Although this SA applies irrespective of an entity's governance structure or size, particular considerations apply where all of those charged with governance are involved in managing an entity, and for listed entities. This SA does not establish requirements regarding the auditor's communication with an entity's management or owners unless they are also charged with a governance role.

2. This SA has been drafted in terms of an audit of financial statements, but may also be applicable, adapted as necessary in the circumstances, to audits of other historical financial information when those charged with governance have a responsibility to oversee the preparation and presentation of the other historical financial information.

3. Recognising the importance of effective two-way communication during an audit of financial statements, this SA provides an overarching framework for the auditor's communication with those charged with governance, and identifies some specific matters to be communicated with them. Additional matters to be communicated, which complement the requirements of this SA, are identified in other SAs. Further matters, not required by this or other SAs, may be required to be communicated by laws or regulations, by agreement with the entity, or by additional requirements applicable to the engagement. Nothing in this SA precludes the auditor from communicating any other matters to those charged with governance. (Ref: Para. A28-A31)

## Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

## Objectives

5. The objectives of the auditor are to:

(a) 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) Obtain from those charged with governance information relevant to the audit;

(c) 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) Promote effective two-way communication between the auditor and those charged with governance. (Ref: Para. A1-A4)

## Definitions

6. For purposes of the SAs, the following terms have the meanings attributed below:

(a) Those charged with governance – The person(s) or organisation(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. 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 undertakings or an owner-manager. In some cases, those charged with governance are responsible for approving[3] the entity's financial statements (in other cases management has this responsibility). For discussion of the diversity of governance structures, see paragraphs A5-A12.

[3] As described at paragraph [A43] of [proposed] SA 700, (hitherto known as AAS 28) "The Independent Auditor's Report on General Purpose Financial Statements". The Standard is being revised in the light of the corresponding International Standard.

(b) Management – The person(s) with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager. Management is responsible for the preparation of the financial statements, overseen by those charged with governance, and in some cases management is also responsible for approving[4] the entity's financial statements (in other cases those charged with governance have this responsibility).

## Requirements

### Those Charged with Governance

7. The auditor shall determine the appropriate person(s) within the entity's governance structure with whom to communicate. (Ref: Para. A5-A8)

### Communication with a Subgroup of Those Charged with Governance

8. When the auditor communicates with a subgroup of those charged with governance, for example, an audit committee, or an individual, the auditor shall determine whether the auditor also needs to communicate with the governing body. (Ref: Para. A9-A11)

### When All of Those Charged with Governance are Involved in Managing the Entity

9. In some cases, all of those charged with governance are involved in managing the entity, for example, a small business where a single owner manages the entity and no one else has a governance role. In these cases, if matters required by this SA are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again with those same person(s) in their governance role. These matters are noted in paragraph 12(c). The auditor shall

[4] See footnote 3.

nonetheless be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity. (Ref: Para. A12)

## Matters to be Communicated

### The Auditor's Responsibilities in Relation to the Financial Statement Audit

10. 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. (Ref: Para. A13-A14)

### Planned Scope and Timing of the Audit

11. The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit. (Ref: Para. A15-A19)

### Significant Findings from the Audit

12. The auditor shall communicate with those charged with governance: (Ref: Para. A20)

(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[5], not to be most appropriate to the particular circumstances of the entity; (Ref: Para. A21)

(b) Significant difficulties, if any, encountered during the audit; (Ref: Para. A22)

(c) Unless all of those charged with governance are involved in managing the entity:

(i) Material weaknesses, if any, in the design, implementation or operating effectiveness of internal control that have come to the auditor's attention and have been communicated to management as required by SA 315[6] or SA 330[7];

(ii) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and (Ref: Para. A23)

(iii) Written representations the auditor is requesting; and

(d) Other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process. (Ref: Para. A24)

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[5] Revised ISA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with International Standards on Auditing", Paragraph 13 (a) defines the applicable financial reporting framework as "The financial reporting framework adopted by management and, where appropriate, those charged with governance 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. 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".

[6] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 32. SA 315 is published in the February, 2008 issue of the Journal.

[7] SA 330, "The Auditor's Responses to Assessed Risks", paragraph 19. SA 330 is published in the February, 2008 issue of the Journal.

### Auditor Independence

13. In the case of listed entities, the auditor shall communicate with those charged with governance: (Ref: Para. A25-A27)

(a) A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms[8] have complied with relevant ethical requirements regarding independence; and

(b) (i) All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor; and

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

## The Communication Process

### Establishing the Communication Process

14. The auditor shall communicate with those charged with governance the form, timing and expected general content of communications. (Ref: Para. A32-A40)

### Forms of Communication

[8] As defined in SQC 1, "Network firm is an entity under common control, ownership or management with the firm or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally or internationally".

15. The auditor shall communicate in writing with those charged with governance regarding significant findings from the audit when, 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. (Ref: Para. A41-A43)

16. The auditor shall communicate in writing with those charged with governance regarding auditor independence when required by paragraph 13.

### Timing of Communications

17. The auditor shall communicate with those charged with governance on a timely basis. (Ref: Para. A44-A45)

### Adequacy of the Communication Process

18. 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. (Ref: Para. A46-A48)

### Documentation

19. Where matters required by this SA to be communicated are communicated orally, the auditor shall document them, 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. (Ref: Para. A49)

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## Application and Other Explanatory Material

## The Role of Communication (Ref: Para. 5)

A1. This SA focuses primarily on communications from the auditor to those charged with governance. Nevertheless, 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.

A2. Although the auditor is responsible for communicating matters required by this SA, management also has a responsibility to communicate matters of governance interest to those charged with governance. Communication by the auditor does not relieve management of this responsibility. Similarly, communication by management with those charged with governance of matters that the auditor is required to communicate does not relieve the auditor of the responsibility to also communicate them. Communication of these matters by management may, however, affect the form or timing of the auditor's communication with those charged with governance.

A3. Clear communication of specific matters required to be communicated by SAs is an integral part of every audit. SAs do not, however, require the auditor to perform procedures specifically to identify any other matters to communicate with those charged with governance.

Legal or Regulatory Restrictions on Communicating with Those Charged with Governance

A4. Laws or regulations may restrict the auditor's communication of certain matters with those charged with governance. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider obtaining legal advice.

Those Charged with Governance (Ref: Para. 7)

A5. Governance structures may vary reflecting different size and ownership characteristics. For example:

- In most of the entities, those charged with governance hold positions that are an integral part of the entity's legal structure, for example, company directors. In others, for example, some government undertakings a body that is not part of the entity is charged with governance.

- 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.

A6. 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, a council of governors, 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. When governance is a collective responsibility, a subgroup such as an audit committee or even an individual, may be charged with specific tasks to assist the governing body in meeting its responsibilities. Alternatively, a

subgroup or individual may have specific, legally identified responsibilities that differ from those of the governing body.

A7. Such diversity means that it is not possible for this SA to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Also, in some cases the appropriate person(s) 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, some not-for-profit organisations, and some government entities. In such cases, the auditor may need to discuss and agree with the engaging party the relevant person(s) 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 person(s) with whom to communicate may vary depending on the matter to be communicated.

A8. Proposed Revised SA 600, "Special Considerations- Audits of Group Financial Statements (Including the Work of Component Auditors)[9]", includes specific matters to be communicated by group auditors with those charged with governance. When the entity is a component of a group, the appropriate person(s) with whom the component auditor communicates depends on the engagement circumstances and the matter to be communicated. In some cases, a number of components may be conducting the same businesses within the same system of internal control and using the same accounting practices. Where those charged with governance of those components are the same (e.g., common board of directors), duplication may be avoided by dealing with these components concurrently for the purpose of communication.

Communication with a Subgroup of Those Charged with Governance (Ref: Para. 8)

[9] The Exposure Draft of Revised SA 600, has been published in the June, 2008 issue of the Journal.

A9. When considering communicating with a subgroup of those charged with governance, the auditor may take into account such matters as:

- The respective responsibilities of the subgroup and the governing body.
- The nature of the matter to be communicated.
- Relevant legal or regulatory requirements.
- Whether the subgroup has the authority to take action in relation to the information communicated, and can provide further information and explanations the auditor may need.

A10. When deciding whether there is also a need to communicate information, in full or in summary form, with the governing body, the auditor may be influenced by the auditor's assessment of how effectively and appropriately the subgroup communicates relevant information with the governing body. The auditor may make explicit in agreeing the terms of engagement that, unless prevented by laws or regulations, the auditor retains the right to communicate directly with the governing body.

A11. Audit committees (or similar subgroups with different names) exist in many jurisdictions. Although their specific authority and functions may differ, communication with the audit committee, where one exists, has become a key element in the auditor's communication with those charged with governance. Good governance principles suggest that:

- The auditor will be invited to regularly attend meetings of the audit committee.
- The chair of the audit committee and, when relevant, the other members of the audit committee, will liaise with the auditor periodically.
- The audit committee will meet the auditor without management present at least annually.

When All of Those Charged with Governance are Involved in Managing the Entity (Ref: Para. 9)

A12. In some cases, all of those charged with governance are involved in managing the entity, and the application of communication requirements is modified to recognise this position. In such cases, communication with person(s) with management responsibilities may not adequately inform all of those with whom the auditor would otherwise communicate in their governance capacity. For example, in a company where all directors are involved in managing the entity, some of those directors (e.g., one responsible for marketing) may be unaware of significant matters discussed with another director (e.g., one responsible for the preparation of the financial statements).

## Matters to be Communicated

### The Auditor's Responsibilities in Relation to the Financial Statement Audit (Ref: Para. 10)

A13. The auditor's responsibilities in relation to the financial statement audit are often included in the engagement letter or other suitable form of written agreement that records the agreed terms of the engagement. Providing those charged with governance with a copy of that engagement letter or other suitable form of written agreement may be an appropriate way to communicate with them regarding such matters as:

- The auditor's responsibility for performing the audit in accordance with SAs, which is directed towards the expression of an opinion on the financial statements. The matters that SAs require to be communicated, therefore, include significant matters arising from the audit of the financial statements that are relevant to those charged with governance in overseeing the financial reporting process.
- The fact that SAs do not require the auditor to design procedures for the purpose of identifying supplementary matters to communicate with those charged with governance.
- When applicable, the auditor's responsibility for communicating particular matters required by laws or regulations, by agreement with the entity or by additional requirements applicable to the engagement.

A14. Laws or regulations, an agreement with the entity or additional requirements applicable to the engagement may provide for broader communication with those charged with governance. For example, (a) an agreement with the entity may provide for particular matters to be communicated when they arise from services provided by a firm or network firm other than the financial statement audit; or (b) the mandate of a public sector auditor may provide for matters to be communicated that come to the auditor's attention as a result of other work, such as performance audits.

Planned Scope and Timing of the Audit (Ref: Para. 11)

A15. Communication regarding the planned scope and timing of the audit may:

(a) Assist those charged with governance to understand better the consequences of the auditor's work, to discuss issues of risk and materiality with the auditor, and to identify any areas in which they may request the auditor to undertake additional procedures; and

(b) Assist the auditor to understand better the entity and its environment.

A16. Care is required when communicating with those charged with governance about the planned scope and timing of the audit so as not to compromise the effectiveness of the audit, particularly where some or all of those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable.

A17. Matters communicated may include:

- How the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error.
- The auditor's approach to internal control relevant to the audit.

- The application of materiality in the context of an audit.[10]

A18. Other planning matters that it may be appropriate to discuss with those charged with governance include:

- Where the entity has an internal audit function, the extent to which the auditor will use the work of internal audit, and how the external and internal auditors can best work together in a constructive and complementary manner.
- The views of those charged with governance of:
  - The appropriate person(s) in the entity's governance structure with whom to communicate.
  - The allocation of responsibilities between those charged with governance and management.
  - The entity's objectives and strategies, and the related business risks that may result in material misstatements.
  - Matters, which those charged with governance, consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken.
  - Significant communications with regulators.
  - Other matters, which, those charged with governance, consider may influence the audit of the financial statements.
- The attitudes, awareness, and actions of those charged with governance concerning (a) the entity's internal control and its importance in the entity, including how those charged with governance oversee the effectiveness of internal control, and (b) the detection or possibility of fraud.

[10] Proposed Revised SA 320, "Materiality in Planning and Performing an Audit". Hitherto known as AAS 13, "Audit Materiality". The Standard is being revised in the light of the corresponding Proposed International Standard, ISA 320.

- The actions of those charged with governance in response to developments in accounting standards, corporate governance practices, exchange listing rules, and related matters.
- The responses of those charged with governance to previous communications with the auditor.

A19. While communication with those charged with governance may assist the auditor to plan the scope and timing of the audit, it does not change the auditor's sole responsibility to establish the overall audit strategy and the audit plan, including the nature, timing and extent of procedures necessary to obtain sufficient appropriate audit evidence.

Significant Findings from the Audit (Ref: Para. 12)

A20. The communication of findings from the audit may include requesting further information from those charged with governance in order to complete the audit evidence obtained. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.

Significant Qualitative Aspects of Accounting Practices (Ref: Para. 12(a))

A21. Financial reporting frameworks ordinarily allow for the entity to make accounting estimates, and judgments about accounting policies and financial statement disclosures. Open and constructive communication about significant qualitative aspects of the entity's accounting practices may include comment on the acceptability of significant accounting practices. Appendix 1 identifies matters that may be included in this communication.

Significant Difficulties Encountered During the Audit (Ref: Para. 12(b))

A22. Significant difficulties encountered during the audit may include such matters as:

- Significant delays in management providing required information.
- An unnecessarily brief time within which to complete the audit.
- Extensive unexpected effort required to obtain sufficient appropriate audit evidence.
- The unavailability of expected information.
- Restrictions imposed on the auditor by management.
- Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested.

In some circumstances, such difficulties may constitute a scope limitation that leads to a modification of the auditor's opinion.[11]

Significant Matters Discussed, or Subject to Correspondence with Management (Ref: Para. 12(c)(ii))

A23. Significant matters discussed, or subject to correspondence with management may include such matters as:

- Business conditions affecting the entity, and business plans and strategies that may affect the risks of material misstatement.
- Concerns about management's consultations with other accountants on accounting or auditing matters.
- Discussions or correspondence in connection with the initial or recurring appointment of the auditor regarding accounting practices, the application of auditing standards, or fees for audit or other services.

[11] The concept of modification of the auditor's opinion has been dealt in SA 700, "The Auditor's Report on Financial Statements" (hitherto known as AAS 28). The AASB is however also in the process of developing a Standard corresponding to ISA 705, "Modifications to the Opinion in the Independent Auditor's Report".

Other Significant Matters Relevant to the Financial Reporting Process (Ref: Para. 12(d))

A24. Other significant matters arising from the audit that are directly relevant to those charged with governance in overseeing the financial reporting process may include such matters as material misstatements of fact or material inconsistencies in information accompanying the audited financial statements that have been corrected.

Auditor Independence (Ref: Para. 13)

A25. The auditor is subject to independence and other ethical requirements as enunciated in the Code of Ethics issued by the ICAI[12].

A26. The relationships and other matters, and safeguards to be communicated, vary with the circumstances of the engagement, but generally address:

(a) Threats to independence, which may be categorised as: self-interest threats, self-review threats, advocacy threats, familiarity threats, and intimidation threats; and

(b) Safeguards created by the profession, legislation or regulation, safeguards within the entity, and safeguards within the firm's own systems and procedures.

The communication required by paragraph 13(a) may include an inadvertent violation of relevant ethical requirements as they relate to auditor independence, and any remedial action taken or proposed.

A27. The communication requirements relating to auditor independence that apply in the case of listed entities may also be relevant in the case of some other entities, particularly those that may be of significant public interest because, as a result of their business, their size or their corporate status, they have a wide range of stakeholders. Examples of entities that are not listed entities, but where

[12] Attention of the members is also invited, for instance, to the Guidance Note on Independence of Auditors, issued by the ICAI.

communication of auditor independence may be appropriate, include public sector entities, credit institutions, insurance companies, and retirement benefit funds. On the other hand, there may be situations where communications regarding independence may not be relevant, for example, where all of those charged with governance have been informed of relevant facts through their management activities. This is particularly likely where the entity is owner-managed, and the auditor's firm and network firms have little involvement with the entity beyond a financial statement audit.

Supplementary Matters (Ref: Para. 3)

A28. Those charged with governance are responsible for ensuring, through oversight of management, that the entity establishes and maintains internal control to provide reasonable assurance with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

A29. The auditor may become aware of supplementary matters that do not necessarily relate to the oversight of the financial reporting process but which are, nevertheless, likely to be significant to the responsibilities of those charged with governance in overseeing the strategic direction of the entity or the entity's obligations related to accountability. Such matters may include, for example, significant deficiencies in governance structures or processes, and significant decisions or actions by senior management that lack appropriate authorisation.

A30. In determining whether to communicate supplementary matters with those charged with governance, the auditor may discuss matters of this kind, of which the auditor has become aware, with the appropriate level of management, unless it is inappropriate to do so in the circumstances.

A31. If a supplementary matter is communicated, it may be appropriate for the auditor to make those charged with governance aware that:

(a) Identification and communication of such matters is incidental to the purpose of the audit, which is to form an opinion on the financial statements;

(b) No procedures were carried out with respect to the matter other than any that were necessary to form an opinion on the financial statements; and

(c) No procedures were carried out to determine whether other such matters exist.

## The Communication Process

### Establishing the Communication Process (Ref: Para. 14)

A32. Clear communication of the auditor's responsibilities, the planned scope and timing of the audit, and the expected general content of communications helps establish the basis for effective two-way communication.

A33. Matters that may also contribute to effective two-way communication include discussion of:

- The purpose of communications. When the purpose is clear, the auditor and those charged with governance are better placed to have a mutual understanding of relevant issues and the expected actions arising from the communication process.
- The form in which communications will be made.
- The person(s) in the audit team and amongst those charged with governance who will communicate regarding particular matters.
- The auditor's expectation that communication will be two-way, and that those charged with governance will communicate with the auditor, matters they consider relevant to the audit, for example, strategic decisions that may significantly affect the nature, timing and extent of audit procedures, the suspicion or the detection of fraud, and concerns with the integrity or competence of senior management.
- The process for taking action and reporting back on matters communicated by the auditor.

- The process for taking action and reporting back on matters communicated by those charged with governance.

A34. The communication process will vary with the circumstances, including the size and governance structure of the entity, how those charged with governance operate, and the auditor's view of the significance of matters to be communicated. Difficulty in establishing effective two-way communication may indicate that the communication between the auditor and those charged with governance is not adequate for the purpose of the audit (see paragraph A48).

Considerations Specific to Smaller Entities

A35. In the case of audits of smaller entities, the auditor may communicate in a less structured manner with those charged with governance than in the case of listed or larger entities.

Communication with Management

A36. Many matters may be discussed with management in the ordinary course of an audit, including matters required by this SA to be communicated with those charged with governance. Such discussions recognise management's executive responsibility for the conduct of the entity's operations and, in particular, management's responsibility for the preparation of the financial statements.

A37. Before communicating matters with those charged with governance, the auditor may discuss them with management, unless that is inappropriate. For example, it may not be appropriate to discuss questions of management's competence or integrity with management. In addition to recognising management's executive responsibility, these initial discussions may clarify facts and issues, and give management an opportunity to provide further information and explanations. Similarly, when the entity has an internal audit function, the auditor may discuss matters with the internal auditor before communicating with those charged with governance.

Communication with Third Parties

A38. Those charged with governance may wish to provide third parties, for example, bankers or certain regulatory authorities, with copies of a written communication from the auditor. In some cases, disclosure to third parties may be illegal or otherwise inappropriate. When a written communication prepared for those charged with governance is provided to third parties, it may be important in the circumstances that the third parties be informed that the communication was not prepared with them in mind, for example, by stating in written communications with those charged with governance:

a) That the communication has been prepared for the sole use of those charged with governance and, where applicable, the group management and the group auditor, should not be relied upon by third parties;

(b) That no responsibility is assumed by the auditor to third parties; and

(c) Any restrictions on disclosure or distribution to third parties.

A39. The auditor may be required by laws or regulations to, for example:

- Notify a regulatory or enforcement body of certain matters communicated with those charged with governance. The auditor has a duty to report misstatements to authorities where management and those charged with governance fail to take corrective action;
- Submit copies of certain reports prepared for those charged with governance to relevant regulatory or funding bodies, or other bodies such as Central Government in the case of some public sector undertakings; or
- Make reports prepared for those charged with governance publicly available.

A40. Unless required by laws or regulations to provide a third party with a copy of the auditor's written communications with those charged with governance, the auditor may need the prior consent of those charged with governance before doing so.

Forms of Communication (Ref: Para. 15-16)

A41. Effective communication may involve structured presentations and written reports as well as less structured communications, including discussions. The auditor may communicate matters other than those identified in paragraphs 15 and 16 either orally or in writing. Written communications may include an engagement letter that is provided to those charged with governance.

A42. In addition to the significance of a particular matter, the form of communication (e.g., whether to communicate orally or in writing, the extent of detail or summarisation in the communication, and whether to communicate in a structured or unstructured manner) may be affected by such factors as:

- Whether the matter has been satisfactorily resolved.
- Whether management has previously communicated the matter.
- The size, operating structure, control environment, and legal structure of the entity.
- In the case of an audit of special purpose financial statements, whether the auditor also audits the entity's general purpose financial statements.
- Legal requirements. In some jurisdictions, a written communication with those charged with governance is required in a prescribed form by local law.
- The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- The amount of ongoing contact and dialogue the auditor has with those charged with governance.
- Whether there have been significant changes in the membership of a governing body.

A43. When a significant matter is discussed with an individual member of those charged with governance, for example, the chair of an audit committee, it may be appropriate for the auditor to summarise the matter in later communications so that all of those charged with governance have full and balanced information.

Timing of Communications (Ref: Para. 17)

A44. The appropriate timing for communications will vary with the circumstances of the engagement. Relevant circumstances include the significance and nature of the matter, and the action expected to be taken by those charged with governance. For example:

- Communications regarding planning matters may often be made early in the audit engagement and, for an initial engagement, may be made as part of agreeing the terms of the engagement.
- It may be appropriate to communicate a significant difficulty encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor to overcome the difficulty, or if it is likely to lead to a modified opinion.
- Similarly, it may be appropriate to communicate material weaknesses in the design, implementation or operating effectiveness of internal control that have come to the auditor's attention as soon as practicable.
- Communications regarding independence may be appropriate whenever significant judgments are made about threats to independence and related safeguards, for example, when accepting an engagement to provide non-audit services, and at a concluding discussion. A concluding discussion may also be an appropriate time to communicate findings from the audit, including the auditor's views about the qualitative aspects of the entity's accounting practices.
- When auditing both general purpose and special purpose financial statements, it may be appropriate to co-ordinate the timing of communications.

A45. Other factors that may be relevant to the timing of communications include:

- The size, operating structure, control environment, and legal structure of the entity being audited.
- Any legal obligation to communicate certain matters within a specified timeframe.

- The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- The time at which the auditor identifies certain matters, for example, the auditor may not identify a particular matter (e.g., non-compliance with a law) in time for preventive action to be taken, but communication of the matter may enable remedial action to be taken.

Adequacy of the Communication Process (Ref: Para. 18)

A46. The auditor need not design specific procedures to support the evaluation of the two-way communication between the auditor and those charged with governance; rather, that evaluation may be based on observations resulting from audit procedures performed for other purposes. Such observations may include:

- The appropriateness and timeliness of actions taken by those charged with governance in response to matters raised by the auditor. Where significant matters raised in previous communications have not been dealt with effectively, it may be appropriate for the auditor to inquire as to why appropriate action has not been taken, and to consider raising the point again. This avoids the risk of giving an impression that the auditor is satisfied that the matter has been adequately addressed or is no longer significant.
- The apparent openness of those charged with governance in their communications with the auditor.
- The willingness and capacity of those charged with governance to meet with the auditor without management present.
- The apparent ability of those charged with governance to fully comprehend matters raised by the auditor, for example, the extent to which those charged with governance probe issues, and question recommendations made to them.
- Difficulty in establishing with those charged with governance a mutual understanding of the form, timing and expected general content of communications.

- Where all or some of those charged with governance are involved in managing the entity, their apparent awareness of how matters discussed with the auditor affect their broader governance responsibilities, as well as their management responsibilities.
- Whether the two-way communication between the auditor and those charged with governance meets applicable legal and regulatory requirements.

A47. As noted in paragraph A1, effective two-way communication assists both the auditor and those charged with governance. Further, SA 315 identifies participation by those charged with governance, including their interaction with internal audit, if any, and external auditors, as an element of the entity's control environment.[13] Inadequate two-way communication may indicate an unsatisfactory control environment and influence the auditor's assessment of the risks of material misstatements. There is also a risk that the auditor may not have obtained sufficient appropriate audit evidence to form an opinion on the financial statements.

A48. If the two-way communication between the auditor and those charged with governance is not adequate and the situation cannot be resolved, the auditor may take such actions as:

- Modifying the auditor's opinion on the basis of a scope limitation.
- Obtaining legal advice about the consequences of different courses of action.
- Communicating with third parties (e.g., a regulator), or a higher authority in the governance structure that is outside the entity, such as the owners of a business (e.g., shareholders in a general meeting), or the responsible government minister or parliament in the public sector.
- Withdrawing from the engagement where permitted in the relevant jurisdiction.

[13]SA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement", paragraph A66.

### Documentation (Ref: Para. 19)

A49. Documentation of oral communication may include a copy of minutes prepared by the entity retained as part of the audit documentation where those minutes are an appropriate record of the communication.

## Material Modifications to ISA 260, Communication with Those Charged with Governance

The SA 260, "Communication with Those Charged with Governance" does not contain any material modifications vis-a-vis ISA 260.

# Appendix

(Ref: Para. 12(a), and A21)

## Qualitative Aspects of Accounting Practices

The communication required by paragraph 12(a), and discussed in paragraph A21, may include such matters as:

### Accounting Policies

- The appropriateness of the accounting policies to the particular circumstances of the entity, having regard to the need to balance the cost of providing information with the likely benefit to users of the entity's financial statements. Where acceptable alternative accounting policies exist, the communication may include identification of the financial statement items that are affected by the choice of significant accounting policies as well as information on accounting policies used by similar entities.
- The initial selection of, and changes in significant accounting policies, including the application of new accounting pronouncements. The communication may include: the effect of the timing and method of adoption of a change in accounting policy on the current and future earnings of the entity; and the timing of a change in accounting policies in relation to expected new accounting pronouncements.
- The effect of significant accounting policies in controversial or emerging areas (or those unique to an industry, particularly when there is a lack of authoritative guidance or consensus).
- The effect of the timing of transactions in relation to the period in which they are recorded.

### Accounting Estimates

- For items for which estimates are significant, issues discussed in Proposed Revised SA 540[14] including, for example:
  - Management's identification of accounting estimates.
  - Management's process for making accounting estimates.
  - Risks of material misstatement.
  - Indicators of possible management bias.
  - Disclosure of estimation uncertainty in the financial statements.

## Financial Statement Disclosures

- The issues involved, and related judgments made, in formulating particularly sensitive financial statement disclosures (e.g., disclosures related to revenue recognition, remuneration, going concern, subsequent events, and contingency issues).
- The overall neutrality, consistency, and clarity of the disclosures in the financial statements.

## Related Matters

- The potential effect on the financial statements of significant risks, exposures and uncertainties, such as pending litigation, that are disclosed in the financial statements.
- The extent to which the financial statements are affected by unusual transactions, including non-recurring amounts recognised during the period, and the extent to which such transactions are separately disclosed in the financial statements.
- The factors affecting asset and liability carrying values, including the entity's bases for determining useful lives assigned to tangible and intangible

[14] The Exposure Draft of Revised SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", has been published in the September, 2008 issue of the Journal.

assets. The communication may explain how factors affecting carrying values were selected and how alternative selections would have affected the financial statements.

- The selective correction of misstatements, for example, correcting misstatements with the effect of increasing reported earnings, but not those that have the effect of decreasing reported earnings.

# SA 299 (AAS 12)

## RESPONSIBILITY OF JOINT AUDITORS

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

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Standard on Auditing (SA) 299*, "Responsibility of Joint Auditors" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

The Statement on the Responsibility of Joint Auditors issued by the Institute earlier shall stand completely withdrawn in respect of all audits relating to accounting periods beginning on or after April 1, 1996.

* Issued in November, 1996.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The practice of appointing more than one auditor to conduct the audit of large entities is in vogue these days. Such auditors, known as joint auditors, conduct the audit jointly and report on the financial statements of the entity. This Standard deals with the professional responsibilities which the auditors undertake in accepting such appointments as joint auditors. The Standard does not deal with the relationship between a principal auditor who is appointed to report on the financial statements of an entity and another auditor who is appointed to report on the financial statements of one or more divisions or branches included in the financial statements of the entity, e.g., the relationship between a company auditor appointed under section 224 of the Companies Act, 1956 and a branch auditor appointed under section 228 of the said Act.[2]

## Division of Work

2. Where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors.

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

## Coordination

4. Where, in the course of his work, a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or require discussion with, or application of judgement by, other joint auditors, he should communicate the same to all the other joint auditors in writing. This

[2] These aspects have been dealt with in Standard on Auditing (SA) 600 (revised 2002), "Using the Work of Another Auditor".

should be done by the submission of a report or note prior to the finalisation of the audit.

## Relationship Among Joint Auditors

5. In respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible –

(a) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;

(b) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors. It may, however, be clarified that all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing or extent of the audit procedures agreed upon among them; proper execution of these audit procedures is the separate and specific responsibility of the joint auditor concerned;

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

(d) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and

(e) for ensuring that the audit report complies with the requirements of the relevant statute.

6. If any matters of the nature referred to in paragraph 4 above are brought to the attention of the entity or other joint auditors by an auditor after the audit report has been submitted, the other joint auditors would not be responsible for those matters.

7. Subject to paragraph 5(b) above, it is the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the area of work allocated to him. The issues such as appropriateness of using test checks or sampling should be decided by each joint auditor in relation to his own area of work. This responsibility is not shared by the other joint auditors. Thus, it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing

system of internal control relating to the work allocated to him. Similarly, the nature, timing and extent of the enquiries to be made in the course of audit as well as the other audit procedures to be applied are solely the responsibility of each joint auditor.

8. In the case of audit of a large entity with several branches, including those required to be audited by branch auditors, the branch audit reports/returns may be required to be scrutinised by different joint auditors in accordance with the allocation of work. In such cases, it is the specific and separate responsibility of each joint auditor to review the audit reports/returns of the divisions/branches allocated to him and to ensure that they are properly incorporated into the accounts of the entity. In respect of the branches which do not fall within any divisions or zones which are separately assigned to the various joint auditors, they may agree among themselves as regards the division of work relating to the review of such branch returns. It is also the separate and specific responsibility of each joint auditor to exercise his judgement with regard to the necessity of visiting such divisions/branches in respect of which the work is allocated to him.

9. A significant part of the audit work involves obtaining and evaluating information and explanations from the management. This responsibility is shared by all the joint auditors unless they agree upon a specific pattern of distribution of this responsibility. In cases where specific divisions, zones or units are allocated to different joint auditors, it is the separate and specific responsibility of each joint auditor to obtain appropriate information and explanations from the management in respect of such divisions/zones/units and to evaluate the information and explanations so obtained by him.

10. Each joint auditor is entitled to assume that the other joint auditors have carried out their part of the audit work in accordance with the generally accepted audit procedures.[3] It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in such a manner. Each joint auditor is entitled to rely upon the other joint auditors for bringing to his notice any departure from generally accepted accounting principles or any material error noticed in the course of the audit.

11. Where separate financial statements of a division/branch are audited by

[3] Reference may be made in this regard to the Standards on Auditing and other mandatory Statements relating to auditing matters issued by the Council of the Institute from time to time.

one of the joint auditors, the other joint auditors are entitled to proceed on the basis that such financial statements comply with all the legal and professional requirements regarding the disclosures to be made and present a true and fair view of the state of affairs and of the working results of the division/branch concerned, subject to such observations as may be communicated by the joint auditor concerned.

## Reporting Responsibilities

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

## Effective Date

13. This Standard on Auditing becomes operative in respect of all audits relating to accounting periods beginning on or after April 1, 1996.

# SA 300 (AAS 8)

## AUDIT PLANNING

***(Effective for all audits relating to accounting periods beginning on or after April 1, 1989)***

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Standard on Auditing (SA) 300*, "Audit Planning" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in April, 1989. The date Standard on Auditing (SA) 300 (Revised) comes into effect, this Standard on Auditing shall stand withdrawn. SA 300(Revised) is effective for audits of Financial Statements beginning on or after April 1, 2008.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. Standard on Auditing (SA) 200, "Basic Principles Governing an Audit", states (paragraphs 12-14):

> "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 a knowledge of the client's business.
>
> Plans should be made to cover, among other things:
>
> (a) acquiring knowledge of the client's accounting systems, policies and internal control procedures;
>
> (b) establishing the expected degree of reliance to be placed on internal control;
>
> (c) determining and programming the nature, timing, and extent of the audit procedures to be performed; and
>
> (d) coordinating the work to be performed.
>
> Plans should be further developed and revised as necessary during the course of the audit."

The purpose of this Standard is to amplify the basic principle outlined above.

2. This Standard applies to the planning process of the audit of both financial statements and other financial information. The Statement is framed in the context of recurring audits. In a first audit, the auditor may need to extend his planning process beyond the matters discussed herein.

3. Planning should be continuous throughout the engagement and involves:

- developing an overall plan for the expected scope and conduct of the audit; and
- developing an audit programme showing the nature, timing and extent of audit procedures.

Changes in conditions or unexpected results of audit procedures may cause revisions of the overall plan and of the audit programme. The reasons for significant changes may be documented.

4. Adequate audit planning helps to:

- ensure that appropriate attention is devoted to important areas of the audit;
- ensure that potential problems are promptly identified;
- ensure that the work is completed expeditiously;
- utilise the assistants properly; and
- co-ordinate the work done by other auditors and experts.

5. In planning his audit, the auditor will consider factors such as complexity of the audit, the environment in which the entity operates, his previous experience with the client and knowledge of the client's business.

6. The auditor may wish to discuss elements of his overall plan and certain audit procedures with the client to improve the efficiency of the audit and to coordinate audit procedures with work of the client's personnel. The overall audit plan and the audit programme, however, remain the auditor's responsibility.

## Knowledge of the Client's Business

7. The auditor needs to obtain a level of knowledge of the client's business that will enable him to identify the events, transactions and practices that, in his judgement, may have a significant effect on the financial information. Among other things, the auditor can obtain such knowledge from:

- The client's annual reports to shareholders.
- Minutes of meetings of shareholders, board of directors and important committees.
- Internal financial management reports for current and previous periods, including budgets, if any.
- The previous year's audit working papers, and other relevant files.
- Firm personnel responsible for non-audit services to the client who may be able to provide information on matters that may affect the audit.
- Discussions with client.
- The client's policy and procedures manual.
- Relevant publications of the Institute of Chartered Accountants of India and other professional bodies, industry publications, trade journals,

magazines, newspapers or text books.

- Consideration of the state of the economy and its effect on the client's business.
- Visits to the client's premises and plant facilities.

8. With respect to the previous year's audit working papers and other relevant files, the auditor should pay particular attention to matters that required special consideration and decide whether they might affect the work to be done in the current year.

9. Discussions with the client might include such subjects as:

- Changes in management, organisational structure, and activities of the client.
- Current Government legislation, rules, regulations and directives affecting the client.
- Current business developments affecting the client.
- Current or impending financial difficulties or accounting problems.
- Existence of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
- New or closed premises and plant facilities.
- Recent or impending changes in technology, type of products or services and production or distribution methods.
- Significant matters arising from previous year's financial statements, audit report and management letters, if any.
- Changes in the accounting practices and procedures and in the system of internal control.
- Scope and timing of the examination.
- Assistance of client personnel in data preparation.
- Relevance of any work to be carried out by the client's internal auditors.

10. In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgements regarding the appropriateness of accounting policies and disclosures.

## Development of an Overall Plan

11. The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit:

- The terms of his engagement and any statutory responsibilities.
- The nature and timing of reports or other communication.
- The applicable legal or statutory requirements.
- The accounting policies adopted by the client and changes in those policies.
- The effect of new accounting or auditing pronouncements on the audit.
- The identification of significant audit areas.
- The setting of materiality levels for audit purposes.
- Conditions requiring special attention, such as the possibility of material error or fraud or the involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
- The degree of reliance he expects to be able to place on accounting system and internal control.
- Possible rotation of emphasis on specific audit areas.
- The nature and extent of audit evidence to be obtained.
- The work of internal auditors and the extent of their involvement, if any, in the audit.
- The involvement of other auditors in the audit of subsidiaries or branches of the client.
- The involvement of experts.
- The allocation of work to be undertaken between joint auditors and the procedures for its control and review.
- Establishing and coordinating staffing requirements.

12. The auditor should document his overall plan. The form and extent of the documentation will vary depending on the size and complexity of the audit. A time budget, in which hours are budgeted for the various audit areas or procedures, can be an effective planning tool.

## Developing the Audit Programme

13. The auditor should prepare a written audit programme setting forth the procedures that are needed to implement the audit plan. The programme may also contain the audit objectives for each area and should have sufficient details to serve as a set of instructions to the assistants involved in the audit and as a means to control the proper execution of the work.

14. In preparing the audit programme, the auditor, having an understanding of the accounting system and related internal controls, may wish to rely on certain internal controls in determining the nature, timing and extent of required auditing procedures. 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.

15. 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.

16. 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.

## Effective Date

17. This Standard on Auditing becomes operative in respect of all audits relating to accounting periods beginning on or after April 1, 1989.

# SA 300(REVISED)[1]

## PLANNING AN AUDIT OF FINANCIAL STATEMENTS

***(Effective for audits of financial statements for periods beginning on or after 1st April 2008)***

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Standard on Auditing (SA) 300 (Revised), "Planning an Audit of Financial Statements" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services[2]," which sets out the authority of Standards on Auditing (SAs).

[1] Issued in December, 2007. Earlier known as the Auditing and Assurance Standard (AAS) 8, "Audit Planning".

[2] Published in July 2007 issue of the Journal.

## Introduction

### Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to plan an audit of financial statements. This SA is framed in the context of recurring audits. Additional considerations in initial audit engagements are separately identified. (Ref: Para. A1-A4)

### Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after 1st April 2008.

## Objective

3. The objective of the auditor is to plan the audit so that it will be performed in an effective manner.

## Requirements

### Involvement of Key Engagement Team Members

4. 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. (Ref: Para. A5)

### Preliminary Engagement Activities

5. The auditor shall undertake the following activities at the beginning of the current audit engagement:

(a) Performing procedures required by SA 220[3], "Quality Control for Audit Work" regarding the continuance of the client relationship and the specific audit engagement;

(b) Evaluating compliance with ethical requirements, including independence, as required by SA 220; and

(c) Establishing an understanding of the terms of the engagement, as

[3] Hitherto known as the Auditing and Assurance Standard (AAS) 17, "Quality Control for Audit Work".

required by SA 210[4], "Terms of Audit Engagements". (Ref: Para. A6-A8)

Planning Activities

6. 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.

7. In establishing the overall audit strategy, the auditor shall:

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

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

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

(d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and

(e) Ascertain the nature, timing and extent of resources necessary to perform the engagement. (Ref: Para. A9-A12)

8. The auditor shall develop an audit plan that shall include a description of:

(a) The nature, timing and extent of planned risk assessment procedures, as determined under SA 315 "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

(b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330 "The Auditor's Responses to Assessed Risks".

(c) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs. (Ref: Para. A13)

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[4] Hitherto known as the Auditing and Assurance Standard (AAS) 26, "Terms of Audit Engagements".

9. The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. (Ref: Para. A14)

10. The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. (Ref: Para. A15-A16)

Documentation

11. 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. (Ref: Para. A17-A20)

Additional Considerations in Initial Audit Engagements

12. The auditor shall undertake the following activities prior to starting an initial audit:

(a) Performing procedures required by SA 220 regarding the acceptance of the client relationship and the specific audit engagement; and

(b) Communicating with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements. (Ref: Para. A21)

## Application and Other Explanatory Material

The Role and Timing of Planning (Ref: Para. 1)

A1. Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways, including the following:

- Helping the auditor to devote appropriate attention to important areas of the audit.
- Helping the auditor identify and resolve potential problems on a timely basis.

- Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
- 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.
- Facilitating the direction and supervision of engagement team members and the review of their work.
- Assisting, where applicable, in coordination of work done by auditors of components[5] and experts[6].

A2. The nature and extent of planning activities will vary according to the size and complexity of the entity, the key engagement team members' previous experience with the entity, and changes in circumstances that occur during the audit engagement.

A3. 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:

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

A4. The auditor may decide to discuss elements of planning with the

[5] The auditor may refer the requirements of SA 600, "Using the Work of Another Auditor".

[6] The auditor may refer the requirements of SA 620, "Using the Work of an Expert".

entity's management to facilitate the conduct and management of the audit engagement (for example, to coordinate some of the planned audit procedures with the work of the entity's personnel). Although these discussions often occur, the overall audit strategy and the audit plan remain the auditor's responsibility. 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. For example, discussing the nature and timing of detailed audit procedures with management may compromise the effectiveness of the audit by making the audit procedures too predictable.

Involvement of Key Engagement Team Members (Ref: Para. 4)

A5. 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[7].

Preliminary Engagement Activities (Ref: Para. 5)

A6. Performing the preliminary engagement activities specified in paragraph 5 at the beginning of the current audit engagement assists the auditor in identifying and evaluating events or circumstances that may adversely affect the auditor's ability to plan and perform the audit engagement.

A7. Performing these preliminary engagement activities enables the auditor to plan an audit engagement for which, for example:

- The auditor maintains the necessary independence and ability to perform the engagement.
- There are no issues with management integrity that may affect the auditor's willingness to continue the engagement.
- There is no misunderstanding with the client as to the terms of the engagement.

[7] SA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement", paragraph 10, establishes requirements and provides guidance on the engagement team's discussion of the susceptibility of the entity to material misstatements of the financial statements. SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", paragraph 15 provides guidance on the emphasis given during this discussion to the susceptibility of the entity's financial statements to material misstatement due to fraud.

A8. The auditor's consideration of client continuance and ethical requirements, including independence, occurs throughout the audit engagement as changes in conditions and circumstances occur. Performing initial procedures on both client continuance and evaluation of ethical requirements (including independence) at the beginning of the current audit engagement means that they are completed prior to the performance of other significant activities for the current audit engagement. For continuing audit engagements, such initial procedures often occur shortly after (or in connection with) the completion of the previous audit.

Planning Activities

The Overall Audit Strategy (Ref: Para. 6-7)

A9. 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:

- 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;
- 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;
- When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates; and
- 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.

A10. The Appendix lists examples of considerations in establishing the overall audit strategy.

A11. 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.

Considerations Specific to Smaller Entities

A12. In audits of small entities, the entire audit may be conducted by a very small audit team. Many audits of small entities involve the engagement partner (who may be a sole practitioner) working with one engagement team member (or without any engagement team members). With a smaller team, co-ordination of, and communication between, team members are easier. Establishing the overall audit strategy for the audit of a small entity need not be a complex or time-consuming exercise; it varies according to the size of the entity, the complexity of the audit, and the size of the engagement team. For example, a brief memorandum prepared at the completion of the previous audit, based on a review of the working papers and highlighting issues identified in the audit just completed, updated in the current period based on discussions with the owner-manager, can serve as the documented audit strategy for the current audit engagement if it covers the matters noted in paragraph 7.

The Audit Plan (Ref: Para. 8)

A13. 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.

Changes to Planning Decisions During the Course of the Audit (Ref: Para. 9)

A14. 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 the performance of substantive procedures may contradict the audit evidence obtained through tests of controls.

Direction, Supervision and Review (Ref: Para. 10)

A15. 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:

- The size and complexity of the entity.
- The area of the audit.
- The assessed risks of material misstatement (for example, an increase in the assessed risk of material misstatement for a given area of the audit ordinarily requires a corresponding increase in the extent and timeliness of direction and supervision of engagement team members, and a more detailed review of their work).
- The capabilities and competence of the individual team members performing the audit work.

SA 220 contains further guidance on the direction, supervision and review of audit work.

Considerations Specific to Smaller Entities

A16. When an audit is carried out entirely by the engagement partner, questions of direction and supervision of engagement team members and review of their work do not arise. In such cases, the engagement partner, having personally conducted all aspects of the work, will be aware of all material issues. Forming an objective view on the appropriateness of the judgments made in the course of the audit can present practical problems when the same individual also performs the entire audit. When particularly complex or unusual issues are involved, and the audit is performed by a sole practitioner, it may be desirable to consult with other suitably-experienced

auditors or the auditor's professional body[8].

Documentation (Ref: Para. 11)

A17. 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. For example, the auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing and conduct of the audit.

A18. 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.

A19. 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.

Considerations Specific to Smaller Entities

A20. As discussed in paragraph A12, a suitable, brief memorandum may serve as the documented strategy for the audit of a smaller entity. For the audit plan, standard audit programs and/or checklists (see paragraph A18) drawn up on the assumption of few relevant control activities, as is likely to be the case in a smaller entity, may be used provided that they are tailored to the circumstances of the engagement, including the auditor's risk assessments.

Additional Considerations in Initial Audit Engagements (Ref: Para. 12)

A21. The purpose and objective of planning the audit are the same

[8] In India, The Institute of Chartered Accountants of India governs the accountancy profession to provide services of high quality in the public interest which are accepted worldwide.

whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not ordinarily have the previous experience with the entity that is considered when planning recurring engagements. For initial audits, additional matters the auditor may consider in establishing the overall audit strategy and audit plan include the following:

- Unless prohibited by law or regulation, arrangements to be made with the predecessor auditor, for example, to review the predecessor auditor's working papers. Any major issues (including the application of accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan.
- The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances (see SA 510[9] "Initial Engagements–Opening Balances").
- Other procedures required by the firm's system of quality control for initial audit engagements (for example, the firm's system of quality control may require the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance).

## Material Modifications to ISA 300, "Planning an Audit of Financial Statements"

The SA 300, "Planning an Audit of Financial Statements" does not contain any material modifications vis a vis ISA 300.

[9] Hitherto known as AAS 22, "Initial Engagements-Opening Balances".

# Appendix

(Ref: Para. 6-7 and A9-A12)

## Considerations in Establishing the Overall Audit Strategy

This appendix provides examples of matters the auditor may consider in establishing the overall audit strategy. Many of these matters will also influence the auditor's detailed audit plan. The examples provided cover a broad range of matters applicable to many engagements. While some of the matters referred to below may be required by other SAs, not all matters are relevant to every audit engagement and the list is not necessarily complete.

## Characteristics of the Engagement

- The financial reporting framework on which the financial information to be audited has been prepared, including any need for reconciliations to another financial reporting framework.
- Industry-specific reporting requirements such as reports mandated by industry regulators.
- The expected audit coverage, including the number and locations of components to be included.
- The nature of the control relationships between a parent and its components that determine how the group is to be consolidated.
- The extent to which components are audited by other auditors.
- The nature of the business segments to be audited, including the need for specialized knowledge.
- The reporting currency to be used, including any need for currency translation for the financial information audited.
- The need for a statutory audit of standalone financial statements in addition to an audit for consolidation purposes.
- The availability of the work of internal auditors and the extent of the auditor's potential reliance on such work.
- The entity's use of service organizations and how the auditor may obtain evidence concerning the design or operation of controls performed by them.
- The expected use of audit evidence obtained in previous audits, for example, audit evidence related to risk assessment procedures and tests of controls.
- The effect of information technology on the audit procedures, including the availability of data and the expected use of computer-assisted audit techniques.

- The coordination of the expected coverage and timing of the audit work with any reviews of interim financial information and the effect on the audit of the information obtained during such reviews.
- The availability of client personnel and data.

## Reporting Objectives, Timing of the Audit, and Nature of Communications

- The entity's timetable for reporting, such as at interim and final stages.
- The organization of meetings with management and those charged with governance to discuss the nature, timing and extent of the audit work.
- The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications, both written and oral, including the auditor's report, management letters and communications to those charged with governance.
- The discussion with management regarding the expected communications on the status of audit work throughout the engagement.
- Communication with auditors of components regarding the expected types and timing of reports to be issued and other communications in connection with the audit of components.
- The 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.
- Whether there are any other expected communications with third parties, including any statutory or contractual reporting responsibilities arising from the audit.

## Significant Factors, Preliminary Engagement Activities, and Knowledge Gained on Other Engagements

- The determination of appropriate materiality levels, including:
  - Setting materiality for planning purposes.
  - Setting and communicating materiality for auditors of components.
  - Reconsidering materiality as audit procedures are performed during the course of the audit.
  - Preliminary identification of material components and account balances.

- Preliminary identification of areas where there may be a higher risk of material misstatement.
- The impact of the assessed risk of material misstatement at the overall financial statement level on direction, supervision and review.
- 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.
- Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified weaknesses and action taken to address them.
- The discussion of matters that may affect the audit with firm personnel responsible for performing other services to the entity.
- Evidence of management's commitment to the design, implementation and maintenance of sound internal control, including evidence of appropriate documentation of such internal control.
- Volume of transactions, which may determine whether it is more efficient for the auditor to rely on internal control.
- Importance attached to internal control throughout the entity to the successful operation of the business.
- Significant business developments affecting the entity, including changes in information technology and business processes, changes in key management, and acquisitions, mergers and divestments.
- 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.

## Nature, Timing and Extent of Resources

- The selection of the engagement team (including, where necessary, the engagement quality control reviewer) and the assignment of audit work to the team members, including the assignment of appropriately experienced team members to areas where there may be higher risks of material misstatement.
- Engagement budgeting, including considering the appropriate amount of time to set aside for areas where there may be higher risks of material misstatement.

# SA 315[1]

# IDENTIFYING AND ASSESSING THE RISK OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

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

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[1] Issued in December, 2007. The date this Standard (along with SA 330) becomes effective, the existing Standard on Auditing (SA) 400, "Risk Assessments and Internal Control", SA 310, "Knowledge of the Business", and SA 401, "Auditing in a Computer Information Systems Environment", issued in June 2002, April 2000 and January 2003, respectively, would stand withdrawn.

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Standard on Auditing (SA) 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[2] , which sets out the authority of SAs.

[2] Published in the July 2007 issue of the Journal.

# Introduction

## Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal control.

## Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2008.

# Objective

3. 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.

# Definitions

4. For purposes of the SAs, the following terms have the meanings attributed below:

(a) Assertions – 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.

(b) Business risk – A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.

(c) Internal control – 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.

(d) Risk assessment procedures – 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.

(e) Significant risk – An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

(f) Material Weakness- A weakness in internal control that could have a material effect on the financial statements.

## Requirements

### Risk Assessment Procedures and Related Activities

5. 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. (Ref: Para. A1-A5)

6. 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. (Ref: Para. A6)

(b) Analytical procedures. (Ref: Para. A7-A8)

(c) Observation and inspection. (Ref: Para. A9)

7. The auditor shall consider whether information obtained from the auditor's client acceptance or continuance process is relevant to identifying risks of material misstatement.

8. Where the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to identifying risks of material misstatement.

9. When the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. (Ref: Para. A10-A11)

10. The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion. (Ref: Para. A12-A14)

## The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control

### The Entity and Its Environment

11. The auditor shall obtain an understanding of the following:

(a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A15-A20)

(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; 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. (Ref: Para. A21-A23)

(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. (Ref: Para. A24)

(d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A25-A31)

(e) The measurement and review of the entity's financial performance. (Ref: Para. A32-A37)

### The Entity's Internal Control

12. 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. (Ref: Para. A38-A61)

Nature and Extent of the Understanding of Relevant Controls

13. When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel. (Ref: Para. A62-A64)

Components of Internal Control

Control environment

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

(a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and

(b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by control environment weaknesses. (Ref: Para. A65-A74)

The entity's risk assessment process

15. 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; and

(d) Deciding about actions to address those risks. (Ref: Para. A75)

16. If the entity has established such a process (referred to hereafter as the 'entity's risk assessment process'), the auditor shall obtain an understanding of it, and the results thereof. Where the auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether there was an underlying risk of a kind that the auditor expects would have been identified by the entity's risk assessment process. If there is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or if there is a material weakness in the entity's risk assessment process.

17. If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or represents a material weakness in the entity's internal control. (Ref: Para. A76)

The information system, including the related business processes, relevant to financial reporting, and communication

18. 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, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;

(c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;

(d) How the information system captures events and conditions, other than transactions, that are significant to the financial statements;

(e) The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures;

(f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. (Ref: Para. A77-A81).

19. The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including:

(a) Communications between management and those charged with governance; and

(b) External communications, such as those with regulatory authorities. (Ref: Para. A82-A83)

Control activities relevant to the audit

20. The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. 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. (Ref: Para. A84-A90)

21. In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT. (Ref: Para. A91-A93)

Monitoring of controls

22. The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates corrective actions to its controls. (Ref: Para. A94-A96)

23. The auditor shall obtain an understanding of the sources of the information used in the entity's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose. (Ref: Para. A97)

## Identifying and Assessing the Risks of Material Misstatement

24. The auditor shall identify and assess the risks of material misstatement at:

(a) the financial statement level; and (Ref: Para. A98-A101)

(b) the assertion level for classes of transactions, account balances, and disclosures; (Ref: Para. A102-A106)

to provide a basis for designing and performing further audit procedures.

25. For this purpose, 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; (Ref: Para. A107-A108)

(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 (Ref: Para. A109-A111)

(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.

Risks that Require Special Audit Consideration

26. As part of the risk assessment as described in paragraph 24, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.

27. 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. (Ref: Para. A112-A116)

28. When the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk. (Ref: Para. A117-A119)

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence

29. In respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or

account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. In such cases, the entity's controls over such risks are relevant to the audit and the auditor shall obtain an understanding of them. (Ref: Para. A120-A122)

### Revision of Risk Assessment

30. The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances where the auditor obtains audit evidence from performing further audit procedures, or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor shall revise the assessment and modify the further planned audit procedures accordingly. (Ref: Para. A123)

## Material Weakness in Internal Control

31. The auditor shall evaluate whether, on the basis of the audit work performed, the auditor has identified a material weakness in the design, implementation or maintenance of internal control. (Ref: Para. A124-A125)

32. The auditor shall communicate material weaknesses in internal control identified during the audit on a timely basis to management at an appropriate level of responsibility, and, as required by SA 260 (Revised), "Communication with Those Charged with Governance"[3], with those charged with governance (unless all of those charged with governance are involved in managing the entity). (Ref: Para. A126)

## Documentation

33. The auditor shall document:

(a) The discussion among the engagement team where required by paragraph 10, and the significant decisions reached;

(b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph 11 and of each of the internal control components specified in paragraphs 14-23; the sources of information from which the understanding was obtained; and the risk assessment procedures performed;

(c) The identified and assessed risks of material misstatement at the

[3] Hitherto known as AAS 27,"Communications of Audit Matters with Those Charged with Governance".

financial statement level and at the assertion level as required by paragraph 24; and

(d) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 26-29. (Ref: Para. A127-A130)

## Application and Other Explanatory Material

### Risk Assessment Procedures and Related Activities (Ref: Para. 5)

A1. 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;
- Establishing materiality and evaluating whether the judgment about materiality remains appropriate as the audit progresses;
- Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures;
- 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;
- Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and
- Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

A2. 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.

A3. The auditor uses professional judgment to determine the extent of the understanding required. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to meet the objective stated in this SA. The depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.

A4. The risks to be assessed include both those due to error and those due to fraud, and both are covered by this SA. However, the significance of fraud is such that further requirements and guidance are included in SA 240 (Revised)[4], "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", in relation to risk assessment procedures and related activities to obtain information that is used to identify the risks of material misstatement due to fraud.

A5. Although the auditor is required to perform all the risk assessment procedures described in paragraph 6 in the course of obtaining the required understanding of the entity (see paragraphs 11-23), the auditor is not required to perform all of them for each aspect of that understanding. Other procedures may be performed where the information to be obtained therefrom may be helpful in identifying risks of material misstatement. Examples of such procedures include:

- Reviewing information obtained from external sources such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications.
- Making inquiries of the entity's external legal counsel or of valuation experts that the entity has used.

Inquiries of Management and Others Within the Entity (Ref: Para. 6(a))

A6. 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. For example:

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[4] Standard on Auditing (SA) 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", has been published in 'The Chartered Accountant', December, 2007. SA 240 would be applicable for all audits relating to accounting periods beginning on or after April 1, 2009.

- Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared.
- 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 terms.
- 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.

Analytical Procedures (Ref: Para. 6(b))

A7. 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.

A8. 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. SA 520, "Analytical Procedures"[5], establishes requirements and provides

[5] Hitherto known as the Auditing and Assurance Standard (AAS) 14, "Analytical Procedures".

guidance on the use of analytical procedures.

Observation and Inspection (Ref: Para. 6(c))

A9. 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 directors' meetings).
- The entity's premises and plant facilities.

Information Obtained in Prior Periods (Ref: Para. 9)

A10. The auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as:

- Past misstatements and whether they were corrected on a timely basis.
- The nature of the entity and its environment, and the entity's internal control.
- Significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.

A11. The auditor is required to determine whether information obtained in prior periods remains relevant, if the auditor intends to use that information for the purposes of the current audit. This is because changes in the control environment, for example, may affect the relevance of information obtained in the prior year. To determine whether changes have occurred that may affect the relevance of such information, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems.

Discussion Among the Engagement Team (Ref: Para. 10)

A12. The discussion among the engagement team about the susceptibility of

the entity's financial statements to material misstatement:

- Provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity.
- Allows the engagement team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.
- Assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing, and extent of further audit procedures.
- Provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

SA 240 (Revised) provides further requirements and guidance in relation to the discussion among the engagement team about the risks of fraud.

A13. It is not always necessary or practical for the discussion to include all members in a single discussion (as, for example, in a multi-location audit), nor is it necessary for all of the members of the engagement team to be informed of all of the decisions reached in the discussion. The engagement partner may discuss matters with key members of the engagement team including, if considered appropriate, specialists and those responsible for the audits of components, while delegating discussion with others, taking account of the extent of communication considered necessary throughout the engagement team. A communications plan, agreed by the engagement partner, may be useful.

Considerations Specific to Smaller Entities

A14. Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, it is the engagement partner who, having personally conducted the planning of the audit, would be responsible for considering the susceptibility of the entity's financial statements to material misstatement due to fraud or error.

The Required Understanding of the Entity and Its Environment,

## Including the Entity's Internal Control

### The Entity and Its Environment

Industry, Regulatory and Other External Factors (Ref: Para. 11(a))

#### Industry factors

A15. 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:

- The market and competition, including demand, capacity, and price competition.
- Cyclical or seasonal activity.
- Product technology relating to the entity's products.
- Energy supply and cost.

A16. 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. For example, long-term contracts may involve significant estimates of revenues and expenses that give rise to risks of material misstatement. In such cases, it is important that the engagement team include members with sufficient relevant knowledge and experience, as required by SA 220, "Quality Control for Audits of Historical Financial Information"[6].

#### Regulatory factors

A17. Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, 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 (corporate and other).

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[6] Hitherto known as the Auditing and Assurance Standard (AAS) 17, "Quality Control for Audit Work".

- Government policies currently affecting the conduct of the entity's business, such as monetary, including foreign exchange controls, fiscal, financial incentives (for example, government aid programs), and tariffs or trade restrictions policies.
- Environmental requirements affecting the industry and the entity's business.

A18. SA 250 (Revised), "Consideration of Laws and Regulations in an Audit of Financial Statements"[7], includes some specific requirements related to the legal and regulatory framework applicable to the entity and the industry.

A19. In case of the audits of certain entities, in addition to legislation or regulations, there may be government policy requirements and resolutions of the legislature that affect the entity's operations. Such elements are essential to consider when obtaining an understanding of the entity and its environment.

Other external factors

A20. 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 or currency revaluation.

Nature of the Entity (Ref: Para.11(b))

A21. An understanding of the nature of an entity enables the auditor to understand such matters as:

- Whether the entity has a complex structure, for example with subsidiaries or other components in multiple locations. Complex structures often introduce issues that may give rise to risks of material misstatement. Such issues may include whether goodwill, joint ventures, investments, or special-purpose entities are accounted for appropriately.
- 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. SA 550, "Related Parties"[8], establishes requirements and provides guidance on the auditor's considerations relevant to related parties.

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[7] Hitherto known as the Auditing and Assurance Standard (AAS) 21, "Considerations of Laws and Regulations in an Audit of Financial Statements".

[8] Hitherto known as the Auditing and Assurance Standard (AAS) 23, "Related Parties". Reference may also be made to the Accounting Standard (AS) 18, "Related Party Disclosures" for definition of related party and related party transactions.

A22. Examples of matters that the auditor may consider when obtaining an understanding of the nature of the entity include:

- Business operations – such as:
  - Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as internet sales and marketing activities.
  - Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).
  - Alliances, joint ventures, and outsourcing activities.
  - Geographic dispersion and industry segmentation.
  - Location of production facilities, warehouses, and offices, and location and quantities of inventories.
  - Key customers and important suppliers of goods and services, employment arrangements (including the existence of union contracts, pension and other post employment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters).
  - Research and development activities and expenditures.
  - Transactions with related parties.
- Investments and investment activities – such as:
  - Planned or recently executed acquisitions or divestitures.
  - Investments and dispositions of securities and loans.
  - Capital investment activities.
  - Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities.
- Financing and financing activities – such as:
  - Major subsidiaries and associated entities, including consolidated and non-consolidated structures.
  - Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements.
  - Beneficial owners (local, foreign, business reputation and experience) and related parties.

- Use of derivative financial instruments.

- Financial reporting – such as:
  - Accounting principles and industry - specific practices, including industry - specific significant categories (for example, loans and investments for banks, or research and development for pharmaceuticals).
  - Revenue recognition practices.
  - Accounting for fair values.
  - Foreign currency assets, liabilities and transactions.
  - Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for stock-based compensation).

A23. Significant changes in the entity from prior periods may give rise to, or change, risks of material misstatement.

The Entity's Selection and Application of Accounting Policies (Ref: Para.11(c))

A24. An understanding of the entity's selection and application of accounting policies may encompass such matters as:

- The methods the entity uses to account for significant and unusual transactions.
- The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.
- Changes in the entity's accounting policies.
- Financial reporting standards and laws and regulations that are new to the entity, and when and how the entity will adopt such requirements.

Objectives and Strategies and Related Business Risks (Ref. Para.11(d))

A25. 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 or those charged with governance 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.

A26. 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. A failure to recognise the need for change may also give rise to business risk. Business risk may arise, for example, from:

- The development of new products or services that may fail;
- A market which, even if successfully developed, is inadequate to support a product or service; or
- Flaws in a product or service that may result in liabilities and reputational risk.

A27. 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.

A28. 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).
- New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation, or increased costs).
- Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure).
- Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the entity's inability to meet requirements).
- Use of IT (a potential related business risk might be, for example, that systems and processes are incompatible).
- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk

might be, for example, incomplete or improper implementation).

A29. A business risk may have an immediate consequence for the risk of material misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statement level. For example, the business risk arising from a contracting customer base may increase the risk of material misstatement associated with the valuation of receivables. However, the same risk, particularly in combination with a contracting economy, may also have a longer-term consequence, which the auditor considers when assessing the appropriateness of the going concern assumption. Whether a business risk may result in a risk of material misstatement is, therefore, considered in light of the entity's circumstances. Examples of conditions and events that may indicate risks of material misstatement are indicated in the Appendix 2.

A30. Usually, management identifies business risks and develops approaches to address them. Such a risk assessment process is part of internal control and is discussed in paragraph 15 and paragraphs A75-A76.

A31. In case of audits of certain entities, "management objectives" may be influenced by concerns regarding public accountability and may include objectives which have their source in legislation, regulations, and government directions.

Measurement and Review of the Entity's Financial Performance (Ref: Para.11(e))

A32. 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 – See SA 240 (Revised) for requirements and guidance in relation to the risks of fraud.

A33. The measurement and review of financial performance is not the same as the monitoring of controls (discussed as a component of internal control in paragraphs A94-A97), though their purposes may overlap:

- The measurement and review of performance is directed at whether business performance is meeting the objectives set by management (or

third parties).

- Monitoring of controls is specifically concerned with the effective operation of internal control.

In some cases, however, performance indicators also provide information that enables management to identify deficiencies in internal control.

A34. Examples of internally-generated information used by management for measuring and reviewing financial performance, and which the auditor may consider, 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, segment information and divisional, departmental or other level performance reports.
- Employee performance measures and incentive compensation policies.
- Comparisons of an entity's performance with that of competitors.

A35. External parties may also measure and review the entity's financial performance. For example, external information such as analysts' reports and credit rating agency reports may represent useful information for the auditor. Such reports can often be obtained from the entity being audited.

A36. Internal measures may highlight unexpected results or trends requiring management to determine their cause and take corrective action (including, in some cases, the detection and correction of misstatements on a timely basis). Performance measures may also indicate to the auditor that risks of misstatement of related financial statement information do exist. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared to that of other entities in the same industry. Such information, particularly if combined with other factors such as performance-based bonus or incentive remuneration, may indicate the potential risk of management bias in the preparation of the financial statements.

Considerations specific to smaller entities

A37. Smaller entities often do not have processes to measure and review financial performance. Inquiry of management may reveal that it relies on certain key indicators for evaluating financial performance and taking appropriate action. If such inquiry indicates an absence of performance

measurement or review, there may be an increased risk of misstatements not being detected and corrected.

The Entity's Internal Control

A38. An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the nature, timing, and extent of further audit procedures.

A39. The following application material on internal control is presented in four sections, as follows:

- General Nature and Characteristics of Internal Control.
- Controls Relevant to the Audit.
- Nature and Extent of the Understanding of Relevant Controls.
- Components of Internal Control.

General Nature and Characteristics of Internal Control (Ref: Para. 12)

Purpose of internal control

A40. 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.

Considerations specific to smaller entities

A41. Smaller entities may use less structured means and simpler processes and procedures to achieve their objectives.

Limitations of internal control

A42. 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 limitations inherent to internal control. These include the 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. 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.

A43. 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.

A44. 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.

Considerations specific to smaller entities

A45. Smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager[9] 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.

A46. 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.

Division of internal control into components

A47. The division of internal control into the following five components, for purposes of the SAs, 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;

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[9] Owner-manager refers to the proprietor of an entity who is involved in running the entity on a day-to-day basis.

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

(d) Control activities; and

(e) Monitoring of controls.

The division does not necessarily reflect how an entity designs, implements and maintains internal control, or how it may classify any particular component. Auditors may use different terminology or frameworks to describe the various aspects of internal control, and their effect on the audit than those used in this SA, provided all the components described in this SA are addressed.

A48. Application material relating to the five components of internal control as they relate to a financial statement audit is set out in paragraphs A65-A97 below. Appendix 1 provides further explanation of these components of internal control.

Characteristics of manual and automated elements of internal control relevant to the auditor's risk assessment

A49. 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.

A50. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported:

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

that depend on IT.

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

A51. Generally, IT benefits an entity's internal control by enabling an entity to:

- Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
- Enhance the timeliness, availability, and accuracy of information;
- Facilitate the additional analysis of information;
- Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
- Reduce the risk that controls will be circumvented; and
- Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

A52. IT also poses specific risks to an entity's internal control, including, for example:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- Unauthorised changes to data in master files.
- Unauthorised changes to systems or programs.
- Failure to make necessary changes to systems or programs.
- Inappropriate manual intervention.
- Potential loss of data or inability to access data as required.

A53. 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.

A54. 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.

A55. 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.

Controls Relevant to the Audit

A56. There is a direct relationship between an entity's objectives and the controls 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.

A57. 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.

A58. 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.

A59. 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.

A60. 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.

A61. 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.

Nature and Extent of the Understanding of Relevant Controls (Ref: Para. 13)

A62. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first. An improperly designed control may represent a material weakness in the entity's internal control.

A63. 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.

A64. 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 (see paragraph A51), 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. Tests of the operating effectiveness of controls are further described in SA 330, "The Auditor's Responses to Assessed Risks".

Components of Internal Control—Control Environment (Ref: Para. 14)

A65. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people.

A66. Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

(a) Communication and enforcement of integrity and ethical values – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.

(b) Commitment to competence – Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

(c) Participation by those charged with governance – Attributes of those charged with governance such as:

- ♦ Their independence from management.
- ♦ Their experience and stature.
- ♦ The extent of their involvement and the information they receive, and the scrutiny of activities.
- ♦ The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.

(d) Management's philosophy and operating style – Characteristics such as management's:

- ♦ Approach to taking and managing business risks.
- ♦ Attitudes and actions toward financial reporting.
- ♦ Attitudes toward information processing and accounting functions and personnel.

(e) Organisational structure – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.

(f) Assignment of authority and responsibility - Matters such as how authority and responsibility for operating activities are assigned and how reporting

relationships and authorisation hierarchies are established.

(g) Human resource policies and practices – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

Audit evidence for elements of the control environment

A67. Relevant audit evidence may be obtained through a combination of inquiries and other risk assessment procedures such as corroborating inquiries through observation or inspection of documents. For example, through inquiries of management and employees, the auditor may obtain an understanding of how management communicates to employees its views on business practices and ethical behavior. The auditor may then determine whether relevant controls have been implemented by considering, for example, whether management has a written code of conduct and whether it acts in a manner that supports the code.

Effect of the control environment on the assessment of the risks of material misstatement

A68. Some elements of an entity's control environment have a pervasive effect on assessing the risks of material misstatement. For example, an entity's control consciousness is influenced significantly by those charged with governance, because one of their roles is to counterbalance pressures on management in relation to financial reporting that may arise from market demands or remuneration schemes. The effectiveness of the design of the control environment in relation to participation by those charged with governance is therefore influenced by such matters as:

- Their independence from management and their ability to evaluate the actions of management.
- Whether they understand the entity's business transactions.
- The extent to which they evaluate whether the financial statements are prepared in accordance with the applicable financial reporting framework.

A69. An active and independent board of directors may influence the philosophy and operating style of senior management. However, other elements may be more limited in their effect. For example, although human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may reduce the risk of errors in processing financial information, they may not mitigate a strong bias by top management to overstate earnings.

A70. 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, weaknesses 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. As explained in SA 330, the control environment also influences the nature, timing, and extent of the auditor's further procedures.

A71. 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.

Considerations specific to smaller entities

A72. The control environment within small entities is likely to differ from larger entities. For example, those charged with governance in small entities may not include an independent or outside member, and the role of governance may be undertaken directly by the owner-manager where there are no other owners. The nature of the control environment may also influence the significance of other controls, or their absence. For example, the active involvement of an owner-manager may mitigate certain of the risks arising from a lack of segregation of duties in a small business; it may, however, increase other risks, for example, the risk of override of controls.

A73. In addition, audit evidence for elements of the control environment in smaller entities may not be available in documentary form, in particular where communication between management and other personnel may be informal, yet effective. For example, small entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example.

A74. Consequently, the attitudes, awareness and actions of management or the owner-manager are of particular importance to the auditor's understanding of a smaller entity's control environment.

Components of Internal Control—The Entity's Risk Assessment Process (Ref: Para. 15)

A75. The entity's risk assessment process forms the basis for how management determines the risks to be managed. If that process is appropriate to the circumstances, including the nature, size and complexity of the entity, it assists the auditor in identifying risks of material misstatement. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

Considerations specific to smaller entities (Ref: Para. 17)

A76. There is unlikely to be an established risk assessment process in a small entity. In such cases, it is likely that management will identify risks through direct personal involvement in the business. Irrespective of the circumstances, however, inquiry about identified risks and how they are addressed by management is still necessary.

Components of Internal Control—The Information System, Including the Related Business Processes, Relevant to Financial Reporting, and Communication

The information system, including related business processes, relevant to financial reporting (Ref: Para. 18)

A77. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures and records designed and established to:

- Initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity;
- Resolve incorrect processing of transactions, for example, automated suspense files and procedures followed to clear suspense items out on a timely basis;
- Process and account for system overrides or bypasses to controls;
- Transfer information from transaction processing systems to the general ledger;
- Capture information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortisation of assets and changes in the recoverability of accounts receivables; and
- Ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarised and appropriately reported in the financial statements.

Journal entries

A78. An entity's information system typically includes the use of standard journal entries that are required on a recurring basis to record transactions. Examples might be journal entries to record sales, purchases, and cash disbursements in the general ledger, or to record accounting estimates that are periodically made by management, such as changes in the estimate of uncollectible accounts receivable.

A79. An entity's financial reporting process also includes the use of non-standard journal entries to record non-recurring, unusual transactions or adjustments. Examples of such entries include consolidating adjustments and entries for a business combination or disposal or non-recurring estimates such as the impairment of an asset. In manual general ledger systems, non-standard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. When automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may therefore be more easily identified through the use of computer-assisted audit techniques.

Related business processes

A80. An entity's business processes are the activities designed to:

- Develop, purchase, produce, sell and distribute an entity's products and services;
- Ensure compliance with laws and regulations; and
- Record information, including accounting and financial reporting information.

Business processes result in the transactions that are recorded, processed and reported by the information system. Obtaining an understanding of the entity's business processes, which include how transactions are originated, assists the auditor obtain an understanding of the entity's information system relevant to financial reporting in a manner that is appropriate to the entity's circumstances.

Considerations specific to smaller entities

A81. Information systems and related business processes relevant to financial reporting in small entities are likely to be less sophisticated than in larger entities, but their role is just as significant. Small entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies.

Understanding the entity's systems and processes may therefore be easier in an audit of smaller entities, and may be more dependent on inquiry than on review of documentation. The need to obtain an understanding, however, remains important.

Communication (Ref: Para. 19)

A82. Communication by the entity of the financial reporting roles and responsibilities and of significant matters relating to financial reporting involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes such matters as the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Communication may take such forms as policy manuals and financial reporting manuals. Open communication channels help ensure that exceptions are reported and acted on.

Considerations specific to smaller entities

A83. Communication may be less structured and easier to achieve in a small entity than in a larger entity due to fewer levels of responsibility and management's greater visibility and availability.

Components of Internal Control—Control Activities (Ref: Para. 20)

A84. 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. Examples of specific control activities include those relating to the following:

- Authorization.
- Performance reviews.
- Information processing.
- Physical controls.
- Segregation of duties.

A85. Control activities that are relevant to the audit are:

- Those that are required to be treated as such, being control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence, as required by paragraphs 28 and 29,

respectively; or

- Those that are considered to be relevant in the judgment of the auditor.

A86. The auditor's judgment about whether a control activity is relevant to the audit is influenced by the risk that the auditor has identified that may give rise to a material misstatement and whether the auditor thinks it is likely to be appropriate to test the operating effectiveness of the control in determining the extent of substantive testing.

A87. The auditor's emphasis may be on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that risks of material misstatement are likely to be higher. When multiple control activities each achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective.

A88. The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities.

Considerations specific to smaller entities

A89. The concepts underlying control activities in small entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, small entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions, lessening or removing the need for more detailed control activities.

A90. Control activities relevant to the audit of a smaller entity are likely to relate to the main transaction cycles such as revenues, purchases and employment expenses.

Risks arising from IT (Ref: Para. 21)

A91. The use of IT affects the way that control activities are implemented. From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process, and include effective general IT-controls and application controls.

A92. General IT-controls are policies and procedures that relate to many

applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments. General IT-controls that maintain the integrity of information and security of data commonly include controls over the following:

- Data center and network operations.
- System software acquisition, change and maintenance.
- Program change.
- Access security.
- Application system acquisition, development, and maintenance.

They are generally implemented to deal with the risks referred to in paragraph A52 above.

A93. Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of individual applications. Application controls can be preventive or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorised, and are completely and accurately recorded and processed. Examples include edit checks of input data, and numerical sequence checks with manual follow-up of exception reports or correction at the point of data entry.

Components of Internal Control—Monitoring of Controls (Ref: Para. 22)

A94. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary corrective actions. 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.

A95. In many entities, internal auditors or personnel performing similar functions contribute to the monitoring of an entity's activities. SA 610, "Considering the Work of Internal Audit"[10] establishes requirements and provides guidance on the auditor's consideration of the work of internal auditing. Management's monitoring activities may also include using

[10] Hitherto known as AAS 7, "Relying Upon the Work of an Internal Auditor".

information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

Considerations specific to smaller entities

A96. Management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to corrective action to the control.

Sources of information (Ref: Para. 23)

A97. Much of the information used in monitoring may be produced by the entity's information system. If management assumes that data used for monitoring are accurate without having a basis for that assumption, errors that may exist in the information could potentially lead management to incorrect conclusions from its monitoring activities. Accordingly, an understanding of:

- the sources of the information related to the entity's monitoring activities; and
- the basis upon which management considers the information to be sufficiently reliable for the purpose;

  is required as part of the auditor's understanding of the entity's monitoring activities as a component of internal control.

## Identifying and Assessing the Risks of Material Misstatement

### Assessment of Risks of Material Misstatement at the Financial Statement Level (Ref: Para. 24 (a))

A98. Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

A99. Risks at the financial statement level may derive in particular from a weak control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, weaknesses such as

management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

A100. The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example:

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

A101. SA 705, "Modifications to the Opinion in the Independent Auditor's Report"[11] establishes requirements and provides guidance in determining whether there is a need for the auditor to consider a qualification or disclaimer of opinion or, as may be required in some cases, to withdraw from the engagement where this is legally possible.

Assessment of Risks of Material Misstatement at the Assertion Level (Ref: Para. 24(b))

A102. Risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.

The Use of Assertions

A103. 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.

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[11] At present, there is no separate Standard on Auditing (SA) corresponding to International Standard on Auditing (ISA) 705. However, the concept of modified audit report has been discussed in SA 700, "The Auditor's Report on Financial Statements".

A104. 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.

A105. 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.

A106. 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 A104, 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.

Process of Identifying Risks of Material Misstatement (Ref: Para. 25(a))

A107. Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing, and extent of further audit procedures to be performed.

A108. Appendix 2 provides examples of conditions and events that may indicate the existence of risks of material misstatement.

Relating Controls to Assertions [Ref: Para. 25(c)]

A109. In making risk assessments, the auditor may identify the controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. Generally, it is useful to obtain an understanding of controls and relate them to assertions in the context of processes and systems in which they exist because individual control activities often do not in themselves address a risk. Often, only multiple control activities, together with other components of internal control, will be sufficient to address a risk.

A110. Conversely, some control activities may have a specific effect on an individual assertion embodied in a particular class of transactions or account balance. For example, the control activities that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence and completeness assertions for the inventory account balance.

A111. Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements in that assertion. For example, a sales manager's review of a summary of sales activity for specific

stores by region ordinarily is only indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.

Significant Risks

Identifying Significant Risks (Ref: Para. 27)

A112. 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. Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks.

A113. 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.

A114. 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.

A115. SA 330 describes the consequences for further audit procedures of identifying a risk as significant.

Significant risks relating to the risks of material misstatement due to fraud

A116. SA 240 (Revised) provides further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud.

Understanding Controls Related to Significant Risks (Ref: Para. 28)

A117. Although risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls, management may have other responses intended to deal with such risks. Accordingly, the auditor's understanding of whether the entity has designed and implemented controls for significant risks arising from non-routine or judgmental matters includes whether and how management responds to the risks. Such responses might include:

- Control activities such as a review of assumptions by senior management or experts.
- Documented processes for estimations.
- Approval by those charged with governance.

A118. For example, where there are one-off events such as the receipt of notice of a significant lawsuit, consideration of the entity's response may include such matters as whether it has been referred to appropriate experts (such as internal or external legal counsel), whether an assessment has been made of the potential effect, and how it is proposed that the circumstances are to be disclosed in the financial statements.

A119. In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. This may indicate a material weakness in the entity's internal control.

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence (Ref: Para. 29)

A120. Risks of material misstatement may relate directly to the recording of routine classes of transactions or account balances, and the preparation of reliable financial statements. Such risks may include risks of inaccurate or incomplete processing for routine and significant classes of transactions such as an entity's revenue, purchases, and cash receipts or cash payments.

A121. Where such routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk. For example, the auditor may consider this to be the case in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported only in electronic form such as in an integrated system. In such cases:

- Audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of

controls over its accuracy and completeness.

- The potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively.

A122. The consequences for further audit procedures of identifying such risks are described in SA 330.

Revision of Risk Assessment (Ref: Para. 30)

A123. During the audit, information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example, the risk assessment may be based on an expectation that certain controls are operating effectively. In performing tests of those controls, the auditor may obtain audit evidence that they were not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures the auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessments. In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity and the further planned audit procedures may not be effective in detecting material misstatements. See SA 330 for further guidance.

Material Weakness in Internal Control (Ref: Para. 31)

A124. The types of material weaknesses in internal control that the auditor may identify when obtaining an understanding of the entity and its internal controls may include:

- Risks of material misstatement that the auditor identifies and which the entity has not controlled, or for which the relevant control is inadequate.
- A weakness in the entity's risk assessment process that the auditor identifies as material, or the absence of a risk assessment process in those cases where it would be appropriate for one to have been established.

A125. Material weaknesses may also be identified in controls that prevent, or detect and correct, error, or those to prevent and detect fraud.

A126. In case of certain audit engagements, there may be additional communication or reporting requirements. For example, internal control weaknesses may have to be reported to the regulator.

Documentation (Ref: Para. 33)

A127. The manner in which the requirements of paragraph 33 are documented is for the auditor to determine using professional judgment. For example, in audits of small entities the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan that is required by SA 300 (Revised), "Planning an Audit of Financial Statements". Similarly, for example, the results of the risk assessment may be documented separately, or may be documented as part of the auditor's documentation of further procedures (see SA 330). The form and extent of the documentation is influenced by the nature, size and complexity of the entity and its internal control, availability of information from the entity and the audit methodology and technology used in the course of the audit.

A128. For entities that have uncomplicated businesses and processes relevant to financial reporting, the documentation may be simple in form and relatively brief. It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of understanding documented by the auditor include those on which the auditor based the assessment of the risks of material misstatement.

A129. The extent of documentation may also reflect the experience and capabilities of the members of the audit engagement team. Provided the requirements of SA 230[12], "Audit Documentation" are always met, an audit undertaken by an engagement team comprising less experienced individuals may require more detailed documentation to assist them to obtain an appropriate understanding of the entity than one that includes experienced individuals.

A130. For recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity's business or processes.

## Material Modifications to ISA 315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment

### Additions

1. Paragraph 4 of the Requirement part of ISA 315 deals with the definition of terms, which needs to be defined for the proper interpretation of the Standard. The definition of the term, "Material weakness" has been added in paragraph 4.

### Deletions

[12] Hitherto known as AAS 3, "Documentation".

1. Paragraph A19 of the Application Section of ISA 315 deals with the application of the requirements of ISA 315 to the audits of public sector entities regarding the effect of ministerial directives, government policy requirements and resolutions of the legislature on the operations of the entity. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, the operation of the entity may be affected by government policy requirements and resolutions of the legislature. Accordingly, the spirit of erstwhile A19, highlighting the fact that in some cases, the entity's operations may be affected by such requirements/resolutions, has been retained.

2. Paragraph A31 of the Application Section of ISA 315 deals with the application of the requirements of ISA 315 to the audits of public sector entities regarding the influence of concerns relating to public accountability, including objectives having source in legislation, regulations, government ordinances, etc., on 'management objectives'. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, the management's objectives are influenced by such aspects. Accordingly, the spirit of erstwhile A31, highlighting the fact that in some cases, the management objectives may be influenced by the concerns relating to public accountability, including objectives having source in legislation, regulations, government directions, has been retained.

3. Paragraph A61 of the Application Section of ISA 315 deals with the application of the requirements of ISA 315 to the audits of public sector entities regarding the additional reporting responsibilities of the auditor with respect to internal control because of any code of practice or compliance with legislative authorities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size,

a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, the statute or regulations may require the auditor to report on compliance with certain specific aspects of internal control. Accordingly, the spirit of erstwhile A61, highlighting such additional reporting responsibilities of the auditor, has been retained.

4. Paragraph A106 of the Application Section of ISA 315 deals with the application of the requirements of ISA 315 to the audits of public sector entities regarding the relevance of management's assertions that transactions and events have been carried out in accordance with legislation or proper authority, for the financial statement audit. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, there may be similar assertions made by the management that may fall within the scope of the financial statement audit. Accordingly, the spirit of erstwhile A106, highlighting such fact, has been retained and an example has been added.

5. Paragraph A126 of the Application Section of ISA 315 deals with the application of the requirements of ISA 315 to the audits of public sector entities regarding the additional communication and reporting requirements for the auditor. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such additional communication or reporting requirements may exist even in case of non public sector entities. Accordingly, the spirit of erstwhile A126, highlighting such fact, has been retained though a specific reference to public sector entities has been deleted.

# Appendix 1

(Ref: Paras. 4(c), 14-23 and A65-A97)

## Internal Control Components

1. This appendix further explains the components of internal control, as set out in paragraphs 4(c), 14-23 and A65-A97, as they relate to a financial statement audit.

### Control Environment

2. The control environment encompasses the following elements:

(a) Communication and enforcement of integrity and ethical values. The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.

(b) Commitment to competence. Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job.

(c) Participation by those charged with governance. An entity's control consciousness is influenced significantly by those charged with governance. The importance of the responsibilities of those charged with governance is recognised in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures and the process for reviewing the effectiveness of the entity's internal control.

(d) Management's philosophy and operating style. Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions toward financial reporting may manifest themselves through conservative or aggressive selection from available alternative accounting principles, or conscientiousness and conservatism with which accounting estimates are developed.

(e) Organizational structure. 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. The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it may include policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognise how and for what they will be held accountable.

(g) Human resource policies and practices. Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity. For example, standards for recruiting the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior – 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 behavior. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

## Entity's Risk Assessment Process

3. For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyses significant estimates recorded in the financial statements.

4. Risks relevant to reliable financial reporting include external and internal events, transactions or circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific

risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:

- Changes in operating environment. Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
- New personnel. New personnel may have a different focus on or understanding of internal control.
- New or revamped information systems. Significant and rapid changes in information systems can change the risk relating to internal control.
- Rapid growth. Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- New technology. Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
- New business models, products, or activities. Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
- Corporate restructurings. Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
- Expanded foreign operations. The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
- New accounting pronouncements. Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

## Information System, Including the Related Business Processes, Relevant To Financial Reporting, And Communication

5. 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).

6. The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods and

records that:

- Identify and record all valid transactions.
- Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Present properly the transactions and related disclosures in the financial statements.

7. 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.

8. Communication, which involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting, may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

## Control Activities

9. Generally, control activities that may be relevant to an audit may be categorised as policies and procedures that pertain to the following:

- Performance reviews. These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.
- Information processing. The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT-controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-

up of exception reports. Examples of general IT-controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.

- Physical controls. Controls that encompass:
  - The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
  - The authorisation for access to computer programs and data files.
  - The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting records).

  The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on circumstances such as when assets are highly susceptible to misappropriation.
- Segregation of duties. Assigning different people the responsibilities of authorising transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

10. Certain control activities may depend on the existence of appropriate higher level policies established by management or those charged with governance. For example, authorisation controls may be delegated under established guidelines, such as, investment criteria set by those charged with governance; alternatively, non-routine transactions such as, major acquisitions or divestments may require specific high level approval, including in some cases that of shareholders.

## Monitoring of Controls

11. An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of controls may include activities such as, management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms

of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring is done also to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.

12. Internal auditors or personnel performing similar functions may contribute to the monitoring of an entity's controls through separate evaluations. Ordinarily, they regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the effectiveness of internal control, and communicate information about strengths and weaknesses and recommendations for improving internal control.

13. Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

# Appendix 2

(Ref: Para. A29 and A108)

## Conditions and Events that May Indicate Risks of Material Misstatement

The following are examples of conditions and events that may indicate the existence of risks of material misstatement. The examples provided cover a broad range of conditions and events; however, not all conditions and events are relevant to every audit engagement and the list of examples is not necessarily complete.

- Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies.
- Operations exposed to volatile markets, for example, futures trading.
- Operations that are subject to a high degree of complex regulation.
- Going concern and liquidity issues including loss of significant customers.
- Constraints on the availability of capital and credit.
- Changes in the industry in which the entity operates.
- Changes in the supply chain.
- Developing or offering new products or services, or moving into new lines of business.
- Expanding into new locations.
- Changes in the entity such as large acquisitions or reorganisations or other unusual events.
- Entities or business segments likely to be sold.
- The existence of complex alliances and joint ventures.
- Use of off-balance-sheet finance, special-purpose entities, and other complex financing arrangements.
- Significant transactions with related parties.
- Lack of personnel with appropriate accounting and financial reporting skills.
- Changes in key personnel including departure of key executives.

- Weaknesses in internal control, especially those not addressed by management.
- Inconsistencies between the entity's IT strategy and its business strategies.
- Changes in the IT environment.
- Installation of significant new IT systems related to financial reporting.
- Inquiries into the entity's operations or financial results by regulatory or government bodies.
- Past misstatements, history of errors or a significant amount of adjustments at period end.
- Significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end.
- Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold and classification of marketable securities.
- Application of new accounting pronouncements.
- Accounting measurements that involve complex processes.
- Events or transactions that involve significant measurement uncertainty, including accounting estimates.
- Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.

# SA 320 (AAS 13)

## AUDIT MATERIALITY

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

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Standard on Auditing (SA) 320*, "Audit Materiality" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in January, 1997.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard is to establish standards on the concept of materiality and its relationship with audit risk.

2. The auditor should consider materiality and its relationship with audit risk when conducting an audit.

## Materiality

3. Information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality depends on the size and nature of the item, judged in the particular circumstances of its misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.

4 The objective of an audit of financial information prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable the auditor to express an opinion on such financial information. The assessment of what is material is a matter of professional judgement.

5. The concept of materiality recognises that some matters, either individually or in the aggregate, are relatively important for true and fair presentation of financial information in conformity with recognised accounting policies and practices. The auditor considers materiality at both the overall financial information level and in relation to individual account balances and classes of transactions. Materiality may also be influenced by other considerations, such as the legal and regulatory requirements, non-compliance with which may have a significant bearing on the financial information, and considerations relating to individual account balances and relationships. This process may result in different levels of materiality depending on the matter being audited.

6. Although the auditor ordinarily establishes an acceptable materiality level to detect quantitatively material misstatements, both the amount (quantity) and nature (quality) of misstatements need to be considered. An example of a qualitative misstatement would be the inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misled by the description.

7. The auditor needs to consider the possibility of misstatements of relatively small amounts that, cumulatively, could have a material effect on the financial information. For example, an error in a month-end (or other periodic) procedure could be an indication of a potential material misstatement if that error is repeated each month or each period, as the case may be.

8. Materiality should be considered by the auditor when –

(a) determining the nature, timing and extent of audit procedures;

(b) evaluating the effect of misstatements.

## The Relationship between Materiality and Audit Risk

9. When planning the audit, the auditor considers what would make the financial information materially misstated. The auditor's preliminary assessment of materiality, related to specific account balances and classes of transactions, helps the auditor decide such questions as what items to examine and whether to use sampling and analytical procedures. This enables the auditor to select audit procedures that, in combination, can be expected to support the audit opinion at an acceptably low degree of audit risk.

10. There is an inverse relationship between materiality and the degree of audit risk, that is, 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. The auditor takes the inverse relationship between materiality and audit risk into account when determining the nature, timing and extent of audit procedures. For example, if, after planning for specific audit procedures, the auditor determines that the acceptable materiality level is lower, audit risk is increased. The auditor would compensate for this by either:

(a) reducing the assessed degree of control risk, where this is possible, and supporting the reduced degree by carrying out extended or additional tests of control; or

(b) reducing detection risk by modifying the nature, timing and extent of planned substantive procedures.

## Materiality and Audit Risk in Evaluating Audit Evidence

11. The auditor's assessment of materiality and audit risk may be different at the time of initially planning the engagement from that at the time of evaluating the results of his audit procedures. This could be because of a change in circumstances or a change in the auditor's knowledge as a result of the audit. For example, if the audit is planned prior to period end, the auditor will anticipate the results of operations and the financial position. If actual results of operations and financial position are substantially different, the assessment of materiality and audit risk may also change. Additionally, the auditor may, in planning the audit work, intentionally set the acceptable cut off level for verifying individual transactions at a lower level than is intended to be used to evaluate the results of the audit. This may be done to cover a larger number of items and thereby reduce the likelihood of undiscovered misstatements and to provide the auditor with the margin of safety when evaluating the effect of misstatements discovered during the audit.

12. In forming his opinion on the financial information, the auditor should consider whether the effect of aggregate uncorrected misstatements on the financial information is material. Qualitative considerations also influence an auditor in reaching a conclusion as to whether the misstatements are material.

13. The aggregate of uncorrected misstatements comprises:

(a) specific misstatements identified by the auditor, including the net effect of uncorrected misstatements identified during the audit of previous periods; and

(b) the auditor's best estimate of other misstatements which cannot be specifically identified (that is, projected errors).

14. When the auditor tests an account balance or class of transactions by an analytical procedure, he ordinarily would not specifically identify misstatements but would only obtain an indication of whether misstatements might exist in the balance or class and possibly its approximate magnitude. If the analytical procedure indicates that misstatements might exist, but not its approximate amount, the auditor ordinarily would have to employ other procedures to enable him to estimate the aggregate misstatement in the balance or class.

15. When an auditor uses audit sampling to test an account balance or class of transactions, he projects the amount of known misstatements identified by him in his sample to the items in the balance or class from which his sample was selected. That projected misstatement, along with the results of other substantive tests, contributes to the auditor's assessment of aggregate misstatement in the balance or class.

16. If the aggregate of the uncorrected misstatements that the auditor has identified approaches the materiality level, or if auditor determines that the aggregate of uncorrected misstatements causes the financial information to be materially misstated, he should consider requesting the management to adjust the financial information or extending his audit procedures. In any event, the management may want to adjust the financial information for known misstatements. The adjustment of financial information may involve, for example, application of appropriate accounting principles, other adjustments in amounts, or the addition of appropriate disclosure of inadequately disclosed matters. If the management refuses to adjust the financial information and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should express a qualified or adverse opinion, as appropriate.

## Effective Date

17. This Standard on Auditing becomes operative for all audits relating to accounting periods beginning on or after April 1, 1996.

# SA 330[1]

## THE AUDITOR'S RESPONSES TO ASSESSED RISKS

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

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[1] Issued in December, 2007. The date this Standard (along with SA 315) becomes effective, the existing Standard on Auditing (SA) 400, "Risk Assessments and Internal Control", SA 310, "Knowledge of the Business", and SA 401, "Auditing in a Computer Information Systems Environment", issued in June 2002, April 2000 and January 2003, respectively, would stand withdrawn.

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Material Modifications to ISA 330, The Auditor's Responses to Assessed Risks

Standard on Auditing (SA) 330, "The Auditor's Responses to Assessed Risks" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[2], which sets out the authority of SAs.

[2] Published in the July, 2007 issue of the Journal.

## Scope of this SA

1. This Standard on Auditing (SA) 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.

## Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2008.

## Objective

3. 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.

## Definitions

4. For purposes of the SAs, the following terms have the meanings attributed below:

(a) Substantive procedure – 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.

(b) Test of controls – An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

## Requirements

### Overall Responses

5. The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. (Ref: Para. A1-A3)

## Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level

6. 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. (Ref: Para. A4-A8)

7. 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 (Ref: Para. A9-A18)

(b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk. (Ref: Para. A19)

### Tests of Controls

8. 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. (Ref: Para. A20-A24)

9. 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. (Ref: Para. A25)

Nature and Extent of Tests of Controls

10. In designing and performing tests 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. (Ref: Para. A26-A29)

(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. (Ref: Para. A30-A31)

Timing of Tests of Controls

11. The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls, subject to paragraphs 12 and 15 below, in order to provide an appropriate basis for the auditor's intended reliance. (Ref: Para. A32)

Using audit evidence obtained during an interim period

12. When the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor shall:

(a) Obtain audit evidence about significant changes to those controls subsequent to the interim period; and

(b) Determine the additional audit evidence to be obtained for the remaining period. (Ref: Para. A33-A34)

Using audit evidence obtained in previous audits

13. 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. (Ref: Para. A35)

14. 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. The auditor shall obtain this evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls, and:

(a) If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor shall test the controls in the current audit. (Ref: Para. A36)

(b) If there have not been such changes, the auditor shall test the controls at least once in every third audit, and shall test some controls each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods. (Ref: Para. A37-A39)

Controls over significant risks

15. When the auditor plans to rely on controls over a risk the auditor has determined to be a significant risk, the auditor shall test those controls in the current period.

Evaluating the Operating Effectiveness of Controls

16. 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. (Ref: Para. A40)

17. 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 tests of controls that have been performed provide an appropriate basis for reliance on the controls;

(b) Additional tests of controls are necessary; or

(c) The potential risks of misstatement need to be addressed using substantive procedures. (Ref: Para. A41)

18. The auditor shall evaluate whether, on the basis of the audit work performed, the auditor has identified a material weakness in the operating effectiveness of controls.

19. The auditor shall communicate material weaknesses in internal control identified during the audit on a timely basis to management at an appropriate level of responsibility and, as required by SA 260, "Communication with Those Charged with Governance"[3], with those charged with governance (unless all of those charged with governance are involved in managing the entity).

Substantive Procedures

20. Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of

[3] Hitherto known as AAS 27, "Communication of Audit Matters with Those Charged with Governance".

transactions, account balance, and disclosure. (Ref: Para. A42-A47)

Substantive Procedures Related to the Financial Statement Closing Process

21. The auditor's substantive procedures shall include the following audit procedures related to the financial statement closing process:

(a) Agreeing or reconciling the financial statements with the underlying accounting records; and

(b) Examining material journal entries and other adjustments made during the course of preparing the financial statements. (Ref: Para. A48)

Substantive Procedures Responsive to Significant Risks

22. When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details. (Ref: Para. A49)

Timing of Substantive Procedures (Ref: Para.A50)

23. When substantive procedures are performed at an interim date, the auditor shall cover the remaining period by performing:

(a) substantive procedures, combined with tests of controls for the intervening period; or

(b) if the auditor determines that it is sufficient, further substantive procedures only;

that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. (Ref: Para. A51-A53)

24. If misstatements that the auditor did not expect when assessing the risks of material misstatement are detected at an interim date, the auditor shall evaluate whether the related assessment of risk and the planned nature, timing, or extent of substantive procedures covering the remaining period need to be modified. (Ref: Para. A54)

## Adequacy of Presentation and Disclosure

25. The auditor shall perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related

disclosures, is in accordance with the applicable financial reporting framework. (Ref: Para. A55)

## Evaluating the Sufficiency and Appropriateness of Audit Evidence

26. Based on the audit procedures performed and the audit evidence obtained, the auditor shall evaluate before the conclusion of the audit whether the assessments of the risks of material misstatement at the assertion level remain appropriate. (Ref: Para. A56-A57)

27. The auditor shall conclude whether sufficient appropriate audit evidence has been obtained. In forming an opinion, the auditor shall consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. (Ref: Para. A58)

28. If the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion, the auditor shall attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall express a qualified opinion or a disclaimer of opinion.

## Documentation

29. The auditor shall document:

(a) The overall responses to address the assessed risks of material misstatement at the financial statement level, and the nature, timing and extent of the further audit procedures performed;

(b) The linkage of those procedures with the assessed risks at the assertion level; and

(c) The results of the audit procedures, including the conclusions where these are not otherwise clear. (Ref: Para. A59)

30. If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in previous audits, the auditor shall document the conclusions reached about relying on such controls that were tested in a previous audit.

31. The auditors' documentation shall demonstrate that the financial statements agree or reconcile with the underlying accounting records.

## Application and Other Explanatory Material

### Overall Responses (Ref: Para. 5)

A1. Overall responses to address the assessed risks of material misstatement at the financial statement level may include:

- Emphasizing to the audit team the need to maintain professional skepticism.
- Assigning more experienced staff or those with special skills or using experts.
- Providing more supervision.
- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
- Making general changes to the nature, timing or extent of audit procedures, for example: performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence.

A2. The assessment of the risks of material misstatement at the financial statement level, and thereby the auditor's overall responses, is affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at the period end. Weaknesses in the control environment, however, have the opposite effect; for example, the auditor may respond to an ineffective control environment by:

- Conducting more audit procedures as of the period end rather than at an interim date.
- Obtaining more extensive audit evidence from substantive procedures.
- Increasing the number of locations to be included in the audit scope.

A3. Such considerations, therefore, have a significant bearing on the auditor's general approach, for example, an emphasis on substantive procedures (substantive approach), or an approach that uses tests of controls as well as substantive procedures (combined approach).

## Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level

### The Nature, Timing and Extent of Further Audit Procedures (Ref: Para. 6)

A4. The auditor's assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. For example, (as appropriate and notwithstanding the requirements of this SA)[4], the auditor may determine that:

(a) Only by performing tests of controls may the auditor achieve an effective response to the assessed risk of material misstatement for a particular assertion;

(b) Performing only substantive procedures is appropriate for particular assertions and, therefore, the auditor excludes the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion, or because testing controls would be inefficient and therefore the auditor does not intend to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures; or

(c) A combined approach using both tests of controls and substantive procedures is an effective approach.

A5. The nature of an audit procedure refers to its purpose (i.e., test of controls or substantive procedure) and its type (i.e., inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedure). The nature of the audit procedures is of most importance in responding to the assessed risks.

A6. Timing of an audit procedure refers to when it is performed, or the period or date to which the audit evidence applies.

A7. Extent of an audit procedure refers to the quantity to be performed, for example, a sample size or the number of observations of a control activity.

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[4] For example, as required by paragraph 20, irrespective of the approach selected, the auditor designs and performs substantive procedures for each significant class of transactions, account balance, and disclosure.

A8. Designing and performing 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 provides a clear linkage between the auditors' further audit procedures and the risk assessment.

Responding to the Assessed Risks at the Assertion Level (Ref: Para. 7(a))

Nature

A9. The auditor's assessed risks may affect both the types of audit procedures to be performed and their combination. For example, when an assessed risk is high, the auditor may confirm the completeness of the terms of a contract with the counterparty, in addition to inspecting the document. Further, certain audit procedures may be more appropriate for some assertions than others. For example, in relation to revenue, tests of controls may be most responsive to the assessed risk of misstatement of the completeness assertion, whereas substantive procedures may be most responsive to the assessed risk of misstatement of the occurrence assertion.

A10. The reasons for the assessment given to a risk are relevant in determining the nature of audit procedures. For example, if an assessed risk is lower because of the particular characteristics of a class of transactions without consideration of the related controls, then the auditor may determine that substantive analytical procedures alone provide sufficient appropriate audit evidence. On the other hand, if the assessed risk is lower because of internal controls, and the auditor intends to base the substantive procedures on that low assessment, then the auditor performs tests of those controls, as required by paragraph 8(a). This may be the case, for example, for a class of transactions of reasonably uniform, non-complex characteristics that are routinely processed and controlled by the entity's information system.

Timing

A11. The auditor may perform tests of controls or substantive procedures at an interim date or at the period end. The higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer to, or at, the period end rather than at an earlier date, or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). This is particularly relevant when considering the response to the risks of fraud. For example, the auditor may

conclude that, when the risks of intentional misstatement or manipulation have been identified, audit procedures to extend audit conclusions from interim date to the period end would not be effective.

A12. On the other hand, performing audit procedures before the period end may assist the auditor in identifying significant matters at an early stage of the audit, and consequently resolving them with the assistance of management or developing an effective audit approach to address such matters.

A13. In addition, certain audit procedures can be performed only at or after the period end, for example:

- Agreeing the financial statements to the accounting records;
- Examining adjustments made during the course of preparing the financial statements; and
- Procedures to respond to a risk that, at the period end, the entity may have entered into improper sales contracts, or transactions may not have been finalised.

A14. Further relevant factors that influence the auditor's consideration of when to perform audit procedures include the following:

- The control environment.
- When relevant information is available (for example, electronic files may subsequently be overwritten, or procedures to be observed may occur only at certain times).
- The nature of the risk (for example, if there is a risk of inflated revenues to meet earnings expectations by subsequent creation of false sales agreements, the auditor may wish to examine contracts available on the date of the period end).
- The period or date to which the audit evidence relates.

Extent

A15. The extent of an audit procedure judged necessary is determined after considering the materiality, the assessed risk, and the degree of assurance the auditor plans to obtain. When a single purpose is met by a combination of procedures, the extent of each procedure is considered separately. In general, the extent of audit procedures increases as the risk of material

misstatement increases. For example, in response to the assessed risk of material misstatement due to fraud, increasing sample sizes or performing substantive analytical procedures at a more detailed level may be appropriate. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk.

A16. The use of computer-assisted audit techniques (CAATs) may enable more extensive testing of electronic transactions and account files, which may be useful when the auditor decides to modify the extent of testing, for example, in responding to the risks of material misstatement due to fraud. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

A17. In certain circumstances, the audit mandate and any other special auditing requirements may affect the auditor's consideration of the nature, timing and extent of further audit procedures.

Considerations specific to smaller entities

A18. In the case of very small entities, there may not be many control activities that could be identified by the auditor, or the extent to which their existence or operation have been documented by the entity may be limited. In such cases, it may be more efficient for the auditor to perform further audit procedures that are primarily substantive procedures. In some rare cases, however, the absence of control activities or of other components of control may make it impossible to obtain sufficient appropriate audit evidence.

Higher Assessments of Risk (Ref: Para 7(b))

A19. When obtaining more persuasive audit evidence because of a higher assessment of risk, the auditor may increase the quantity of the evidence, or obtain evidence that is more relevant or reliable, e.g., by placing more emphasis on obtaining third party evidence or by obtaining corroborating evidence from a number of independent sources.

## Tests of Controls

Designing and Performing Tests of Controls (Ref: Para. 8)

A20. Tests of controls are performed only on those controls that the auditor has determined are suitably designed to prevent, or detect and correct, a

material misstatement in an assertion. If substantially different controls were used at different times during the period under audit, each is considered separately.

A21. Testing the operating effectiveness of controls is different from obtaining an understanding of and evaluating the design and implementation of controls. However, the same types of audit procedures are used. The auditor may, therefore, decide it is efficient to test the operating effectiveness of controls at the same time as evaluating their design and determining that they have been implemented.

A22. Further, although some risk assessment procedures may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. For example, the auditor's risk assessment procedures may have included:

- Inquiring about management's use of budgets.
- Observing management's comparison of monthly budgeted and actual expenses.
- Inspecting reports pertaining to the investigation of variances between budgeted and actual amounts.

These audit procedures provide knowledge about the design of the entity's budgeting policies and whether they have been implemented, but may also provide audit evidence about the effectiveness of the operation of budgeting policies in preventing or detecting material misstatements in the classification of expenses.

A23. In addition, the auditor may design a test of controls to be performed concurrently with a test of details on the same transaction. Although the purpose of a test of controls is different from the purpose of a test of details, both may be accomplished concurrently by performing a test of controls and a test of details on the same transaction, also known as a dual-purpose test. For example, the auditor may design, and evaluate the results of, a test to examine an invoice to determine whether it has been approved and to provide substantive audit evidence of a transaction. A dual-purpose test is designed and evaluated by considering each purpose of the test separately.

A24. In some cases, as discussed in SA 315, the auditor may find it impossible to design effective substantive procedures that by themselves

provide sufficient appropriate audit evidence at the assertion level. This may occur when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system. In such cases, paragraph 8(b) requires the auditor to perform tests of relevant controls.

Audit Evidence and Intended Reliance (Ref: Para. 9)

A25. 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.

Nature and Extent of Tests of Controls

Other audit procedures in combination with inquiry (Ref: Para. 10(a))

A26. 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.

A27. 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. For other controls, however, documentation may not be available or relevant. For example, documentation of operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control activities, such as control activities performed by a computer. In such circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation or the use of CAATs.

Extent of tests of controls

A28. 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 tests 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.

SA 530 (Revised)[5], "Audit Sampling" contains further guidance on the extent of testing.

A29. Because of the inherent consistency of IT processing, it may not be necessary to increase the extent of testing of an automated control. An automated control can be expected to function consistently unless the program (including the tables, files, or other permanent data used by the program) is changed. Once the auditor determines that an automated control is functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor may consider performing tests to determine that the control continues to function effectively. Such tests might include determining that:

- Changes to the program are not made without being subject to the appropriate program change controls;
- The authorised version of the program is used for processing transactions; and
- Other relevant general controls are effective.

Such tests also might include determining that changes to the programs have not been made, as may be the case when the entity uses packaged software applications without modifying or maintaining them. For example, the auditor

[5] Hitherto known as Auditing and Assurance Standard (AAS) 15, "Audit Sampling".

may inspect the record of the administration of IT security to obtain audit evidence that unauthorised access has not occurred during the period.

Testing of indirect controls (Ref: Para. 10(b))

A30. In some circumstances, it may be necessary to obtain audit evidence supporting the effective operation of indirect controls. For example, when the auditor decides to test the effectiveness of a user review of exception reports detailing sales in excess of authorized credit limits, the user review and related follow up is the control that is directly of relevance to the auditor. Controls over the accuracy of the information in the reports (for example, the general IT-controls) are described as "indirect" controls.

A31. Because of the inherent consistency of IT processing, audit evidence about the implementation of an automated application control, when considered in combination with audit evidence about the operating effectiveness of the entity's general controls (in particular, change controls), may also provide substantial audit evidence about its operating effectiveness.

Timing of Tests of Controls

Intended period of reliance (Ref: Para. 11)

A32. 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.

Using audit evidence obtained during an interim period (Ref: Para. 12)

A33. Relevant factors in determining what additional audit evidence to obtain about controls that were operating during the period remaining after an interim period, include:

- The significance of the assessed risks of material misstatement at the assertion level.
- The specific controls that were tested during the interim period, and significant changes to them since they were tested, including changes in

the information system, processes, and personnel.

- The degree to which audit evidence about the operating effectiveness of those controls was obtained.
- The length of the remaining period.
- The extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls.
- The control environment.

A34. Additional audit evidence may be obtained, for example, by extending tests of controls over the remaining period or testing the entity's monitoring of controls.

Using audit evidence obtained in previous audits (Ref: Para. 13)

A35. In certain circumstances, audit evidence obtained from previous audits may provide audit evidence where the auditor performs audit procedures to establish its continuing relevance. For example, in performing a previous audit, the auditor may have determined that an automated control was functioning as intended. The auditor may obtain audit evidence to determine whether changes to the automated control have been made that affect its continued effective functioning through, for example, inquiries of management and the inspection of logs to indicate what controls have been changed. Consideration of audit evidence about these changes may support either increasing or decreasing the expected audit evidence to be obtained in the current period about the operating effectiveness of the controls.

Controls that have changed from previous audits (Ref: Para. 14(a))

A36. Changes may affect the relevance of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance. For example, changes in a system that enable an entity to receive a new report from the system probably do not affect the relevance of audit evidence from a previous audit; however, a change that causes data to be accumulated or calculated differently does affect it.

Controls that have not changed from previous audits (Ref: Para. 14(b))

A37. The auditor's decision on whether to rely on audit evidence obtained in previous audits for controls that:

(a) Have not changed since they were last tested; and

(b) Are not controls that mitigate a significant risk;

is a matter of professional judgment. In addition, the length of time between retesting such controls is also a matter of professional judgment, but is required by paragraph 14 (b) to be at least once in every third year.

A38. In general, the higher the risk of material misstatement, or the greater the reliance on controls, the shorter the time period elapsed, if any, is likely to be. Factors that may decrease the period for retesting a control, or result in not relying on audit evidence obtained in previous audits at all, include the following:

- A weak control environment.
- Weak monitoring of controls.
- A significant manual element to the relevant controls.
- Personnel changes that significantly affect the application of the control.
- Changing circumstances that indicate the need for changes in the control.
- Weak general IT-controls.

A39. When there are a number of controls for which the auditor intends to rely on audit evidence obtained in previous audits, testing some of those controls in each audit provides corroborating information about the continuing effectiveness of the control environment. This contributes to the auditor's decision about whether it is appropriate to rely on audit evidence obtained in previous audits.

Evaluating the Operating Effectiveness of Controls (Ref: Para. 16 -19)

A40. A material misstatement detected by the auditor's procedures may indicate the existence of a material weakness in internal control.

A41. The concept of effectiveness of the operation of controls recognises that some deviations in the way controls are applied by the entity may occur. 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. The detected rate of deviation, in particular in comparison with the expected rate, may indicate that the control cannot be

relied on to reduce risk at the assertion level to that assessed by the auditor.

Substantive Procedures (Ref: Para. 20)

A42. Paragraph 20 requires the auditor to design and perform substantive procedures for each material class of transactions, account balance, and disclosure, irrespective of the assessed risks of material misstatement. 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.

Nature and Extent of Substantive Procedures

A43. 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.

A44. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. SA 520[6], "Analytical Procedures" establishes requirements and provides guidance on the application of analytical procedures during an audit.

A45. The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.

A46. Because the assessment of the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to

[6] Hitherto known as Auditing and Assurance Standard (AAS) 14, "Analytical Procedures".

be increased when the results from tests of controls are unsatisfactory. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.

A47. 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. See SA 530 for additional guidance.

Substantive Procedures Related to the Financial Statement Closing Process (Ref: Para. 21(b))

A48. The nature, and also the extent, of the auditor's examination of journal entries and other adjustments depends on the nature and complexity of the entity's financial reporting process and the related risks of material misstatement.

Substantive Procedures Responsive to Significant Risks (Ref: Para. 22)

A49. Paragraph 22 of this SA requires the auditor to perform substantive procedures that are specifically responsive to risks the auditor has determined to be significant risks. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a risk that management is inflating sales by improperly recognising revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment. In these circumstances, the auditor may, for example, design external confirmations not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor may find it effective to supplement such external confirmations with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms. Substantive procedures related to significant risks are most often designed to obtain audit evidence with high reliability.

Timing of Substantive Procedures (Ref: Para. 23-24)

A50. In most cases, audit evidence from a previous audit's substantive procedures provides little or no audit evidence for the current period. There are, however, exceptions, e.g., a legal opinion obtained in a previous audit related to the structure of a securitisation to which no changes have occurred, may be relevant in the current period. In such cases, it may be

appropriate to use audit evidence from a previous audit's substantive procedures if that evidence and the related subject matter have not fundamentally changed, and audit procedures have been performed during the current period to establish its continuing relevance.

Using audit evidence obtained during an interim period (Ref: Para. 23)

A51. In some circumstances, the auditor may determine that it is effective to perform substantive procedures at an interim date, and to compare and reconcile information concerning the balance at the period end with the comparable information at the interim date to:

(a) Identify amounts that appear unusual;

(b) Investigate any such amounts; and

(c) Perform substantive analytical procedures or tests of details to test the intervening period.

A52. Performing substantive procedures at an interim date without undertaking additional procedures at a later date increases the risk that the auditor will not detect misstatements that may exist at the period end. This risk increases as the remaining period is lengthened. Factors such as the following may influence whether to perform substantive procedures at an interim date:

- The control environment and other relevant controls.
- The availability at a later date of information necessary for the auditor's procedures.
- The purpose of the substantive procedure.
- The assessed risk of material misstatement.
- The nature of the class of transactions or account balance and related assertions.
- The ability of the auditor to perform appropriate substantive procedures or substantive procedures combined with tests of controls to cover the remaining period in order to reduce the risk that misstatements that may exist at the period end will not be detected.

A53. Factors such as the following may influence whether to perform substantive analytical procedures with respect to the period between the

interim date and the period end:

- Whether the period end balances of the particular classes of transactions or account balances are reasonably predictable with respect to amount, relative significance, and composition.
- Whether the entity's procedures for analysing and adjusting such classes of transactions or account balances at interim dates and for establishing proper accounting cutoffs are appropriate.
- Whether the information system relevant to financial reporting will provide information concerning the balances at the period end and the transactions in the remaining period that is sufficient to permit investigation of:
  (a) Significant unusual transactions or entries (including those at or near the period end);
  (b) Other causes of significant fluctuations, or expected fluctuations that did not occur; and
  (c) Changes in the composition of the classes of transactions or account balances.

Misstatements detected at an interim date (Ref: Para. 24)

A54. When the auditor concludes that the planned nature, timing or extent of substantive procedures covering the remaining period need to be modified as a result of unexpected misstatements detected at an interim date, such modification may include extending or repeating the procedures performed at the interim date at the period end.

## Adequacy of Presentation and Disclosure (Ref: Para. 25)

A55. Evaluating the overall presentation of the financial statements, including the related disclosures, relates to whether the individual financial statements are presented in a manner that reflects the appropriate classification and description of financial information, and the form, arrangement, and content of the financial statements and their appended notes. This includes, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.

## Evaluating the Sufficiency and Appropriateness of Audit Evidence (Ref: Para. 26-28)

A56. An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing or extent of other planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example,

- The extent of misstatements that the auditor detects by performing substantive procedures may alter the auditor's judgment about the risk assessments and may indicate a material weakness in internal control.
- The auditor may become aware of discrepancies in accounting records, or conflicting or missing evidence.
- Analytical procedures performed at the overall review stage of the audit may indicate a previously unrecognised risk of material misstatement.

In such circumstances, the auditor may need to re-evaluate the planned audit procedures, based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and related assertions. SA 315 contains further guidance on revising the auditor's risk assessment.

A57. The auditor cannot assume that an instance of fraud or error is an isolated occurrence. Therefore, the consideration of how the detection of a misstatement affects the assessed risks of material misstatement is important in determining whether the assessment remains appropriate.

A58. The auditor's judgment as to what constitutes sufficient appropriate audit evidence is influenced by such factors as the following:

- Significance of the potential misstatement in the assertion and the likelihood of its having a material effect, individually or aggregated with other potential misstatements, on the financial statements.
- Effectiveness of management's responses and controls to address the risks.
- Experience gained during previous audits with respect to similar potential misstatements.

- Results of audit procedures performed, including whether such audit procedures identified specific instances of fraud or error.
- Source and reliability of the available information.
- Persuasiveness of the audit evidence.
- Understanding of the entity and its environment, including the entity's internal control.

### Documentation (Ref: Para. 29)

A59. The form and extent of audit documentation is a matter of professional judgment, and is influenced by the nature, size and complexity of the entity and its internal control, availability of information from the entity and the audit methodology and technology used in the audit.

## Material Modifications to ISA 330, The Auditor's Responses to Assessed Risks

### Deletion

1. Paragraph A17 of the Application Section of ISA 330 dealt with the application of the requirements of ISA 330 to the audits of public sector entities regarding the auditor's consideration of the nature, timing and extent of further audit procedures. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non-public sector entities the auditor may be required to give special considerations regarding the nature, timing and extent as a result of the terms of appointment of the auditor or any other special reporting requirement under the statute or regulation under which the entity operates. Accordingly, the spirit of erstwhile A17, highlighting the fact that in some cases, the auditor's consideration of the nature, timing and extent of further audit procedures may be affected by the audit mandate or any other special auditing requirements, has been retained.

# SA 402 (AAS 24)

## AUDIT CONSIDERATIONS RELATING TO ENTITIES USING SERVICE ORGANISATIONS

***(Effective for all audits relating to accounting periods beginning on or after April 1, 2003)***

## Contents


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Standard on Auditing (SA) 402*, "Audit Considerations Relating to Entities Using Service Organisations" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in August, 2002.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard on Auditing (SA) is to establish standards for an auditor whose client uses a service organisation. This SA also describes the reports of the auditors of the service organisation which may be obtained by the auditor of the client.

2. The auditor should consider how a service organisation affects the client's accounting and internal control systems so as to plan the audit and develop an effective audit approach.

3. Service organisations undertake a wide range of activities, for example, information processing, maintenance of accounting records, facilities management, maintenance of safe custody of assets such as investments, and initiation or execution of transactions on behalf of the other enterprise. Not all the activities undertaken by the service organisations are likely, by themselves, to have a significant effect on a user enterprise's financial statements. A client may use a service organisation such as one that executes transactions and maintains related accountability or records transactions and processes related data (e.g., a computer systems service organisation). If a client uses a service organisation, certain policies, procedures and records maintained by the service organisation might be relevant to the audit of the financial statements of the client. Consequently, the auditor would consider the nature and extent of activities undertaken by service organisations so as to determine whether those activities are relevant to the audit and, if so, to assess their effect on audit risk.

## Considerations for the Auditor of the Client

4. A service organisation may establish and execute policies and procedures that affect a client organisation's accounting and internal control systems. These policies and procedures are physically and operationally separate from the client's organisation. When the services provided by the service organisation are limited to recording and processing transactions of the client and the client retains authorisation and maintenance of accountability, the client might be able to implement effective policies and procedures within its organisation. When the service organisation executes the client's transactions and maintains accountability, the client may deem it necessary to rely on policies and

procedures at the service organisation.

5. While planning the audit, the auditor of the client should determine the significance of the activities of the service organisation to the client and their relevance to the audit. In doing so, the auditor of the client would need to consider the following, as appropriate:

- Nature of the services provided by the service organisation.
- Terms of contract and relationship between the client and the service organisation.
- The material financial statement assertions that are affected by the use of the service organisation.
- Inherent risk associated with those assertions.
- Extent to which the client's accounting and internal control systems interact with the systems at the service organisation.
- Client's internal controls that are applied to the transactions processed by the service organisation.
- Service organisation's capability and financial strength, including the possible effect of the failure of the service organisation on the client.
- Information about the service organisation such as that reflected in user and technical manuals, if any.
- Information available on general controls and computer systems controls relevant to the client's applications.

6. The auditor of the client would also consider the availability of third-party reports from service organisation's auditors, internal auditors, or regulatory agencies as a means of providing information about the accounting and internal control systems of the service organisation and about its operation and effectiveness.

Consideration of the above may lead the auditor to decide that the control risk assessment will not be affected by controls at the service organisation; if so, further consideration of this SA is unnecessary.

7. If the auditor of the client concludes that the activities of the service organisation are significant to the entity and relevant to the audit, the auditor should obtain sufficient information to understand

the accounting and internal control systems of the service organisation and to assess control risk at either the maximum, or a lower level if tests of control are performed.

8. If the information is insufficient, the auditor of the client would consider the need to request the service organisation to have its auditor perform such procedures as to supply the necessary information in the forms of reports mentioned at paragraph 12. If such reports are not made available within a reasonable time, the auditor of the client would consider the need to visit the service organisation to obtain the relevant information. An auditor of the client wishing to visit a service organisation may advise the client to request the service organisation to give the auditor of the client access to the necessary information.

9. The auditor of the client may be able to obtain an understanding of the accounting and internal control systems affected by the service organisation by reading the third-party report of the service organisation's auditor. In addition, when assessing control risk for assertions affected by the systems, controls of the service organisation, the auditor of the client may also use the service organisation auditor's report. When the auditor of the client uses the report of a service organisation's auditor, the auditor of the client should consider the professional competence of the other auditor in the context of specific assignment if the other auditor is not a member of the Institute of Chartered Accountants of India.

10. The auditor of the client may conclude that it would be appropriate to obtain audit evidence from tests of control to support an assessment of control risk at a lower level.

## Service Organisation Auditor's Reports

11. When using a service organisation auditor's report, the auditor of the client should consider the nature of and content of that report.

12. The report of the service organisation's auditor will ordinarily be one of two types as follows:

Type A - Report on Suitability of Design

(a) a description of the service organisation's accounting and internal control systems, ordinarily prepared by the management of the service organisation; and

(b) an opinion by the service organisation's auditor that:

(i) the above description is accurate;

(ii) the systems' controls have been placed in operation; and

(iii) the accounting and internal control systems are suitably designed to achieve their stated objectives.

Type B - Report on Suitability of Design and Operating Effectiveness

(a) a description of the service organisation's accounting and internal control systems, ordinarily prepared by the management of the service organisation; and

(b) an opinion by the service organisation's auditor that:

(i) the above description is accurate;

(ii) the systems' controls have been placed in operation;

(iii) the accounting and internal control systems are suitably designed to achieve their stated objectives; and

(iv) the accounting and internal control systems are operating effectively based on the results from the tests of control. In addition to the opinion on operating effectiveness, the service organisation's auditor would identify the tests of control performed and related results.

The report of the service organisation's auditor will ordinarily contain restrictions as to its use (generally to management of the service organisation and its customers, and the specified client's auditor).

13. The auditor should consider the scope of work performed by the service organisation's auditor and should assess the usefulness and appropriateness of reports issued by the service organisation's auditor.

14. While Type A reports may be useful to an auditor of the client in gaining the required understanding of the accounting and internal control systems, an auditor would not use such reports as a basis for reducing the assessment of control risk.

15. In contrast, Type B reports may provide such a basis since tests of control have been performed. When a Type B report is to be used as evidence to support a lower control risk assessment, the auditor of the

client would consider whether the controls tested by the service organisation's auditor are relevant to the client's transactions (significant assertions in the client's financial statements) and whether the service organisation auditor's tests of control and the results are adequate. With respect to the latter, two key considerations are the length of the period covered by the service organisation auditor's tests and the time since the performance of those tests.

16. For those specific tests of control and results that are relevant, the auditor of the client should consider whether the nature, timing and extent of such tests provide sufficient appropriate audit evidence about the effectiveness of the accounting and internal control systems to support the client auditor's assessed level of control risk.

17. The auditor of a service organisation may be engaged to perform substantive procedures that are of use to auditor of the client. Such engagements may involve the performance of procedures agreed upon by the client and its auditor and by the service organisation and its auditor.

18. When the auditor of the client uses a report from the auditor of a service organisation, no reference should be made in the client auditor's report to the service organisation's auditor's report.

## Effective Date

19. This Auditing and Standard on Auditing becomes operative for all audits related to accounting periods beginning on or after April 1, 2003.

## Compatibility with International Standard on Auditing (ISA) 402

The auditing standards established in these Standards on Auditing are generally consistent in all material respects with those set out in ISA 402 "Audit Considerations Relating to Entities Using Service Organisations".

# SA 500 (AAS 5)

## AUDIT EVIDENCE

***(Effective for all audits relating to accounting periods beginning on or after January 1, 1989)***

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Standard on Auditing (SA) 500*, "Audit Evidence" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in May, 1988.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. Standard on Auditing (SA) 200, "Basic Principles Governing an Audit", states (paragraphs 15-17):

> "The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information.
>
> Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect.
>
> Substantive procedures are designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system.
>
> They are of two types:
>
> (i) tests of details of transactions and balances;
>
> (ii) analysis of significant ratios and trends, including the resulting enquiry of unusual fluctuations and items."

The purpose of this Standard is to amplify the basic principle outlined above. In this Standard, the term "financial information" encompasses financial statements.

## Sufficient Appropriate Audit Evidence

2. Sufficiency and appropriateness are interrelated and apply to evidence obtained from both compliance and substantive procedures. Sufficiency refers to the quantum of audit evidence obtained; appropriateness relates to its relevance and reliability. Normally, the auditor finds it necessary to rely on evidence that is persuasive rather than conclusive. He may often seek evidence from different sources or of different nature to support the same assertion (see paragraphs 5 and 6).

3. The auditor should evaluate whether he has obtained sufficient appropriate audit evidence before he draws his conclusions therefrom. The audit evidence should, in total, enable the auditor to form an opinion on the financial information. In forming such an opinion, the auditor may obtain audit evidence on a selective basis by way of judgmental or statistical sampling

procedures. For example, the auditor may select only certain accounts receivable for confirmation purposes, or make a selection of personnel records for the purpose of testing that changes in payroll rates have been properly authorised.

4. The auditor's judgement as to what is sufficient appropriate audit evidence is influenced by such factors as:

(a) The degree of risk of misstatement which may be affected by factors such as:

  (i) the nature of the item;

  (ii) the adequacy of internal control;

  (iii) the nature or size of the business carried on by the entity;

  (iv) situations which may exert an unusual influence on management;

  (v) the financial position of the entity.

(b) The materiality of the item.

(c) The experience gained during previous audits.

(d) The results of auditing procedures, including fraud or error which may have been found.

(e) The type of information available.

(f) The trend indicated by accounting ratios and analysis.

5. Obtaining audit evidence from compliance procedures is intended to reasonably assure the auditor in respect of the following assertions:

| | | |
|---|---|---|
| Existence | – | that the internal control exists. |
| Effectiveness | – | that the internal control is operating effectively. |
| Continuity | – | that the internal control has so operated throughout the period of intended reliance. |

6. Obtaining audit evidence from substantive procedures is intended to reasonably assure the auditor in respect of the following assertions:

| | | |
|---|---|---|
| Existence | – | that an asset or a liability exists at a given date. |
| Rights and | – | that an asset is a right of the entity and a liability |

| | | |
|---|---|---|
| Obligations | | is an obligation of the entity at a given date. |
| Occurrence | – | that a transaction or event took place which pertains to the entity during the relevant period. |
| Completeness | – | that there are no unrecorded assets, liabilities or transactions. |
| Valuation | – | that an asset or liability is recorded at an appropriate carrying value. |
| Measurement | – | that a transaction is recorded in the proper amount and revenue or expense is allocated to the proper period. |
| Presentation and Disclosure | – | an item is disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any. |

The extent and nature of substantive procedures to be performed will vary with respect to each of the above assertions.

Obtaining evidence relevant to one of the above assertions will not compensate for failure to do so with respect to another matter concerning the same item, e.g., existence of inventory and its valuation.

7. The reliability of audit evidence depends on its source - internal or external, and on its nature - visual, documentary or oral. While the reliability of audit evidence is dependent on the circumstances under which it is obtained, the following generalisations may be useful in assessing the reliability of audit evidence:

- External evidence (e.g. confirmation received from a third party) is usually more reliable than internal evidence.
- Internal evidence is more reliable when related internal control is satisfactory.
- Evidence in the form of documents and written representations is usually more reliable than oral representations.
- Evidence obtained by the auditor himself is more reliable than that obtained through the entity.

8. The auditor may gain increased assurance when audit evidence obtained from different sources or of different nature is consistent. In these circumstances, he may obtain a cumulative degree of assurance higher than that which he attaches to the individual items of evidence by themselves. Conversely, when audit evidence obtained from one source is inconsistent with that obtained from another, further procedures may have to be performed to resolve the inconsistency.

9. The auditor should be thorough in his efforts to obtain evidence and be objective in its evaluation.

10. When the auditor is in reasonable doubt as to any assertion of material significance, he would attempt to obtain sufficient appropriate evidence to remove such doubt. If he is unable to obtain sufficient appropriate evidence he should not express an unqualified opinion.

## Obtaining Audit Evidence

11. The auditor obtains evidence in performing compliance and substantive procedures by one or more of the following methods:

- Inspection
- Observation
- Inquiry and confirmation
- Computation
- Analytical review

The timing of such procedures will be dependent, in part, upon the periods of time during which the audit evidence sought is available.

### Inspection

12. Inspection consists of examining records, documents, or tangible assets. Inspection of records and documents provides evidence of varying degrees of reliability, depending on their nature and source and the effectiveness of internal controls over their processing. Four major categories of documentary evidence, which provide different degrees of reliability to the auditor, are:

- documentary evidence originating from and held by third parties;
- documentary evidence originating from third parties and held by the entity;

- documentary evidence originating from the entity and held by third parties; and
- documentary evidence originating from and held by the entity.

  Inspection of tangible assets is one of the methods to obtain reliable evidence with respect to their existence but not necessarily as to their ownership or value.

### Observation

13. Observation consists of witnessing a process or procedure being performed by others. For example, the auditor may observe the counting of inventories by client personnel or the performance of internal control procedures that leave no audit trail.

### Inquiry and Confirmation

14. Inquiry consists of seeking appropriate information from knowledgeable persons inside or outside the entity. Inquiries may range from formal written inquiries addressed to third parties to informal oral inquiries addressed to persons inside the entity. Responses to inquiries may provide the auditor with information which he did not previously possess or may provide him with corroborative evidence.

15. Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records. For example, the auditor requests confirmation of receivables by direct communication with debtors.

### Computation

16. Computation consists of checking the arithmetical accuracy of source documents and accounting records or performing independent calculations.

### Analytical Review

17. Analytical review consists of studying significant ratios and trends and investigating unusual fluctuations and items.

## Effective Date

18. This Standard on Auditing becomes operative for all audits relating to accounting periods beginning on or after January 1, 1989.

# SA 501 (AAS 34)

## AUDIT EVIDENCE – ADDITIONAL CONSIDERATIONS FOR SPECIFIC ITEMS

***(Effective for all audits relating to accounting periods beginning on or after April 1, 2005)***

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Standard on Auditing (SA) 501*, "Audit Evidence – Additional Considerations For Specific Items" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in March, 2005.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard on Auditing (SA) is to establish standards on the auditor's responsibilities, audit procedures and provide additional guidance to that contained in SA 500, "Audit Evidence", with respect to certain specific financial statement amounts and other disclosures. Application of the standards and guidance provided in this SA will assist the auditor in obtaining audit evidence with respect to the specific financial statement amounts and other disclosures. This SA comprises the following parts:

Part A: Attendance at Physical Inventory Counting

Part B: Inquiry Regarding Litigation and Claims

Part C: Valuation and Disclosure of Long-term Investments

Part D: Segment Information

## Part A: Attendance at Physical Inventory Counting

2. The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence during his attendance at physical inventory counting.

### Definitions

3. Definitions regarding "Inventory" are given in Accounting Standard (AS) 2, "Valuation of Inventories", issued by the Institute of Chartered Accountants of India, and are adopted for the purposes of this SA[2].

4. Physical verification of inventories is the responsibility of the management of the entity. Management ordinarily establishes procedures under which inventory is physically counted at least once in a year (end of the year, generally, or as near the end of the year as possible) to serve as a

[2] Paragraph 3 of the Accounting Standard (AS) 2, "Valuation of Inventories", states as follows:

"3. The following terms are used in this Statement with the meanings specified:

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."

basis for preparation of the financial statements or to ascertain the reliability of the perpetual inventory system.

5. When inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its existence and condition by attendance at physical inventory counting unless impracticable, due to factors such as the nature and location of the inventory. The attendance at such physical inventory counting will enable the auditor to inspect the inventory, to observe compliance with the operation of management's procedures for recording and controlling the results of the count and to provide evidence as to the reliability of management's procedures.

6. If unable to attend the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and where necessary, perform alternative audit procedures to assess whether the changes in inventory between the date of physical count and the period end date are correctly recorded.

7. Where attendance at the physical inventory counting is impracticable, the auditor should consider whether alternative procedures provide sufficient appropriate audit evidence of existence and condition of inventory to conclude that the auditor need not make reference to a scope limitation. For example, the auditor should examine a sample of documents evidencing the movement of inventory into and out of stores shortly before and after the cut – off date, and verify whether the inventory represented by those documents were included or excluded, as appropriate during the inventory count.

8. In planning attendance at the physical inventory count or the alternative procedures, the auditor would consider the following:

- The nature of the accounting and internal control systems used regarding inventory.
- Inherent, control and detection risks, and materiality related to inventory.
- Whether adequate procedures are established and proper instructions issued for physical inventory counting.
- The timing of the count.

- The locations at which inventory is held and its nature.
- Whether an expert's assistance is needed.

When inventory is situated in several locations, the auditor would consider at which locations attendance is appropriate, taking into account the materiality of the inventory and the risk of material misstatement and the assessment of inherent and control risk at different locations.

9. The auditor would review management's instructions regarding:

(a) The application of control procedures, for example, collection of used stock-sheets, accounting for unused stock-sheets, tagging and count and re-count procedures;

(b) Accurate identification of the stage of completion of work in progress, slow moving, obsolete, damaged or rejected items, inventory owned by a third party, for example, on consignment and inventory in transit; and

(c) Appropriate arrangements made regarding the movement of inventory between areas and the shipping and receipt of inventory before and after the cut-off date.

10. The auditor would also consider cut-off procedures including details of the movement of inventory just prior to, during and after the count to ensure that such movements are appropriately included and/or excluded, as applicable from such inventory. For example,

(a) goods purchased but not received are included in the inventories; and

(b) goods sold but not despatched are excluded from the inventories.

11. When the quantities are to be determined by a physical inventory count and the auditor attends such a count, or when the entity operates a perpetual inventory system and the auditor attends a count one or more times during the year, the auditor would ordinarily observe count procedures and perform test counts.

12. If the entity uses procedures to estimate the physical quantity, such as estimating a coal pile, the auditor would need to be satisfied regarding the reasonableness of those procedures.

13. To obtain assurance that management's procedures are adequately implemented, the auditor would observe physical verification procedures performed by the employees and perform test counts. When performing

counts, the auditor would test both the completeness and the accuracy of the count records by tracing items selected from those records to the physical inventory sheets and items selected from the physical inventory to the count records. Where tagging method of physical count of inventory is used, the auditor would verify the tag reconciliation prior to the counting or before finalising the count. The auditor would consider the extent to which copies of such count records need to be retained for subsequent audit procedures, testing and comparison.

14. For practical reasons, the physical inventory count may be conducted at a date other than period end. This will ordinarily be adequate for audit purposes only when the control risk is assessed at less than high. The auditor would assess whether, through the performance of appropriate audit procedures, changes in inventory between the count date and period end are correctly recorded.

15. When the entity operates a perpetual inventory system, which is used to determine the period end balance, the auditor would assess whether, through the performance of additional procedures, the reasons for any significant differences between the physical count and the perpetual inventory records are understood and the records are properly adjusted.

16. The auditor performs audit procedures over the final inventory listing to assess whether it accurately reflects actual inventory counts.

17. When inventory is under the custody and control of a third party, the auditor would ordinarily obtain direct confirmation from the third party/arrange with the entity for sending requests for such confirmation as to the quantities and condition of inventory held on behalf of the entity. Further, depending on materiality of this inventory the auditor would also consider the following:

- The conduct of the third party in the past with the entity and independence of the third party.
- Observing, or arranging for another auditor to observe, the physical inventory count.
- Obtaining another auditor's report on the adequacy of the third party's accounting and internal control systems for ensuring that the inventory is correctly counted and adequately safeguarded.
- Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.

- Subsequent receipt of goods from third parties.

Management Representations

18. The auditor should obtain a written representation from management concerning:

(a) the completeness of information provided regarding the inventory; and

(b) assurance with regard to adherence to laid down procedures for physical inventory count.

Audit Conclusions and Reporting

19. If the auditor is unable to obtain sufficient appropriate audit evidence concerning the existence of inventory or adequacy of procedures adopted by the management in respect of physical inventory count the auditor should make a reference to a scope limitation in his audit report. If the inventory is not disclosed appropriately in the financial statements, the auditor should issue a qualified opinion.

## Part B: Inquiry Regarding Litigation and Claims

Definitions

20(a) "Litigation" means a lawsuit or legal action including all proceedings therein.

(b) "Claims" means a right to payment or right to an equitable remedy for breach of performance.

21. Litigation and claims involving an entity may have a material effect on the financial statements and thus may be required to be disclosed and/or provided for in the financial statements.

22. The auditor should carry out audit procedures in order to become aware of any litigation and claims involving the entity which may have a material effect on the financial statements. Such procedures would include the following:

- Make appropriate inquiries of management including obtaining representations.

- Review board /committee minutes and correspondence with the entity's lawyers.
- Examine legal and other relevant expense accounts.
- Use any information obtained regarding the entity's business including information obtained from discussions with in-house legal department, if any.

23. When litigation or claims have been identified by the management or when the auditor believes they may exist, and are likely to be material, the auditor may seek direct communication with the entity's lawyers and such other professionals to whom the entity engages for litigation and claims. Such communication will assist in obtaining sufficient appropriate audit evidence as to whether potentially material litigation and claims are known and management's estimates of the financial implications, including costs, are reliable.

24. The letter seeking direct communication with the entity's lawyers and such other professionals to whom the entity engages for litigation and claims should be prepared by management. The auditor should maintain control over the process of preparation and sending of the letter. The letter should request the entity's lawyers and such other professionals to whom the entity engages for litigation and claims to communicate directly with the auditor. The letter would ordinarily specify the following:

- A list of litigation and claims.
- Management's assessment of the outcome of the litigation or claim and its estimate of the financial implications, including costs involved.
- A request that the entity's lawyer confirm:
  - the reasonableness of management's assessments;
  - provide the auditor with further information if the list is considered to be incomplete or incorrect; and
  - provide updated information as and when requested by the auditor upto the date of the audit report.

25. The auditor considers the status of legal matters up to the date of the audit report. In some instances, the auditor may need to obtain updated information from lawyers.

26. In certain circumstances, for example, where the matter is complex or there is disagreement between management and the entity's lawyers and such other professionals to whom the entity engages for litigation and claims, it may be necessary for the auditor to meet with the entity's lawyers and such other professionals to whom the entity engages for litigation and claims to discuss the likely outcome of litigation and claims. Such meetings would take place with management's permission and, preferably, with a representative of management in attendance.

27. If management refuses to give the auditor permission to communicate with the entity's lawyers, this would constitute a limitation on the scope of the auditor's work that requires expression of a qualified opinion or a disclaimer of opinion as the case may be. Where a lawyer or a professional refuses to respond in an appropriate manner and the auditor is unable to obtain sufficient appropriate audit evidence by applying alternative procedures, the auditor would consider whether there is a scope limitation which may lead to a qualified opinion or a disclaimer of opinion.

Management Representations

28. The auditor should obtain a written representation from management concerning the completeness and adequacy of information provided regarding the identification of litigation and claims, estimates of financial implications, including costs, etc.

## Part C: Valuation and Disclosure of Long-Term Investments

29. The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence for valuation and disclosure of long term investments.

Definitions

30. Definition regarding "Long Term Investments" is given in Accounting Standard (AS) 13, "Accounting for Investments", issued by the Institute of Chartered Accountants of India and is adopted for the purposes of this SA.[3]

31. When long-term investments are material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding their valuation and disclosure.

32. Audit procedures regarding long-term investments ordinarily include obtaining audit evidence with respect to their ownership and existence as to whether the entity has the ability to continue to hold the investments on a long term basis and discussing with management whether the entity will continue to hold the investments as long-term investments and obtaining written representations to that effect.

33. Other procedures would ordinarily include:

(a) In the case of quoted securities, considering related financial statements and other information, such as market quotations, which provide an indication of value and comparing such values to the carrying amount of the securities up to the date of the auditor's report.

(b) In case of unquoted securities, ascertaining the method adopted by the entity for determining the value of such securities as at the year end. The auditor should examine whether the method adopted by the entity is one of the recognised methods of valuation of securities such as Profit Earning capacity Value method, break-up value method, capitalisation of yield method, yield to maturity method, etc.

(c) In the case of investments other than in the form of securities, ensuring that the market value has been ascertained on the basis of authentic market reports, and /or based on expert's opinion, if warranted.

34. If such values do not exceed the carrying amounts, the auditor would consider whether a write-down is required. If there is an uncertainty as to

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[3] Paragraph 3 of Accounting Standard (AS) 13, "Accounting for Investments", states as follows:

"3. The following terms are used in this Statement with the meanings assigned:

A Current Investment is an investment that is by its nature readily realizable and is intended to be held for not more than one year from the date on which such investment is made.

A long term investment is an investment other than a current investment."

whether the carrying amount will be recovered, the auditor would consider whether appropriate adjustments and/or disclosures have been made.

Management Representations

35. The auditor should obtain a written representation from management regarding :

(a) the completeness of information provided regarding valuation and disclosure of long term investments;

(b) the valuation of long term investments in the financial statements including adequacy of provision for diminution in such values, wherever required; and

(c) the intention of the management to continue to hold long-term investments as long-term investments.

Audit Conclusions and Reporting

36. If the auditor is unable to obtain sufficient appropriate audit evidence concerning the existence, valuation of long term investments or concludes that their disclosure in the financial statements is not adequate, the auditor should express a qualified opinion or a disclaimer of opinion in the audit report, as may be appropriate.

## Part D: Segment Information

37. The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence for appropriate disclosure of segment information.

Definitions

38. "Segment Information" means the information to be disclosed in respect of reportable segments as given in Accounting Standard (AS) 17, "Segment Reporting", issued by the Institute of Chartered Accountants of India or as defined in the financial reporting framework applicable to the entity.

39. When segment information is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its disclosure in accordance with the applicable identified financial reporting framework.

40. The auditor considers segment information in relation to the financial statements taken as a whole, and is not required to apply auditing procedures that would be necessary to express an opinion on the segment information standing alone. Audit procedures regarding segment information ordinarily consist of analytical procedures and other audit tests appropriate in the circumstances.

41. The auditor would discuss with management the methods used in determining segment information, and consider whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework and test the application of such methods. The auditor would consider sales, transfers and charges between segments, elimination of inter-segment amounts, comparisons with budgets and other expected results, for example, operating profits as a percentage of sales, and the allocation of assets and costs among segments including consistency with prior periods and the adequacy of the disclosures with respect to inconsistencies.

Management Representations

42. The auditor should obtain a written representation from management concerning:

(a) the completeness of information regarding segments and disclosure thereof; and

(b) appropriateness of the selected segments based on risks and returns; and

(c) the organizational structure of an enterprise and its internal financial reporting system and any deviations therefrom.

Audit Conclusions and Reporting

43. If the auditor is unable to obtain sufficient appropriate audit evidence concerning segment information or concludes that their disclosure in the financial statements is not adequate, the auditor should express a qualified opinion or a disclaimer of opinion in the audit report, as may be appropriate.

## Effective Date

44. This Standard on Auditing becomes operative for all audits related to accounting periods beginning on or after 1 April 2005.

## Compatibility with the International Standard on Auditing (ISA) 501

The auditing standards established in this SA are generally consistent in all material respects with those set out in ISA 501, "Audit Evidence – Additional Considerations for Specific Items" except the following:

(a) Due to practical reasons, paragraph 23 of the SA requires that when litigation or claims have been identified by the management or when the auditor believes they may exist, and are likely to be material, the auditor may seek direct communication with the entity's lawyers. The auditor need not necessarily communicate with the entity's lawyers and such other professionals to whom the entity engages for litigation and claims in case the auditor is able to obtain the sufficient appropriate audit evidence regarding the identification of litigation and claims involving the entity which may have a material effect on the financial statements. The ISA on the other hand requires that the auditor should communicate with the entity's lawyers to obtain sufficient appropriate audit evidence as to whether potentially material litigation and claims are known and management's estimates of the financial implications, including costs, are reliable.

(b) Each part of the SA contains the requirements related to obtaining the management representations [see paragraphs 18, 28, 35 and 42]. There is, however, no such requirement in the ISA.

# SA 505 (AAS 30)

## EXTERNAL CONFIRMATIONS

***(Effective for all audits relating to accounting periods beginning on or after April 1, 2003)***

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Standard on Auditing (SA) 505*, "External Confirmations" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in August, 2003.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard on Auditing (SA) is to establish standards on the auditor's use of external confirmations as a means of obtaining audit evidence.

2. The auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence to support certain financial statement assertions. In making this determination, the auditor should consider materiality, the assessed level of inherent and control risk, and how the evidence from other planned audit procedures will reduce audit risk to an acceptably low level for the applicable financial statement assertions. The auditor should employ external confirmation procedures in consultation with the management.

3. Standard on Auditing (SA) 500, "Audit Evidence" states that the reliability of audit evidence is influenced by its source and nature. It indicates that, in general, audit evidence from external sources is more reliable than audit evidence generated internally, and that written (documentary) audit evidence is more reliable than audit evidence in oral form. Accordingly, audit evidence in the form of written responses to confirmation requests received directly by the auditor from third parties who are not related to the entity being audited, when considered individually or cumulatively with audit evidence from other procedures, may assist in reducing audit risk for the related financial statement assertions to an acceptably low level.

4. External confirmation is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item affecting assertions made by management in the financial statements. In deciding to what extent to use external confirmations, the auditor considers the characteristics of the environment in which the entity being audited operates and the practice of potential respondents in dealing with requests for direct confirmation.

5. The process of external confirmations, ordinarily, consists of the following:

- Selecting the items for which confirmations are needed.
- Designing the form of the confirmation request.
- Communicating the confirmation request to the appropriate third party.

- Obtaining response from the third party.
- Evaluating the information or absence thereof.

6. External confirmations are frequently used in relation to account balances and their components, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements or transactions an entity has with third parties. The confirmation request is designed to ask if any modifications have been made to the agreement, and if so, the relevant details thereof. Other examples of situations where external confirmations may be used include the following:

- Bank balances and other information from bankers.
- Accounts receivable balances.
- Stocks held by third parties.
- Property title deeds held by third parties.
- Investments purchased but delivery not taken.
- Loans from lenders.
- Accounts payable balances.
- Long outstanding share application money.

7. The reliability of the evidence obtained by external confirmations depends, among other factors, upon the application of appropriate procedures by the auditor in designing the external confirmation request, performing the external confirmation procedures, and evaluating the results of the external confirmation procedures. Factors affecting the reliability of confirmations include the control which the auditor exercises over confirmation requests and responses, the characteristics of the respondents, and any restrictions included in the response or imposed by management.

## Relationship of External Confirmation Procedures to the Auditor's Assessments of Inherent Risk and Control Risk

8. Standard on Auditing (SA) 400, "Risk Assessments and Internal Control" discusses audit risk and the relationship between its components: inherent risk, control risk, and detection risk. It outlines the process of assessing inherent and control risk to determine the nature, timing, and extent of substantive procedures to reduce detection risk, and therefore, audit risk, to an acceptable level.

9. SA 400 also indicates that the nature and extent of evidence to be obtained from the performance of substantive procedures varies depending on the assessment of inherent and control risks, and that the assessed levels of inherent and control risk cannot be sufficiently low to eliminate the need to perform any substantive procedures. These substantive procedures may include the use of external confirmations for specific financial statement assertions.

10. Paragraph 48 of SA 400 indicates that the higher the assessment of inherent and control risk, the more audit evidence the auditor needs to obtain from the performance of substantive procedures. Consequently, as the assessed level of inherent and control risk increases, the auditor designs substantive procedures to obtain more evidence, or more persuasive evidence, about a financial statement assertion. In these situations, the use of confirmation procedures may be effective in providing sufficient appropriate audit evidence.

11. The auditor should assess whether the evidence provided by the confirmations reduces audit risks for the related assertions to an acceptably low level. In making that assessment, the auditor should consider the materiality of the account balance and the auditor's assessment of the inherent and control risk. If the auditor concludes that the evidence provided by the confirmations alone is not sufficient, he should perform additional procedures.

12. The lower the assessed level of inherent and control risk, the less assurance the auditor needs from substantive procedures to form a conclusion about a financial statement assertion. For example, an entity may have a loan that it is repaying according to an agreed repayment schedule, the terms of which the auditor has confirmed in previous years. If the other work carried out by the auditor (including such tests of controls as are necessary) indicates that the terms of the loan have not changed and has lead to the level of inherent and control risk over the balance of the loan outstanding being assessed as low, the auditor might limit substantive procedures to testing details of the payments made, rather than again confirming the balance directly with the lender.

13. Unusual or complex transactions may be associated with higher levels of inherent or control risk than simple transactions. If the entity has entered into an unusual or complex transaction and the level of inherent and control risk is assessed as high, the auditor considers confirming the terms of

transaction with the other parties in addition to examining documentation held by the entity.

## Assertions Addressed by External Confirmations

14. SA 500, "Audit Evidence", categorises the assertions contained in the financial statements as existence, rights and obligations, occurrence, completeness, valuation, measurement, and presentation and disclosure. While external confirmations may provide audit evidence regarding these assertions, the ability of an external confirmation to provide evidence relevant to a particular financial statement assertion varies.

15. External confirmation of an account receivable provides strong evidence regarding the existence of the account as at a certain date. Confirmation also provides evidence regarding the operation of cut-off procedures. However, such confirmation does not ordinarily provide all the necessary audit evidence relating to the assertion regarding valuation, since it is not practicable to ask the debtor to confirm detailed information relating to its ability to pay the account.

16. Similarly, in the case of goods held on consignment, external confirmation is likely to provide strong evidence to support the assertions related to existence and the rights and obligations, but might not provide evidence that supports the assertions related to valuation.

17. The relevance of external confirmations to auditing a particular financial statement assertion is also affected by the objective of the auditor in selecting information for confirmation. For example, when auditing the assertion regarding the completeness of accounts payable, the auditor also needs to obtain evidence that there is no material unrecorded liability. Accordingly, sending confirmation requests to an entity's principal suppliers, asking them to provide copies of their statements of account directly to the auditor, even if the entity's records show no amount currently owing to them, will usually be more effective in detecting unrecorded liabilities than selecting accounts for confirmation based on the larger amounts recorded in the accounts payable subsidiary ledger.

18. When obtaining evidence for assertions not adequately addressed by confirmations, the auditor considers other audit procedures to complement confirmation procedures or to be used instead of confirmation procedures.

## Timing of External Confirmations

19. The auditor may request external confirmations either as at the date of the financial statements or as at any other selected date which is reasonably close to the date of financial statements. The date may be, alternatively, settled by the auditor in consultation with the management. Where the auditor decides to request for confirmations as at date which is other than the date of the financial statements, the auditor would need to examine the movement in the concerned account(s) that occur between the date of the confirmations and the date of the financial statements. For example, when the auditor uses confirmation as at a date prior to the balance sheet to obtain evidence to support a financial statement assertion, the auditor would obtain sufficient appropriate audit evidence that transactions relevant to the assertions in the intervening period have not been materially misstated. For practical reasons, when the level of inherent and control risk is assessed at less than high, the auditor may decide to confirm balances at a date other than the period end, for example, when the audit is to be completed within a short time after the balance sheet date. As with all types of pre-year-end work, the auditor would consider the need to obtain further audit evidence relating to the remainder of the period also.

## Design of the External Confirmation Request

20. The auditor should design external confirmation requests to the specific audit objective. When designing the request, the auditor considers the assertions being addressed and the factors that are likely to affect the reliability of the confirmations. Factors such as the form of the external confirmation request, prior experience on the audit or similar engagements, the nature of the information being confirmed, and the intended respondent, affect the design of the requests because these factors have a direct effect on the reliability of the evidence obtained through external confirmation procedures. The other factors which have an effect on the design of an external confirmation request include effectiveness of the internal control system of the entity, apparent possibility of disputes, inaccuracies and irregularities in the accounts, the possibility that the request will receive a consideration and the materiality of the amount involved.

## Nature of Information Being Confirmed

21. In designing the request, the auditor considers the type of information respondents will be able to confirm readily since this may affect the response

rate and the nature of the evidence obtained. For example, certain respondents' accounting systems may facilitate the external confirmation of single transactions rather than of entire account balances. In addition, respondents may not always be able to confirm certain types of information, such as the overall accounts receivable balance, but may be able to confirm individual invoice amounts within the total balance.

22. The auditor's understanding of the client's arrangements and transactions with the third parties is important in determining the information to be confirmed. The auditor should obtain an understanding of the substance of such transactions and arrangements to decide about the information to be included in the request for confirmation. The auditor also considers the possibility of oral modifications in the arrangements and transactions and, accordingly, requests the management to provide him the details thereof.

23. Confirmation requests ordinarily include authorization of the entity's management to the respondent to disclose the information to the auditor. Respondents may be more willing to respond to a confirmation request containing management's authorization, and in some cases may be unable to respond unless the request contains such authorization.

## Prior Experience

24. The auditor should consider the information from audits of earlier years. This information would, normally, include the misstatements, inaccuracies or irregularities identified by the auditor or those pointed out by the third parties in the earlier years, the response rate etc.

## Form of Confirmation Request—Use of Positive and Negative Confirmations

25. The auditor may use positive or negative external confirmation requests or a combination of both.

26. A positive external confirmation request asks the respondent to reply to the auditor in all cases either by indicating the respondent's agreement with the given information, or by asking the respondent to fill in information. The use of a positive confirmation is preferable when individual account balances are large, or where the internal controls are weak, or where the auditor has reasons to believe that there may be a substantial number of accounts in dispute or inaccurate or irregular. A response to a positive confirmation

request is ordinarily expected to provide reliable audit evidence. There is a risk, however, that a respondent may reply to the confirmation request without verifying that the information is correct. The auditor is not ordinarily able to detect whether this has occurred. The auditor may reduce this risk, however, by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, but ask the respondent 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 respondents.

27. A negative external confirmation request asks the respondent to reply only in the event of disagreement with the information provided in the request. However, when no response has been received to a negative confirmation request, the auditor remains aware that there will be no explicit evidence that intended third parties have received the confirmation requests and verified that the information contained therein is correct or that the confirmation was sent by the respondent but not received by him. Accordingly, the use of negative confirmation requests ordinarily provides less reliable evidence than the use of positive confirmation requests, and the auditor considers performing other substantive procedures to supplement the use of negative confirmations.

28. Negative confirmation requests may be used to reduce audit risk to an acceptable level when:

(a) the assessed level of inherent and control risk is low;

(b) a large number of small balances is involved;

(c) a substantial number of errors is not expected; and

(d) the auditor has no reason to believe that respondents will disregard these requests.

29. A combination of positive and negative external confirmations may be used. For example, where the total accounts receivable balance comprises a small number of large balances and a large number of small balances, the auditor may decide that it is appropriate to confirm all or a sample of the large balances with positive confirmation requests and a sample of the small balances using negative confirmation requests.

## Characteristics of Respondents

30. The reliability of evidence provided by a confirmation is affected by the respondent's competence, independence, authority to respond, knowledge of the matter being confirmed, and objectivity. For this reason, the auditor attempts to ensure, where practicable, that the confirmation request is directed to an appropriate individual. For example, when confirming that a covenant related to an entity's long-term debt has been waived, the auditor directs the request to an official of the creditor who has knowledge about the waiver and has the authority to provide the information.

31. The auditor also assesses whether certain parties may not provide an objective or unbiased response to a confirmation request. Information about the respondent's competence, knowledge, motivation, ability or willingness to respond may come to the auditor's attention. The auditor considers the effect of such information on designing the confirmation request and evaluating the results, including determining whether additional procedures are necessary. The auditor also considers whether there is sufficient basis for concluding that the confirmation request is being sent to a respondent from whom the auditor can expect a response that will provide sufficient appropriate evidence. For example, the auditor may encounter significant unusual year-end transactions that have a material effect on the financial statements, the transactions being with a third party that is economically dependent upon the entity. In such circumstances, the auditor considers whether the third party may be motivated to provide an inaccurate response.

## The External Confirmation Process

32. When performing confirmation procedures, the auditor should maintain control over the process of selecting those to whom a request will be sent, the preparation and sending of confirmation requests, and the responses to those requests. Maintaining control means maintaining direct communications between the intended recipients and the auditor to minimize the possibility that the results of the confirmation process will be biased because of the interception and alteration of confirmation requests or responses. The auditor may give a list of accounts selected for confirmation to the management for preparing requests for confirmations, which should be properly addressed and stamped, alternatively, the auditor may request the management to furnish duly authorised confirmation letters and fill in the names, addresses and other relevant details relating to the accounts selected by him. The auditor should, however, ensure that it is the

auditor who sends out the confirmation requests, that the requests are properly addressed, and that it is requested that all replies and the undelivered confirmations are delivered directly to the auditor. The auditor considers whether replies have come from the purported senders.

No Response to a Positive Confirmation Request

33. The auditor should perform alternative procedures where no response is received to a positive external confirmation request. The alternative audit procedures should be such as to provide the evidence about the financial statement assertions that the confirmation request was intended to provide.

34. When using a confirmation request other than a negative confirmation request, the auditor, generally, follows up with a second and sometimes third request to those parties from whom replies have not been received or, alternatively, contact the recipient of the request to elicit a response. Where the auditor is unable to obtain a response, the auditor would need to use alternative audit procedures. The nature of alternative procedures varies according to the account and assertion in question. In the examination of accounts receivable, alternative procedures may include examination of subsequent cash receipts, examination of shipping documentation or other client documentation to provide evidence for the existence assertion, and sales cut-off tests to provide evidence for the assertion related to completeness. In the examination of accounts payable, alternative procedures may include examination of subsequent cash disbursements or correspondence from third parties to provide evidence of the existence assertion, and examination of other records, such as goods received notes, to provide evidence of the assertion regarding completeness.

Reliability of Responses Received

35. The auditor should consider whether there is any indication that external confirmations received may not be reliable. The auditor should also consider the authenticity of the response and perform appropriate procedures to dispel any doubts. The auditor may choose to verify the source and contents of a response in a telephone call to the purported sender. In addition, the auditor would also request the purported sender to mail the original confirmation directly to the auditor. With ever-increasing use of technology, the auditor needs to consider validating the source of

replies received in electronic format (for example, fax or electronic mail). Oral confirmations should be documented in the work papers. If the information in the oral confirmations or that received though a fax is significant, the auditor requests the parties involved to submit written confirmation of the specific information directly to the auditor since in such cases it is difficult to ascertain the source of the response.

Causes and Frequency of Exceptions

36. When the auditor forms a conclusion that the confirmation process and alternative procedures have not provided sufficient appropriate audit evidence regarding an assertion, the auditor should undertake additional procedures to obtain sufficient appropriate audit evidence. In forming the conclusion, the auditor considers the:

(a) reliability of the confirmations and alternative procedures;

(b) nature of any exceptions, including the implications, both quantitative and qualitative of those exceptions; and

(c) evidence provided by other procedures.

Based on this evaluation, the auditor would determine whether additional audit procedures are needed to obtain sufficient appropriate audit evidence.

37. Any discrepancies revealed by the external confirmations received or by the additional procedures carried out by the auditor might have a bearing on the assertions and the accounts within the given assertion not selected for external confirmation. The auditor, in such a case, should request the management to verify and reconcile the discrepancies. The auditor should also consider what further tests can be carried out to satisfy himself as to the correctness of related assertion.

38. The auditor should also consider the causes and frequency of exceptions reported by respondents. An exception might indicate a misstatement in the entity's records, in which case, the auditor determines the reasons for the misstatement and assesses whether it has a material effect on the financial statements. If an exception indicates a misstatement, the auditor would reconsider the nature, timing and extent of audit procedures necessary to provide the evidence required. If the responses received indicate a pattern of misstatements, the auditor should reconsider his assessment of inherent and control risk and also consider the effect on his audit procedures.

## Evaluating the Results of the Confirmation Process

39. The auditor should evaluate whether the results of the external confirmation process together with the results from any other procedures performed, provide sufficient appropriate audit evidence regarding the financial statement assertion being audited. In conducting this evaluation, the auditor considers the guidance provided by SA 530, "Audit Sampling".

## Management Requests

40. When the auditor seeks to confirm certain balances or other information, and management requests the auditor not to do so, the auditor should consider whether there are valid grounds for such a request and obtain evidence to support the validity of management's requests. The auditor should also ask the management to submit its request in a written form, detailing therein the reasons for such request. The management, for example, might make such a request on the grounds that due to a dispute with the particular debtor, the request for confirmation might aggravate the sensitive negotiations between the entity and the debtor. The auditor, in such a case, would examine any available evidence to support management's request, say, examining the correspondence between the management and the debtor. If the auditor agrees to management's request not to seek external confirmation regarding a particular matter, the auditor should document the reasons for acceding to the management's request and should apply alternative procedures to obtain sufficient appropriate evidence regarding that matter.

41. If the auditor does not accept the validity of management's request and is prevented from carrying out the confirmations, there has been a limitation on the scope of the auditor's work and the auditor should consider the possible impact on the auditor's report. The auditor should, however, in this case also, document the request made by the management along with the reasons given by the management therefor as well as his own reasons for not acceding to the management's request.

42. When considering the reasons provided by management, the auditor would apply professional skepticism and consider whether the request has any implications regarding management's integrity. The auditor would also consider whether management's request might indicate the possible existence of fraud or error. If the auditor believes that fraud or error exists,

the auditor would consider the requirements of SA 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements". The auditor would also need to consider whether the alternative procedures will provide sufficient appropriate evidence regarding that matter.

## Effective Date

43. This Standard on Auditing is effective for audits related to accounting periods beginning on or after 1st April, 2003.

## Compatibility with International Standard on Auditing (ISA) 505

The auditing standards established in this SA are generally consistent in all material respects with the International Standard on Auditing (ISA) 505, "External Confirmations", except the following:

(a) The SA requires the auditor to obtain an understanding of the substance of transactions and agreement with the third parties to decide about the information to be included in the request for confirmation (see paragraph 22). ISA 505 does not contain any requirements in this regard.

(b) The SA requires the auditor to consider the information from audits of earlier years (see paragraph 24). This requirement is not present in ISA 505.

(c) The SA requires the auditor to request the management to verify and reconcile the discrepancies revealed by the external confirmations received or by the additional procedures carried out by the auditor. The SA further requires the auditor to consider what further tests can be carried out to satisfy him self as to the correctness of related assertions (see paragraph 37). This requirement is not present in ISA 505.

# SA 510 (AAS 22)

## INITIAL ENGAGEMENTS - OPENING BALANCES

***(Effective for all audits commencing on or after July 1, 2001)***

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Standard on Auditing (SA) 510[*], "Initial Engagements - Opening Balances" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

[*] Issued in July, 2001.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard on Auditing (SA) is to establish standards regarding audit of opening balances in case of initial engagements, i.e., when the financial statements are audited for the first time or when the financial statements for the preceding period were audited by another auditor. This Standard would also be considered by the auditor so that he may become aware of contingencies and commitments existing at the beginning of the current period.

2. "Opening balances" means those account balances which exist at the beginning of the period. Opening balances are the closing balances of the preceding period brought forward to the current period and reflect the effect of:

(a) transactions and other events of the preceding periods; and

(b) accounting policies applied in the preceding period.

3. For initial audit engagements, the auditor should obtain sufficient appropriate audit evidence that:

(a) the closing balances of the preceding period have been correctly brought forward to the current period;

(b) the opening balances do not contain misstatements that materially affect the financial statements for the current period; and

(c) appropriate accounting policies are consistently applied.

4. In an initial audit engagement, the auditor will not have previously obtained audit evidence supporting the opening balances.

## Audit Procedures

5. For the purpose of this Statement, the sufficiency and appropriateness of the audit evidence, the auditor will need to obtain regarding opening balances, would depend on the following matters:

- The accounting policies followed by the entity.
- Whether the auditor's report contained an unqualified opinion, a qualified opinion, adverse opinion or disclaimer of opinion where the financial statements for the preceding period were audited.

- The nature of the opening balances, including the risk of their misstatement in the financial statements for the current period.
- The materiality of the opening balances relative to the financial statements for the current period.

6. The auditor will need to consider whether the accounting policies followed in the preceding period, as per which the opening balances have been arrived at, were appropriate and that those policies are consistently applied in the financial statements for the current period and where such accounting policies are inappropriate, the same have been changed in the current period and adequately disclosed.

7. When the financial statements for the preceding period were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by perusing the copies of 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.

8. When the financial statements of the preceding period were not audited or the auditor is not satisfied by using the procedures described in paragraph 7, the auditor will need to perform other procedures such as those discussed in paragraphs 9 and 10.

9. For current assets and liabilities, some audit evidence can ordinarily be obtained as part of the audit procedures performed during the current period. For example, the collection/payment of opening accounts receivable/ accounts payable during the current period will provide some audit evidence as to their existence, rights and obligations, completeness and valuation at the beginning of the period.

10. For other assets and liabilities, such as fixed assets, investments and long-term debt, the auditor will ordinarily examine the records underlying the opening balances. In certain cases, the auditor may be able to obtain confirmation of opening balances from third parties, for example, for long-term debt and investments.

## Audit Conclusions and Reporting

11. If, after performing procedures including those set out above, the auditor is unable to obtain sufficient appropriate audit evidence concerning opening balances, the auditor should, as appropriate, express:

(a) a qualified opinion, or

(b) a disclaimer of opinion.

The auditor may also express an opinion which is qualified or disclaimed regarding the profit or loss and unqualified regarding state of affairs, as appropriate.

12. If 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.

## Effective Date

13. This Standard on Auditing becomes operative for all audits commencing on or after 1st July, 2001.

# Standard on Auditing (SA) 510*(Revised) Initial Audit Engagements—Opening Balances

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Standard on Auditing (SA) 510 (Revised), "Initial Audit Engagements—Opening Balances" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services[1]," which sets out the authority of SAs.

* Hitherto known as Standard on Auditing (SA) 510 (AAS 22), "Initial Engagements-Opening Balances".

[1] Published in the July, 2007 issue of the Journal.

# Introduction

## Scope of this SA

1. This Standard on Auditing (SA) 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 [proposed] SA 710 (Revised)[2] also apply. SA 300 (Revised)[3] includes additional requirements and guidance regarding activities prior to starting an initial audit.

## Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

# Objective

3. 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.

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[2] Currently, SA 710 (AAS 25), "Comparatives" is in force. The Standard is being revised in the light of the corresponding International Standard.

[3] SA 300 (Revised), "Planning an Audit of Financial Statements" has been published in the December, 2007 issue of the Journal

## Definitions

4. For the purposes of the SAs, the following terms have the meanings attributed below:

(a) Initial audit engagement – 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.

(b) Opening balances – 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.

(c) 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.

## Requirements

### Audit Procedures

#### Opening Balances

5. 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.

6. 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[4];

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

(c) Performing one or more of the following: (Ref: Para. A1–A4)

(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.

7. 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 in accordance with SA 450[5].

## Consistency of Accounting Policies

8. The auditor shall obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balances have been

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[4] Accounting Standard (AS) 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires that prior period items should be separately disclosed in the Statement of Profit and Loss in a manner that their impact on the current profit or loss can be perceived.

[5] The Auditing and Assurance Standards Board (AASB) has issued the Exposure Draft of the Standard on Auditing (SA) 450, "Evaluation of Misstatements Identified During the Audit" in the January, 2009 issue of the Journal for public comments.

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.

### Relevant Information in the Predecessor Auditor's Report

9. If the prior period's financial statements were audited by a predecessor auditor and there was a modification to the opinion, the auditor shall evaluate the effect of the matter giving rise to the modification in assessing the risks of material misstatement in the current period's financial statements in accordance with SA 315.[6]

## Audit Conclusions and Reporting

### Opening Balances

10. 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 Proposed SA 705.[7] (Ref: Para. A5)

11. 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 Proposed SA 705.

### Consistency of Accounting Policies

12. If the auditor concludes that:

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[6] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

[7] At present, there is no separate Standard on Auditing (SA) corresponding to International Standard on Auditing (ISA) 705, "Modifications to the Opinion in the Independent Auditor's Report" and the concept of modified audit report has been discussed in SA 700, "The Auditor's Report on Financial Statements" (Hitherto known as AAS 28). SA 700 is being revised in the light of the corresponding International Standard.

(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 Proposed SA 705.

### Modification to the Opinion in the Predecessor Auditor's Report

13. If the predecessor auditor's opinion regarding the prior period's financial statements included a modification to the auditor's opinion that remains relevant and material to the current period's financial statements, the auditor shall modify the auditor's opinion on the current period's financial statements in accordance with Proposed SA 705 and Proposed SA 710 (Revised). (Ref: Para. A6)

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## Application and Other Explanatory Material

### Audit Procedures (Ref: Para. 6)

#### Opening Balances (Ref: Para. 6(c))

A1. 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.

A2. 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.

A3. 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.

A4. For non-current assets and liabilities, such as property plant and equipment, investments and long-term debt, some audit evidence may be obtained by examining the accounting records and other information underlying the opening balances. 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. In other cases, the auditor may need to carry out additional audit procedures.

## Audit Conclusions and Reporting

### Opening Balances (Ref: Para. 10)

A5. Proposed SA 705 establishes requirements and provides guidance on circumstances that may result in a modification to the auditor's opinion on the financial statements, the type of opinion appropriate in the circumstances, and the content of the auditor's report when the auditor's opinion is modified. The inability of the auditor to obtain sufficient appropriate audit evidence regarding opening balances may result in one of the following modifications to the opinion in the auditor's report:

(a) A qualified opinion or a disclaimer of opinion, as is appropriate in the circumstances; or

(b) Unless prohibited by law or regulation, an opinion which is qualified or disclaimed, as appropriate, regarding the results of operations*, and cash flows, where relevant, and unmodified regarding State of Affairs*.

The Appendix includes illustrative auditor's reports.

### Modification to the Opinion in the Predecessor Auditor's Report (Ref: Para. 13)

A6. In some situations, a modification to the predecessor auditor's opinion may not be relevant and material to the opinion on the current period's financial statements. This may be the case where, for example, there was a scope limitation in the prior period, but the matter giving rise to the scope limitation has been resolved in the current period.

* Profit & Loss Account.

* Balance Sheet.

# Material Modifications vis a vis ISA 510, "Initial Audit Engagements - Opening Balances"

## Deletions

1. Paragraph 6 (a) of ISA 510 dealt with the procedure for obtaining sufficient appropriate audit evidence about the opening balances which contain misstatements that materially affect the current period's financial statements by determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, have been restated. Since in India Accounting Standard (AS) 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires that prior period items should be separately disclosed in the Statement of Profit and Loss in a manner that their impact on the current profit or loss can be perceived, the restatement of the prior period financial statements does not exist in the Indian scenario. Hence, to align with the requirements of AS 5, the requirement of restatement of prior period items has been replaced with the requirement to disclose the prior period items in the current year's Statement of Profit & Loss.

2. Paragraph 6 (c) (i) of ISA 510 dealt with the procedure for obtaining sufficient appropriate audit evidence about the opening balances which contain misstatements that materially affect the current period's financial statements by reviewing the predecessor auditor's working papers, where the prior year financial statements were audited. Since in India Clause 1 of Part I of the Second Schedule to the Code of Ethics provides that a Chartered Accountant in Practice shall be deemed to be guilty of professional misconduct if he discloses information acquired in the course of his professional engagement to any person other than his client, an auditor cannot provide access to his working paper to the another auditor. Therefore, keeping in view the requirements of Code of Ethics, the requirement of reviewing the predecessor auditor's working papers has been replaced with the requirement of perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements. Corresponding change has also been made in the paragraph A4 of ISA 510 and Paragraphs A1 and A5 have been deleted.

3. Paragraph A2 of ISA 510 dealt with the outsourcing of an audit of a public sector entity by the statutorily appointed auditor to a private sector audit firm. Since in the Indian context such situation does not exist, the paragraph A2 of the application part has been deleted completely.

# Appendix

(Ref: Para. A5)

## Illustrations of Auditors' Reports with Modified Opinions*

Illustration 1:

Circumstances described in paragraph A5 (a) include the following:

- The auditor did not observe the counting of the physical inventory at the beginning of the current period and was unable to obtain sufficient appropriate audit evidence regarding the opening balances of inventory.
- The possible effects of the inability to obtain sufficient appropriate audit evidence regarding opening balances of inventory are deemed to be material but not pervasive to the entity's results of operations and cash flows.[8]
- The State of Affairs at year end gives a true and fair view.
- In this particular jurisdiction, law and regulation prohibit the auditor from giving an opinion which is qualified regarding the results of operations and cash flows and unmodified regarding State of Affairs.

* The Reporting Standards may give rise to conforming amendments to the illustrations of auditors' reports. Further, at present, there is no separate Standard on Auditing (SA) corresponding to International Standard on Auditing (ISA) 705, "Modifications to the Opinion in the Independent Auditors Report" and the concept of modified audit report has been discussed in SA 700, "The Auditor's Report on Financial Statements" (Hitherto known as AAS 28). SA 700 is being revised in the light of the corresponding International Standard.

[8] If the possible effects, in the auditor's judgment, are considered to be material and pervasive to the entity's results of operations and cash flows, the auditor would disclaim an opinion on the results of operations and cash flows.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

## Report on the Financial Statements[9]

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at March 31, 20X1, and the Statement of Profit and Loss, and the cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

### Management's Responsibility for the Financial Statements

Management is responsible for the preparation and presentation of financial statements that give a true and fair view in accordance with applicable Accounting Standards.[10] This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

### Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of

[9] The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

[10] Depending on the circumstances, this sentence may read: "Management is responsible for the preparation and fair presentation of these financial statements in accordance with applicable accounting standards".

material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation[11] of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[12] An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion

We were appointed as auditors of the company on June 30, 20X0 and thus did not observe the counting of the physical inventories at the beginning of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at March 31, 20X0. Since opening inventories enter into the determination of the results of operations and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the profit for the year reported in the Statement of Profit and Loss and the net cash flows from operating activities reported in the cash flow statement.

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[11] Depending on the circumstances, this sentence may read: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation 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 the entity's internal control".

[12] In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances". In the case of footnote 13, this sentence may read: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances".

### Qualified Opinion

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the State of Affairs of ABC Company as of March 31, 20X1, and of its Results of Operations and its cash flows for the year then ended in accordance with applicable Accounting Standards.

### Other Matters

The financial statements of the Company for the year ended March 31, 20X0, were audited by another auditor whose report dated July 1, 20X0 expressed an unmodified opinion on those statements.

## Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities].

For ABC and Co.
Chartered Accountants
Signature
(Name of the Member Signing the Audit Report)
(Designation[13])
Membership Number

Place of Signature
Date

[13] Partner or Proprietor, as the case may be.

Illustration 2:

Circumstances described in paragraph A5 (b) include the following:

- The auditor did not observe the counting of the physical inventory at the beginning of the current period and was unable to obtain sufficient appropriate audit evidence regarding the opening balances of inventory.
- The possible effects of the inability to obtain sufficient appropriate audit evidence regarding opening balances of inventory are deemed to be material but not pervasive to the entity's results of operations and cash flows.[14]
- The State of Affairs at year end gives a true and fair view.
- An opinion that is qualified regarding the results of operations and cash flows and unmodified regarding State of Affairs is considered appropriate in the circumstances.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements[15]

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at March 31, 20X1, and the Statement of Profit and Loss, and the cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

[14] If the possible effects, in the auditor's judgment, are considered to be material and pervasive to the entity's results of operations and cash flows, the auditor would disclaim the opinion on the results of operations and cash flows.

[15] The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and presentation[16] of financial statements that give a true and fair view in accordance with applicable Accounting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation[17] of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[18] An audit also includes evaluating the

[16] Depending on the circumstances, this sentence may read: "Management is responsible for the preparation and fair presentation of these financial statements in accordance with applicable accounting standards".

[17] Depending on the circumstances, this sentence may read: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation 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 the entity's internal control".

[18] In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this

appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our unmodified opinion on the State of Affairs and our qualified audit opinion on the results of operations and cash flows.

Basis for Qualified Opinion on the results of operations and Cash Flows

We were appointed as auditors of the company on June 30, 20X0 and thus did not observe the counting of the physical inventories at the beginning of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at March 31, 20X0. Since opening inventories enter into the determination of the results of operations and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the profit for the year reported in the Statement of Profit and Loss and the net cash flows from operating activities reported in the cash flow statement.

Qualified Opinion on the results of operations and Cash Flows

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the Statement of Profit and Loss and Cash Flow Statement give a true and fair view of the results of operations and cash flows of ABC Company for the year ended March 31, 20X1 in accordance with applicable Accounting Standards.

Opinion on the State of Affairs

In our opinion, the balance sheet gives a true and fair view of the State of

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sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances". In the case of footnote 19, this sentence may read: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances".

Affairs of ABC Company as of March 31, 20X1 in accordance with applicable Accounting Standards.

Other Matters

The financial statements of the Company for the year ended March 31, 20X0, were audited by another auditor whose report dated July 1, 20X0 expressed an unmodified opinion on those statements.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

For ABC and Co.
Chartered Accountants
Signature
(Name of the Member Signing the Audit Report)
(Designation[19])
Membership Number

Place of Signature
Date

[19] Partner or Proprietor, as the case may be.

# SA 520 (AAS 14)

## ANALYTICAL PROCEDURES

***(Effective for all audits relating to accounting periods beginning on or after April 1, 1997)***

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Standard on Auditing (SA) 520*, "Analytical Procedures" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in December, 1997.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard on Auditing (SA) is to establish standards on the application of analytical procedures during an audit.

2. The auditor should apply analytical procedures at the planning and overall review stages of the audit. Analytical procedures may also be applied at other stages.

3. "Analytical procedures" means the analysis of significant ratios and trends, including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts.

## Nature and Purpose of Analytical Procedures

4. Analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

- Comparable information for prior periods.
- Anticipated results of the entity, such as budgets or forecasts.
- Predictive estimates prepared by the auditor, such as an estimation of depreciation charge for the year.
- Similar industry information, such as a comparison of the entity's ratio of sales to trade debtors with industry averages, or with other entities of comparable size in the same industry.

5. Analytical procedures also include consideration of relationships:

- 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.

6. Various methods may be used in performing the above procedures. These range from simple comparisons to complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, financial statements of components (such as subsidiaries, divisions or segments) and individual elements of financial information. The auditor's choice of procedures, methods and level of

application is a matter of professional judgement.

7. Analytical procedures are used for the following purposes:

(a) to assist the auditor in planning the nature, timing and extent of other audit procedures;

(b) as substantive procedures when their use can be more effective or efficient than tests of details in reducing detection risk for specific financial statement assertions; and

(c) as an overall review of the financial statements in the final review stage of the audit.

## Analytical Procedures in Planning the Audit

8. The auditor should apply analytical procedures at the planning stage to assist in understanding the business and in identifying areas of potential risk. Application of analytical procedures may indicate aspects of the business of which the auditor was unaware and will assist in determining the nature, timing and extent of other audit procedures.

9. Analytical procedures in planning the audit use both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

## Analytical Procedures as Substantive Procedures

10. The auditor's reliance on substantive procedures to reduce detection risk relating to specific financial statement assertions may be derived from tests of details, from analytical procedures, or from a combination of both. The decision about which procedures to use to achieve a particular audit objective is based on the auditor's judgement about the expected effectiveness and efficiency of the available procedures in reducing detection risk for specific financial statement assertions.

11. The auditor will ordinarily inquire of management as to the availability and reliability of information needed to apply analytical procedures and the results of any such procedures performed by the entity. It may be efficient to use analytical data prepared by the entity, provided the auditor is satisfied that such data is properly prepared.

12. When intending to perform analytical procedures as substantive

procedures, the auditor will need to consider a number of factors such as the:

- Objectives of the analytical procedures and the extent to which their results can be relied upon (paragraphs 14-16).
- Nature of the entity and the degree to which information can be disaggregated, for example, 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.
- Availability of information, both financial, such as budgets or forecasts, and non-financial, such as the number of units produced or sold.
- Reliability of the information available, for example, whether budgets are prepared with sufficient care.
- Relevance of the information available, for example, whether budgets have been established as results to be expected rather than as goals to be achieved.
- Source of the information available, for example, sources independent of the entity are ordinarily more reliable than internal sources.
- 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.
- Knowledge gained during previous audits, together with the auditor's understanding of the effectiveness of the accounting and internal control systems and the types of problems that in prior periods have given rise to accounting adjustments.

## Analytical Procedures in the Overall Review at the End of the Audit

13. The auditor should apply analytical procedures at or near the end of the audit when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's knowledge of the business. The conclusions drawn from the results of such procedures are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements and assist

in arriving at the overall conclusion as to the reasonableness of the financial statements. However, in some cases, as a result of application of analytical procedures, the auditor may identify areas where further procedures need to be applied before the auditor can form an overall conclusion about the financial statements.

## Extent of Reliance on Analytical Procedures

14. The application of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the completeness, accuracy and validity of the data produced by the accounting system. However, reliance on the results of analytical procedures will depend on the auditor's assessment of the risk that the analytical procedures may identify relationships as expected when, in fact, a material misstatement exists.

15. The extent of reliance that the auditor places on the results of analytical procedures depends on the following factors:

(a) materiality of the items involved, for example, when inventory balances are material, the auditor does not rely only on analytical procedures in forming conclusions. However, the auditor may rely solely on analytical procedures for certain income and expense items when they are not individually material;

(b) other audit procedures directed toward the same audit objectives, for example, other procedures performed by the auditor in reviewing the collectibility of accounts receivable, such as the review of subsequent cash receipts, might confirm or dispel questions raised from the application of analytical procedures to an ageing schedule of customers' accounts;

(c) accuracy with which the expected results of analytical procedures can be predicted. For example, the auditor will ordinarily expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising; and

(d) assessments of inherent and control risks, for example, if internal control over sales order processing is weak and, therefore, control risk

is high, more reliance on tests of details of transactions and balances than on analytical procedures in drawing conclusions on receivables may be required.

16. The auditor will need to consider testing the controls, if any, over the preparation of information used in applying analytical procedures. When such controls are effective, the auditor will have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The controls over non-financial information can often be tested in conjunction with tests of accounting-related controls. For example, an entity in establishing controls over the processing of sales invoices may include controls over the recording of unit sales. In these circumstances, the auditor could test the controls over the recording of unit sales in conjunction with tests of the controls over the processing of sales invoices.

## Investigating Unusual Items

17. When analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or that deviate from predicted amounts, the auditor should investigate and obtain adequate explanations and appropriate corroborative evidence.

18. The investigation of unusual fluctuations and relationships ordinarily begins with inquiries of management, followed by:

(a) corroboration of management's responses, for example, by comparing them with the auditor's knowledge of the business and other evidence obtained during the course of the audit; and

(b) consideration of the need to apply other audit procedures based on the results of such inquiries, if management is unable to provide an explanation or if the explanation is not considered adequate.

## Effective Date

19. This Standard on Auditing becomes operative for all audits relating to accounting periods beginning on or after April 1, 1997.

# SA 530 (AAS 15)

## AUDIT SAMPLING

***(Effective for all audits relating to accounting periods beginning on or after April 1, 1998)***

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Standard on Auditing (SA) 530*, "Audit Sampling", should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in April, 1998.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard on Auditing (SA) is to establish standards on the design and selection of an audit sample and the evaluation of the sample results. This SA applies equally to both statistical and non-statistical sampling methods. Either method, when properly applied, can provide sufficient appropriate audit evidence.

2. When using either statistical or non-statistical sampling methods, the auditor should design and select an audit sample, perform audit procedures thereon, and evaluate sample results so as to provide sufficient appropriate audit evidence.

3. "Audit sampling" means the application of audit procedures to less than 100% of the items within an account balance or class of transactions to enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population.

4. It is important to recognise that certain testing procedures do not come within the definition of sampling. Tests performed on 100% of the items within a population do not involve sampling. Likewise, applying audit procedures to all items within a population which have a particular characteristic (for example, all items over a certain amount) does not qualify as audit sampling with respect to the portion of the population examined, nor with regard to the population as a whole, since the items were not selected from the total population on a basis that was expected to be representative. Such items might imply some characteristic of the remaining portion of the population but would not necessarily be the basis for a valid conclusion about the remaining portion of the population.

## Design of the Sample

5. When designing an audit sample, the auditor should consider the specific audit objectives, the population from which the auditor wishes to sample, and the sample size.

### Audit Objectives

6. The auditor would first consider the specific audit objectives to be achieved and the audit procedures which are likely to best achieve those

objectives. In addition, when audit sampling is appropriate, consideration of the nature of the audit evidence sought and possible error conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes an error and what population to use for sampling. For example, when performing tests of control over an entity's purchasing procedures, the auditor will be concerned with matters such as whether an invoice was clerically checked and properly approved. On the other hand, when performing substantive procedures on invoices processed during the period, the auditor will be concerned with matters such as the proper reflection of the monetary amounts of such invoices in the financial statements.

### Population

7. The population is the entire set of data from which the auditor wishes to sample in order to reach a conclusion. The auditor will need to determine that the population from which the sample is drawn is appropriate for the specific audit objective. For 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.

8. 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. For 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.

### Stratification

9. To assist in the efficient and effective design of the sample, stratification may be appropriate. Stratification is the process of dividing a population into sub-populations, each of which is a group of sampling units, which have similar characteristics (often monetary value). The strata need to be explicitly

defined so that each sampling unit can belong to only one stratum. This process reduces the variability of the items within each stratum. Stratification therefore, enables the auditor to direct audit efforts towards the items which, for example, contain the greatest potential monetary error. For example, the auditor may direct attention to larger value items for accounts receivable to detect overstated material misstatements. In addition, stratification may result in a smaller sample size.

Sample Size

10. When determining the sample size, the auditor should consider sampling risk, the tolerable error, and the expected error. Examples of some factors affecting sample size are contained in Appendix 1 and Appendix 2.

Sampling Risk

11. Sampling risk[2] arises from the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure.

12. The auditor is faced with sampling risk in both tests of control and substantive procedures as follows:

(a) Tests of Control:

(i) Risk of Under Reliance: The risk that, although the sample result does not support the auditor's assessment of control risk, the actual compliance rate would support such an assessment.

(ii) Risk of Over Reliance: The risk that, although the sample result supports the auditor's assessment of control risk, the actual compliance rate would not support such an assessment.

(b) Substantive Procedures:

(i) Risk of Incorrect Rejection: The risk that, although the sample

[2] Sampling risk can be contrasted with non-sampling risk which arises when the auditor uses any audit procedures. Non-sampling risk arises because, for example, most audit evidence is persuasive rather than conclusive, the auditor might use inappropriate procedures or might misinterpret evidence and, thus, fail to recognise an error. The auditor attempts to reduce non-sampling risk to a negligible degree by appropriate planning, direction, supervision and review.

result supports the conclusion that a recorded account balance or class of transactions is materially misstated, in fact it is not materially misstated.

(ii) Risk of Incorrect Acceptance: The risk that, although the sample result supports the conclusion that a recorded account balance or class of transactions is not materially misstated, in fact it is materially misstated.

13. The risk of under reliance and the risk of incorrect rejection affect audit efficiency as they would ordinarily lead to additional work being performed by the auditor, or the entity, which would establish that the initial conclusions were incorrect. The risk of over reliance and the risk of incorrect acceptance affect audit effectiveness and are more likely to lead to an erroneous opinion on the financial statements than either the risk of under reliance or the risk of incorrect rejection.

14. Sample size is affected by the level of sampling risk the auditor is willing to accept from the results of the sample. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

### Tolerable Error

15. Tolerable error is the maximum error in the population that the auditor would be willing to accept and still conclude that the result from the sample has achieved the audit objective. Tolerable error is considered during the planning stage and, for substantive procedures, is related to the auditor's judgement about materiality. The smaller the tolerable error, the greater the sample size will need to be.

16. In tests of control, the tolerable error is the maximum rate of deviation from a prescribed control procedure that the auditor would be willing to accept, based on the preliminary assessment of control risk. In substantive procedures, the tolerable error is the maximum monetary error in an account balance or class of transactions that the auditor would be willing to accept so that when the results of all audit procedures are considered, the auditor is able to conclude, with reasonable assurance, that the financial statements are not materially misstated.

### Expected Error

17. If the auditor expects error to be present in the population, a larger

sample than when no error is expected ordinarily needs to be examined to conclude that the actual error in the population is not greater than the planned tolerable error. Smaller sample sizes are justified when the population is expected to be error free. In determining the expected error in a population, the auditor would consider such matters as error levels identified in previous audits, changes in the entity's procedures, and evidence available from other procedures.

## Selection of the Sample

18. 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.

19. While there are a number of selection methods, three methods commonly used are:

- Random selection, which ensures that all items in the population have an equal chance of selection, for example, by use of random number tables.
- Systematic selection, which involves selecting items using a constant interval between selections, the first interval having a random start. The interval might be based on a certain number of items (for example, every 20th voucher number) or on monetary totals (for example, every Rs 1,000 increase in the cumulative value of the population). When using systematic selection, the auditor would need to determine that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population. For example, if in a population of branch sales, a particular branch's sales occur only as every 100th item and the sampling interval selected is 50, the result would be that the auditor would have selected all, or none, of the sales of that particular branch.
- Haphazard selection, which may be an acceptable alternative to random selection, provided the auditor attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units. When the auditor uses this method, care needs to be taken to guard against making a selection that is biased, for example, towards items which are easily located, as they may not be representative.

## Evaluation of Sample Results

20. Having carried out, on each sample item, those audit procedures that are appropriate to the particular audit objective, the auditor should:

(a) analyse any errors detected in the sample;

(b) project the errors found in the sample to the population; and

(c) reassess the sampling risk.

### Analysis of Errors in the Sample

21. In analysing the errors detected in the sample, the auditor will first need to determine that an item in question is in fact an error. In designing the sample, the auditor will have defined those conditions that constitute an error by reference to the audit objectives. For example, in a substantive procedure relating to the recording of accounts receivable, a mis-posting between customer accounts does not affect the total accounts receivable. Therefore, it may be inappropriate to consider this an error in evaluating the sample results of this particular procedure, even though it may have an effect on other areas of the audit such as the assessment of doubtful accounts.

22. When the expected audit evidence regarding a specific sample item cannot be obtained, the auditor may be able to obtain sufficient appropriate audit evidence through performing alternative procedures. For example, if a positive account receivable confirmation has been requested and no reply was received, the auditor may be able to obtain sufficient appropriate audit evidence that the receivable is valid by reviewing subsequent payments from the customer. If the auditor does not, or is unable to, perform satisfactory alternative procedures, or if the procedures performed do not enable the auditor to obtain sufficient appropriate audit evidence, the item would be treated as an error.

23. The auditor would also consider the qualitative aspects of the errors. These include the nature and cause of the error and the possible effect of the error on other phases of the audit.

24. In analysing the errors discovered, the auditor may observe that many have a common feature, for example, type of transaction, location, product line, or period of time. In such circumstances, the auditor may decide to identify all items in the population which possess the common feature, thereby producing a sub-population, and extend audit procedures in this

area. The auditor would then perform a separate analysis based on the items examined for each sub-population.

### Projection of Errors

25. The auditor projects the error results of the sample to the population from which the sample was selected. There are several acceptable methods of projecting error results. However, in all the cases, the method of projection will need to be consistent with the method used to select the sampling unit. When projecting error results, the auditor needs to keep in mind the qualitative aspects of the errors found. When the population has been divided into sub-population, the projection of errors is done separately for each sub-population and the results are combined.

### Reassessing Sampling Risk

26. The auditor needs to consider whether errors in the population might exceed the tolerable error. To accomplish this, the auditor compares the projected population error to the tolerable error taking into account the results of other audit procedures relevant to the specific control or financial statement assertion. The projected population error used for this comparison in the case of substantive procedures is net of adjustments made by the entity. When the projected error exceeds tolerable error, the auditor reassesses the sampling risk and if that risk is unacceptable, would consider extending the audit procedure or performing alternative audit procedures.

## Effective Date

27. This Standard on Auditing becomes operative for all audits relating to accounting periods beginning on or after April 1, 1998.

# Appendix 1

Examples of Factors Influencing Sample Size for Tests of Control

| | Conditions leading to | |
|---|---|---|
| Factor | Smaller Sample Size | Larger Sample Size |
| Assessment of control risk | Higher preliminary assessment of control risk | Lower preliminary assessment of control risk |
| Tolerable error | Higher acceptable rate of deviation | Lower acceptable rate of deviation |
| Allowable risk of over reliance | Higher risk of over reliance | Lower risk of over reliance |
| Expected error | Lower expected rate of deviation in population | Higher expected rate of deviation in population* |
| Number of items in population | Virtually no effect on sample size unless population is small | |

*High expected deviation rates ordinarily warrant little, if any, reduction of control risk and, therefore, tests of controls might be omitted.

## Appendix 2

Examples of Factors Influencing Sample Size
for Substantive Procedures

| Factor | Conditions Leading to | |
|---|---|---|
| | Smaller Sample Size | Larger Sample Size |
| Assessment of control risk | Lower control risk | Higher Control risk |
| Reduction in detection risk because of other substantive tests related to the same financial statement assertions | Greater use of other substantive tests | Reduced use of other substantive tests |
| Tolerable error | Large measure of tolerable error | Smaller measure of tolerable error |
| Expected error | Smaller errors or lower frequency | Larger errors or higher frequency |
| Population value | Smaller monetary significance to the financial statements | Larger monetary significance to the financial statements |
| Number of items in population | Virtually no effect on sample size unless population is small | |
| Acceptable level of detection risk | Higher acceptable level of detection risk | Lower acceptable level of detection risk |
| Stratification | Stratification of the population, if appropriate | No stratification of the population |

# Standard on Auditing (SA) 530 (Revised) Audit Sampling*

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Standard on Auditing (SA) 530 (Revised), "Audit Sampling" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services[1]", which sets out the authority of SAs.

* Earlier known as SA 530 (AAS 15), "Audit Sampling".

[1] Published in the July, 2007 issue of the Journal.

# Introduction

## Scope of this SA

1. This Standard on Auditing (SA) applies when the auditor has decided to use audit sampling in performing audit procedures. It deals with the auditor's use of statistical and non-statistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details, and evaluating the results from the sample.

2. This SA complements SA 500 (Revised)[2], which 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 (Revised) provides guidance on the means available to the auditor for selecting items for testing, of which audit sampling is one means.

## Effective Date

3. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

# Objective

4. 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.

# Definitions

5. For purposes of the SAs, the following terms have the meanings attributed below:

(a) Audit sampling (sampling) – The application of audit procedures to less

[2] The Auditing and Assurance Standards Board has issued the Exposure Draft of Revised SA 500, "Considering the Relevance and Reliability of Audit Evidence", which was published in August, 2008 issue of the Journal for public comments.

than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

(b) Population – The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

(c) Sampling risk – 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. Sampling risk can lead to two types of erroneous conclusions:

(i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

(ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

(d) Non-sampling risk – The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. (Ref: Para A1)

(e) Anomaly – A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

(f) Sampling unit – The individual items constituting a population. (Ref: Para A2)

(g) Statistical sampling – An approach to sampling that has the following characteristics:

(i) Random selection of the sample items; and

(ii) The use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have characteristics (i) and (ii) is considered non-statistical sampling.

(h) Stratification – The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).

(i) Tolerable misstatement – A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population. (Ref: Para. A3)

(j) Tolerable rate of deviation – A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

## Requirements

### Sample Design, Size and Selection of Items for Testing

6. When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn. (Ref: Para. A4-A9)

7. The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level. (Ref: Para. A10-A11)

8. The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection. (Ref: Para. A12-A13)

### Performing Audit Procedures

9. The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.

10. If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item. (Ref: Para. A14)

11. 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. (Ref: Para. A15-A16)

## Nature and Cause of Deviations and Misstatements

12. The auditor shall investigate the nature and cause 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. (Ref: Para. A17)

13. 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. 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.

## Projecting Misstatements

14. For tests of details, the auditor shall project misstatements found in the sample to the population. (Ref: Para. A18-A20)

## Evaluating Results of Audit Sampling

15. The auditor shall evaluate:

(a) The results of the sample; and (Ref: Para. A21-A22)

(b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. (Ref: Para. A23)

***

# Application and Other Explanatory Material

## Definitions

### Non-Sampling Risk (Ref: Para. 5(d))

A1. Examples of non-sampling risk include use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognise a misstatement or deviation.

### Sampling Unit (Ref: Para. 5(f))

A2. The sampling units might be physical items (for example, cheques listed on deposit slips, credit entries on bank statements, sales invoices or debtors' balances) or monetary units.

### Tolerable Misstatement (Ref: Para. 5(i))

A3. When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements. Tolerable misstatement is the application of performance materiality, as defined in SA 320 (Revised)[3], to a particular sampling procedure. Tolerable misstatement may be the same amount or an amount lower than performance materiality.

## Sample Design, Size and Selection of Items for Testing

### Sample Design (Ref: Para. 6)

A4. Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.

[3] The Auditing and Assurance Standards Board has issued Exposure Draft of Proposed Standard on Auditing (SA) 320 (Revised), "Materiality in Planning and Performing an Audit", which has been published in the January, 2009 issue of the Journal and has also been hosted on the website of the Institute for public comments.

A5. When designing an audit sample, 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. 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. In fulfilling the requirement of paragraph 8 of SA 500 (Revised), when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

A6. The auditor's consideration of the purpose of the audit procedure, as required by paragraph 6, 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. For 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 misposting 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.

A7. 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. For 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.

A8. 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. Appendix 1 provides further discussion on stratification and value-weighted selection.

A9. The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

Sample Size (Ref: Para. 7)

A10. 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.

A11. The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. Appendices 2 and 3 indicate the influences that various factors typically have on the determination of sample size. When circumstances are similar, the effect on sample size of factors such as those identified in Appendices 2 and 3 will be similar regardless of whether a statistical or non-statistical approach is chosen.

Selection of Items for Testing (Ref: Para. 8)

A12. 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.

A13. The principal methods of selecting samples are the use of random selection, systematic selection and haphazard selection. Each of these methods is discussed in Appendix 4.

Performing Audit Procedures (Ref: Para. 10-11)

A14. 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 authorisation. If the auditor is satisfied that the cheque has been properly cancelled such that it does not constitute a deviation, an appropriately chosen replacement is examined.

A15. 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.

A16. An example of a suitable alternative procedure might be the examination of subsequent cash receipts together with evidence of their source and the items they are intended to settle when no reply has been received in response to a positive confirmation request.

### Nature and Cause of Deviations and Misstatements (Ref: Para. 12)

A17. In analysing 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. 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.

### Projecting Misstatements (Ref: Para. 14)

A18. 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.

A19. 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.

A20. 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. SA 330[4] provides guidance when deviations from controls upon which the auditor intends to rely are detected.

### Evaluating Results of Audit Sampling (Ref: Para. 15)

A21. For tests of controls, an unexpectedly high sample deviation rate may lead to an increase in the assessed risk of material misstatement, unless further audit

[4] SA 330, "The Auditor's Responses to Assessed Risks", paragraphs 17 and A41.

evidence substantiating the initial assessment is obtained. For tests of details, an unexpectedly high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no material misstatement exists.

A22. In the case of tests of details, the projected misstatement plus anomalous misstatement, if any, is the auditor's best estimate of misstatement in the population. When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested. The closer the projected misstatement plus anomalous misstatement is to tolerable misstatement, the more likely that actual misstatement in the population may exceed tolerable misstatement. Also if the projected misstatement is greater than the auditor's expectations of misstatement used to determine the sample size, the auditor may conclude that there is an unacceptable sampling risk that the actual misstatement in the population exceeds the tolerable misstatement. Considering the results of other audit procedures helps the auditor to assess the risk that actual misstatement in the population exceeds tolerable misstatement, and the risk may be reduced if additional audit evidence is obtained.

A23. If the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may:

- Request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or

- Tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

## Material Modifications vis a vis ISA 530, "Audit Sampling"

SA 530 (Revised), "Audit Sampling" does not contain any material modifications vis à vis ISA 530.

# Appendix 1

(Ref: Para. A8)

## 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. This Appendix provides guidance to the auditor on the use of stratification and value-weighted sampling techniques.

### Stratification

1. 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.

2. 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.

3. 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. For 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).

4. If a class of transactions or account balance has been divided into strata, the misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.

## Value-Weighted Selection

5. 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 (described in Appendix 4) and is most efficient when selecting items using random selection.

# Appendix 2

(Ref: Para. A11)

## 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.

| FACTOR | EFFECT ON SAMPLE SIZE | |
|---|---|---|
| 1. An increase in the extent to which the auditor's risk assessment takes into account relevant controls | Increase | 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). |
| 2. An increase in the tolerable rate of | Decrease | The lower the tolerable rate of deviation, the larger the sample |

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|---|---|---|
| deviation | | size needs to be. |
| 3. An increase in the expected rate of deviation of the population to be tested | Increase | The higher the expected rate of deviation, the 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. |
| 4. 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 | Increase | 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. |
| 5. An increase in the number of sampling units in the population | Negligible effect | For 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. |

# Appendix 3

(Ref: Para. A11)

## 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.

| FACTOR | EFFECT ON SAMPLE SIZE | |
|---|---|---|
| 1. An increase in the auditor's assessment of the risk of material misstatement | Increase | 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 |

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|---|---|---|
| | | risk), the larger the sample size will need to be. |
| 2. An increase in the use of other substantive procedures directed at the same assertion | Decrease | 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. |
| 3. An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population | Increase | The 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. |
| 4. An increase in tolerable misstatement | Decrease | The lower the tolerable misstatement, the larger the sample size needs to be. |
| 5. An increase in the amount of misstatement the auditor expects to find in the population | Increase | 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 |

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|---|---|---|
| | | procedures, the results of tests of control, the results of audit procedures applied in prior periods, and the results of other substantive procedures. |
| 6. Stratification of the population when appropriate | Decrease | 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. |
| 7. The number of sampling units in the population | Negligible effect | 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). |

## Appendix 4

(Ref: Para. A13)

## Sample Selection Methods

There are many methods of selecting samples. The principal methods are as follows:

(a) Random selection (applied through random number generators, for example, random number tables).

(b) Systematic selection, 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 computerised random number generator or random number tables. 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.

(c) Monetary Unit Sampling is a type of value-weighted selection (as described in Appendix 1) in which sample size, selection and evaluation results in a conclusion in monetary amounts.

(d) 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.

(e) Block selection 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.

# SA 540 (AAS 18)

## AUDIT OF ACCOUNTING ESTIMATES

***(Effective for all audits commencing on or after 1st April, 2000)***

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Standard on Auditing (SA) 540*, "Audit of Accounting Estimates", should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in April, 2000.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard on Auditing (SA) is to establish standards on the audit of accounting estimates contained in financial statements. This SA is not intended to be applicable to the examination of prospective financial information[2].

2. The auditor should obtain sufficient appropriate audit evidence regarding accounting estimates.

3. "Accounting estimate" means an approximation of the amount of an item in the absence of a precise means of measurement. Examples are:

- Allowances to reduce inventory and accounts receivable to their estimated realisable value.
- Provisions to allocate the cost of fixed assets over their estimated useful lives.
- Accrued revenue.
- Provision for taxation.
- Provision for a loss from a lawsuit.
- Insurer's liability for outstanding claims.
- Losses on construction contracts in progress.
- Amortisation of certain items like goodwill and deferred revenue expenditure.
- Provision to meet warranty claims.
- Provision for retirement benefits in the financial statements of employers.

4. Management is responsible for making accounting estimates included in financial statements. These estimates are often made in conditions of uncertainty regarding the outcome of events that have occurred or are likely to occur and involve the use of judgement. As a result, the risk of material misstatement is greater when accounting estimates are involved.

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[2] In this regard, it may be noted that the Institute of Chartered Accountants of India has issued a Standard on Assurance Engagements (SAE) 3400, "The Examination of Prospective Financial Information".

## Nature of Accounting Estimates

5. The determination of an accounting estimate may be simple or complex, depending upon the nature of the item. For example, accruing a charge for rent may be a simple calculation, whereas estimating a provision for slow-moving or surplus inventory may involve considerable analysis of current data and a forecast of future sales. In complex estimates, a high degree of special knowledge and judgment may be required.

6. Accounting estimates may be determined as part of the routine accounting system operating on a continuing basis, or may be non-routine, operating only at the end of the period. In many cases, accounting estimates are made by using a formula based on experience, such as the use of standard rates for depreciating each category of fixed assets or a standard percentage of sales revenue for computing a warranty provision. In such cases, the formula needs to be reviewed regularly by management, for example, by reassessing the remaining useful lives of assets or by comparing actual results with the estimate and adjusting the formula when necessary.

7. The uncertainty associated with an item, or the lack of objective data may make it incapable of reasonable estimation, in which case, the auditor needs to consider the same while expressing his opinion on the financial statements.

## Audit Procedures

8. The auditor should obtain sufficient appropriate audit evidence as to whether an accounting estimate is reasonable in the circumstances and, when required, is appropriately disclosed in the financial statements. The evidence available to support an accounting estimate will often be more difficult to obtain and less conclusive than evidence available to support other items in the financial statements.

9. An understanding of the procedures and methods, including the accounting and internal control systems, used by management in making the accounting estimates is often important for the auditor to plan the nature, timing and extent of the audit procedures.

10. The auditor should adopt one or a combination of the following approaches in the audit of an accounting estimate:

(a) review and test the process used by management to develop the estimate;

(b) use an independent estimate for comparison with that prepared by management; or

(c) review subsequent events which confirm the estimate made.

Reviewing and Testing the Process Used by Management

11. The steps ordinarily involved in reviewing and testing of the process used by management are:

(a) evaluation of the data and consideration of assumptions on which the estimate is based;

(b) testing of the calculations involved in the estimate;

(c) comparison, when possible, of estimates made for prior periods with actual results of those periods; and

(d) consideration of management's approval procedures.

Evaluation of Data and Consideration of Assumptions

12. The auditor would evaluate whether the data on which the estimate is based is accurate, complete and relevant. When accounting data is used, it will need to be consistent with the data processed through the accounting system. For example, in substantiating a warranty provision, the auditor would obtain audit evidence that the data relating to products still within the warranty period, at period end, agree with the sales information within the accounting system.

13. External evidence is, usually, more reliable for the purpose of an audit than internal evidence. Accordingly, obtaining external evidence may be warranted in certain circumstances. For example, where there may be uncertainties with regard to the anticipated future sales of products requiring provision for obsolescence of inventories, the auditor, in addition to examining internal data such as past levels of sales, orders on hand etc., may seek external evidence to corroborate the requirement for inventory obsolescence provision. Similarly, in respect of claims against the entity arising out of litigation, internal evidence may be required to be corroborated by making a reference to entity's lawyers, if so required. Internal evidence relating to provision for gratuity, pension or other terminal benefits for the staff, where funded by external agencies, may sought to be corroborated by external evidence.

14. The auditor would evaluate whether the data collected is appropriately analysed to form a reasonable basis for determining the accounting estimate. For example, the analysis of the age of accounts receivable to estimate the provision for doubtful debts and advances.

15. The assumptions used in the accounting estimate will be specific to the entity and would be based on internally generated data, while in other cases, the assumptions may be based on industry or government statistics. The auditor would evaluate whether the entity has an appropriate base for the principal assumptions used in the accounting estimate.

16. In evaluating the assumptions on which the estimate is based, the auditor would consider, among other things, whether they are:

- Reasonable in light of actual results in prior periods.
- Consistent with those used for other accounting estimates.
- Consistent with management's plans which appear appropriate.

The auditor would need to pay particular attention to assumptions which are sensitive to variation, subjective or susceptible to material misstatement.

17. In the case of complex estimating processes involving specialised techniques, it may be necessary for the auditor to use the work of an expert, for example, engineers for estimating quantities in stock piles of mineral ores. Requirements as to how to use the work of an expert are prescribed in SA 620, "Using the Work of an Expert."

18. The auditor would review the continuing appropriateness of formulae used by management in the preparation of accounting estimates. For this purpose, the auditor's knowledge of the financial results of the entity in prior periods, practices used by other entities in the industry and the future plans of management as disclosed to the auditor would be useful.

Testing of Calculations

19. The auditor would test the calculation procedures used by management. The nature, timing and extent of the auditor's testing will depend on such factors as the complexity involved in calculating the accounting estimate, the auditor's evaluation of the procedures and methods used by the entity in producing the estimate and the materiality of the estimate in the context of the financial statements.

Comparison of Previous Estimates with Actual Results

20. When possible, the auditor would compare accounting estimates made for prior periods with actual results of those periods to assist in:

(a) obtaining evidence about the general reliability of the entity's estimating procedures;

(b) considering whether adjustments to estimating formulae may be required; and

(c) evaluating whether differences between actual results and previous estimates have been quantified and that, where necessary, appropriate adjustments or disclosures have been made.

Consideration of Management's Approval Procedures

21. Material accounting estimates are ordinarily reviewed and approved by management. The auditor would consider whether such review and approval is performed by the appropriate level of management and that it is evidenced in the documentation supporting the determination of the accounting estimate.

Use of an Independent Estimate

22. The auditor may make or obtain an independent estimate and compare it with the accounting estimate, prepared by management. When using an independent estimate, the auditor would ordinarily evaluate the data, consider the assumptions and test the calculation procedures used in its development. It may also be appropriate to compare accounting estimates so made for prior periods with actual results of those periods.

Review of Subsequent Events

23. Transactions and events which occur after period end, but prior to completion of the audit, may provide audit evidence regarding an accounting estimate made by management. The auditor's review of such transactions and events may reduce, or even remove, the need for the auditor to review and test the process used by management to develop the accounting estimate or to use an independent estimate in assessing the reasonableness of the accounting estimate.

## Evaluation of Results of Audit Procedures

24. The auditor should make a final assessment of the reasonableness of the estimate based on the auditor's knowledge of the business and whether the estimate is consistent with other audit evidence obtained during the audit.

25. The auditor would consider whether there are any significant subsequent transactions or events which affect the data and the assumptions used in determining the accounting estimate.

26. Because of the uncertainties inherent in accounting estimates, evaluating differences can be more difficult than in other areas of the audit. When there is a difference between the auditor's estimate of the amount best supported by the available audit evidence and the estimated amount included in the financial statements, the auditor would determine whether such a difference requires adjustment. If the difference is reasonable, for example, because the amount in the financial statements falls within a range of acceptable results, it may not require adjustment. However, if the auditor believes the difference is unreasonable, management would be requested to revise the estimate. If management refuses to revise the estimate, the difference would be considered a misstatement and would be considered with all other misstatements in assessing whether the effect on the financial statements is material. However, the auditor would also consider whether individual differences which have been accepted as reasonable are biased in one direction, so that, on a cumulative basis, they may have a material effect on the financial statements. In such circumstances, the auditor would evaluate the accounting estimates taken as a whole.

## Effective Date

27. This Standard on Auditing becomes operative for all audits commencing on or after 1st April, 2000.

# Standard on Auditing (SA) 540 (Revised)

# Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures[3]

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[3] Hitherto known as AAS 18, "Audit of Accounting Estimates".

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Material Modifications vis a vis ISA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"

Appendix: Fair Value Measurements and Disclosures Under Different Financial Reporting Frameworks

Revised Standard on Auditing (SA) 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services[4]", which sets out the authority of SAs".

[4] Published in the July, 2007 issue of the Journal.

# Introduction

## Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how SA 315[5] and SA 330[6] and other relevant SAs are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.

### Nature of Accounting Estimates

2. Some financial statement items cannot be measured precisely, but can only be estimated. For purposes of this SA, such financial statement items are referred to as accounting estimates. The nature and reliability of information available to management to support the making of an accounting estimate varies widely, which thereby affects the degree of estimation uncertainty associated with accounting estimates. The degree of estimation uncertainty affects, in turn, the risks of material misstatement of accounting estimates, including their susceptibility to unintentional or intentional management bias. (Ref: Para. A1-A11)

3. The measurement objective of accounting estimates can vary depending on the applicable financial reporting framework and the financial item being reported. The measurement objective for some accounting estimates is to forecast the outcome of one or more transactions, events or conditions giving rise to the need for the accounting estimate. For other accounting estimates, including many fair value accounting estimates, the measurement objective is different, and is expressed in terms of the value of a current transaction or financial statement item based on conditions prevalent at the measurement date, such as estimated market price for a particular type of asset or liability. For example, the applicable financial reporting framework may require fair value

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[5] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment". Published in February, 2008 issue of the Journal.

[6] SA 330, "The Auditor's Responses to Assessed Risks". Published in February, 2008 issue of the Journal.

measurement based on an assumed hypothetical current transaction between knowledgeable, willing parties (sometimes referred to as "marketplace participants" or equivalent) in an arm's length transaction, rather than the settlement of a transaction at some past or future date.[7]

4. A difference between the outcome of an accounting estimate and the amount originally recognised or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements. This is particularly the case for fair value accounting estimates, as any observed outcome is invariably affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements.

### Effective Date

5. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

## Objective

6. The objective of the auditor is to obtain sufficient appropriate audit evidence whether in the context of the applicable financial reporting framework:

(a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognised or disclosed, are reasonable; and

(b) related disclosures in the financial statements are adequate.

## Definitions

7. For purposes of the SAs, the following terms have the meanings attributed below:

(a) Accounting estimate – An approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. Where this SA addresses only accounting estimates involving measurement at fair value, the term "fair value accounting estimates" is used.

[7] Different definitions of fair value may exist among financial reporting frameworks.

(b) Auditor's point estimate or auditor's range – The amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management's point estimate.

(c) Estimation uncertainty – The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.

(d) Management bias – A lack of neutrality by management in the preparation and presentation of information.

(e) Management's point estimate – The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.

(f) Outcome of an accounting estimate –The actual monetary amount which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by the accounting estimate.

## Requirements

### Risk Assessment Procedures and Related Activities

8. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, as required by SA 315,[8] the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates: (Ref: Para. A12)

(a) The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures. (Ref: Para. A13-A15)

(b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates. (Ref: Para. A16-A21)

[8] SA 315, paragraphs 5-6 and 11-12.

(c) How management makes the accounting estimates, and an understanding of the data on which they are based, including: (Ref: Para. A22-A23)

(i) The method, including where applicable the model, used in making the accounting estimate; (Ref: Para. A24-A26)

(ii) Relevant controls; (Ref: Para. A27-A28)

(iii) Whether management has used an expert; (Ref: Para. A29-A30)

(iv) The assumptions underlying the accounting estimates; (Ref: Para. A31-A36)

(v) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and (Ref: Para. A37)

(vi) Whether and, if so, how management has assessed the effect of estimation uncertainty. (Ref: Para. A38)

9. The auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at that time. (Ref: Para. A39-A44)

## Identifying and Assessing the Risks of Material Misstatement

10. In identifying and assessing the risks of material misstatement, as required by SA 315,[9] the auditor shall evaluate the degree of estimation uncertainty associated with an accounting estimate. (Ref: Para. A45-A46)

11. The auditor shall determine whether, in the auditor's judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks. (Ref: Para. A47-A51)

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[9] SA 315, paragraph 24.

## Responses to the Assessed Risks of Material Misstatement

12. Based on the assessed risks of material misstatement, the auditor shall determine: (Ref: Para. A52)

(a) Whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate; and (Ref: Para. A53-A56)

(b) Whether the methods for making the accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances. (Ref: Para. A57-A58)

13. In responding to the assessed risks of material misstatement, as required by SA 330,[10] the auditor shall undertake one or more of the following, taking account of the nature of the accounting estimate: (Ref: Para. A59- A61)

(a) Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate. (Ref: Para. A62-A67)

(b) Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor shall evaluate whether: (Ref: Para. A68-A70)

(i) The method of measurement used is appropriate in the circumstances; and (Ref: Para. A71-A76)

(ii) The assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework. (Ref: Para. A77-A83)

(c) Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures. (Ref: Para. A84- A86)

(d) Develop a point estimate or a range to evaluate management's point estimate. For this purpose: (Ref: Para. A87-A91)

(i) When the auditor uses assumptions or methods that differ from

[10] SA 330, paragraph 5.

management's, the auditor shall obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate. (Ref: Para. A92)

(ii) When the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable. (Ref: Para. A93-A95)

14. In determining the matters identified in paragraph 12 or in responding to the assessed risks of material misstatement in accordance with paragraph 13, the auditor shall consider whether specialised skills or knowledge in relation to one or more aspects of the accounting estimates are required in order to obtain sufficient appropriate audit evidence. (Ref: Para. A96-A101)

## Further Substantive Procedures to Respond to Significant Risks

### Estimation Uncertainty

15. For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of SA 330,[11] the auditor shall evaluate the following: (Ref: Para. A102)

(a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate. (Ref: Para. A103-A106)

(b) Whether the significant assumptions used by management are reasonable. (Ref: Para A107-A109)

(c) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so. (Ref: Para. A110)

16. If, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor shall, if considered necessary, develop a range with

[11] SA 330, paragraph 20.

which to evaluate the reasonableness of the accounting estimate. (Ref: Para. A111-A112)

### Recognition and Measurement Criteria

17. For accounting estimates that give rise to significant risks, the auditor shall obtain sufficient appropriate audit evidence whether the following are in accordance with the requirements of the applicable financial reporting framework:

(a) management's decision to recognise, or to not recognise, the accounting estimates in the financial statements; and (Ref: Para. A113-A114)

(b) the selected measurement basis for the accounting estimates. (Ref: Para. A115)

## Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements

18. The auditor shall evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework, or are misstated. (Ref: Para. A116-A119)

## Disclosures Related to Accounting Estimates

19. The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework. (Ref: Para. A120-A121)

20. For accounting estimates that give rise to significant risks, the auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework. (Ref: Para. A122-A123)

## Indicators of Possible Management Bias

21. The auditor shall review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias. Indicators of possible management bias do not themselves constitute misstatements for the purposes of drawing

conclusions on the reasonableness of individual accounting estimates. (Ref: Para. A124-A125)

### Written Representations

22. The auditor shall obtain written representations from management whether management believes significant assumptions used by it in making accounting estimates are reasonable. (Ref: Para. A126-A127)

### Documentation

23. The audit documentation shall include:

(a) The basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks; and

(b) Indicators of possible management bias, if any. (Ref: Para. A128)

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## Application and Other Explanatory Material

### Nature of Accounting Estimates (Ref: Para. 2)

A1. Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item. Some financial reporting frameworks prescribe specific methods of measurement and the disclosures that are required to be made in the financial statements, while other financial reporting frameworks are less specific. The Appendix to this SA discusses fair value measurements and disclosures under different financial reporting frameworks.

A2. Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements, for example:

- Accounting estimates arising in entities that engage in business activities that are not complex.
- Accounting estimates that are frequently made and updated because they relate to routine transactions.

- Accounting estimates derived from data that is readily available, such as published interest rate data or exchange-traded prices of securities. Such data may be referred to as "observable" in the context of a fair value accounting estimate.
- Fair value accounting estimates where the method of measurement prescribed by the applicable financial reporting framework is simple and applied easily to the asset or liability requiring measurement at fair value.
- Fair value accounting estimates where the model used to measure the accounting estimate is well-known or generally accepted, provided that the assumptions or inputs to the model are observable.

A3. For some accounting estimates, however, there may be relatively high estimation uncertainty, particularly where they are based on significant assumptions, for example:

- Accounting estimates relating to the outcome of litigation.
- Fair value accounting estimates for derivative financial instruments not publicly traded.
- Fair value accounting estimates for which a highly specialised entity-developed model is used or for which there are assumptions or inputs that cannot be observed in the marketplace.

A4. The degree of estimation uncertainty varies based on the nature of the accounting estimate, the extent to which there is a generally accepted method or model used to make the accounting estimate, and the subjectivity of the assumptions used to make the accounting estimate. In some cases, estimation uncertainty associated with an accounting estimate may be so great that the recognition criteria in the applicable financial reporting framework are not met and the accounting estimate cannot be made.

A5. Not all financial statement items requiring measurement at fair value, involve estimation uncertainty. For example, this may be the case for some financial statement items where there is an active and open market that provides readily available and reliable information on the prices at which actual exchanges occur, in which case the existence of published price quotations ordinarily is the best audit evidence of fair value. However, estimation uncertainty may exist even when the valuation method and data are well defined. For example, valuation of securities quoted on an active and open market at the listed market price may

require adjustment if the holding is significant in relation to the market or is subject to restrictions in marketability. In addition, general economic circumstances prevailing at the time, for example, illiquidity in a particular market, may impact estimation uncertainty.

A6. Additional examples of situations where accounting estimates, other than fair value accounting estimates, may be required include:

- Allowance for doubtful accounts.
- Inventory obsolescence.
- Warranty obligations.
- Depreciation method or asset useful life.
- Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability.
- Outcome of long term contracts.
- Financial Obligations / Costs arising from litigation settlements and judgments.

A7. Additional examples of situations where fair value accounting estimates may be required include:

- Complex financial instruments, which are not traded in an active and open market.
- Share-based payments.
- Property or equipment held for disposal.
- Certain assets or liabilities acquired in a business combination, including goodwill and intangible assets.
- Transactions involving the exchange of assets or liabilities between independent parties without monetary consideration, for example, a non-monetary exchange of plant facilities in different lines of business.

A8. Estimation involves judgments based on information available when the financial statements are prepared. For many accounting estimates, these include making assumptions about matters that are uncertain at the time of estimation. The auditor is not responsible for predicting future conditions, transactions or events that, if known at the time of the audit, might have significantly affected management's actions or the assumptions used by management.

Management Bias

A9. Financial reporting frameworks often call for neutrality, that is, freedom from bias. Accounting estimates are imprecise, however, and can be influenced by management judgment. Such judgment may involve unintentional or intentional management bias (for example, as a result of motivation to achieve a desired result). The susceptibility of an accounting estimate to management bias increases with the subjectivity involved in making it. Unintentional management bias and the potential for intentional management bias are inherent in subjective decisions that are often required in making an accounting estimate. For continuing audits, indicators of possible management bias identified during the audit of the preceding periods influence the planning and risk identification and assessment activities of the auditor in the current period.

A10. Management bias can be difficult to detect at an account level. It may only be identified when considered in the aggregate of groups of accounting estimates or all accounting estimates, or when observed over a number of accounting periods. Although some form of management bias is inherent in subjective decisions, in making such judgments there may be no intention by management to mislead the users of financial statements. Where, however, there is intention to mislead, management bias is fraudulent in nature.

A11. Certain entities such as, Central/State governments and related government entities (for example, agencies, boards, commissions) may have significant holdings of specialised assets for which there are no readily available and reliable sources of information for purposes of measurement at fair value or other current value bases, or a combination of both. Often specialised assets held do not generate cash flows and do not have an active market. Measurement at fair value therefore ordinarily requires estimation and may be complex, and in some rare cases may not be possible at all.

## Risk Assessment Procedures and Related Activities (Ref: Para. 8)

A12. The risk assessment procedures and related activities required by paragraph 8 of this SA assist the auditor in developing an expectation of the nature and type of accounting estimates that an entity may have. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to identify and assess the risks of material misstatement in relation to accounting estimates, and to plan the nature, timing and extent of further audit procedures.

Obtaining an Understanding of the Requirements of the Applicable Financial Reporting Framework (Ref: Para. 8(a))

A13. Obtaining an understanding of the requirements of the applicable financial reporting framework assists the auditor in determining whether it, for example:

- Prescribes certain conditions for the recognition,[12] or methods for the measurement, of accounting estimates.
- Specifies certain conditions that permit or require measurement at a fair value, for example, by referring to management's intentions to carry out certain courses of action with respect to an asset or liability.
- Specifies required or permitted disclosures.

Obtaining this understanding also provides the auditor with a basis for discussion with management about how management has applied those requirements relevant to the accounting estimate, and the auditor's determination of whether they have been applied appropriately.

A14. Financial reporting frameworks may provide guidance for management on determining point estimates where alternatives exist. Some financial reporting frameworks, for example, require that the point estimate selected be the alternative that reflects management's judgment of the most likely outcome.[13] Others may require, for example, use of a discounted probability-weighted expected value. In some cases, management may be able to make a point estimate directly. In other cases, management may be able to make a reliable point estimate only after considering alternative assumptions or outcomes from which it is able to determine a point estimate.

A15. Financial reporting frameworks may require the disclosure of information concerning the significant assumptions to which the accounting estimate is particularly sensitive. Furthermore, where there is a high degree of estimation uncertainty, some financial reporting frameworks do not permit an accounting

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[12] Most financial reporting frameworks require incorporation in the balance sheet or income statement of items that satisfy their criteria for recognition. Disclosure of accounting policies or adding notes to the financial statements does not rectify a failure to recognise such items, including accounting estimates.

[13] Different financial reporting frameworks may use different terminology to describe point estimates determined in this way.

estimate to be recognised in the financial statements, but certain disclosures may be required in the notes to the financial statements.

Obtaining an Understanding of How Management Identifies the Need for Accounting Estimates (Ref: Para. 8(b))

A16. In preparing the financial statements, management has the responsibility to determine whether a transaction, event or condition gives rise to the need to make an accounting estimate, and that all necessary accounting estimates have been recognised, measured and disclosed in the financial statements in accordance with the applicable financial reporting framework.

A17. Management's identification of transactions, events and conditions that give rise to the need for accounting estimates is likely to be based on:

- Management's knowledge of the entity's business and the industry in which it operates.
- Management's knowledge of the implementation of business strategies in the current period.
- Where applicable, management's cumulative experience of preparing the entity's financial statements in prior periods.

In such cases, the auditor may obtain an understanding of how management identifies the need for accounting estimates primarily through inquiry of management. In other cases, where management's process is more structured, for example, when management has a formal risk management function, the auditor may perform risk assessment procedures directed at the methods and practices followed by management for periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting estimates as necessary. The completeness of accounting estimates is often an important consideration for the auditor particularly accounting estimates relating to liabilities.

A18. The auditor's understanding of the entity and its environment obtained during the performance of risk assessment procedures, together with other audit evidence obtained during the course of the audit, assist the auditor in identifying circumstances, or changes in circumstances, that may give rise to the need for an accounting estimate.

A19. Inquiries of management about changes in circumstances may include,

for example, inquiries about whether:

- The entity has engaged in new types of transactions that may give rise to accounting estimates.
- Terms of transactions that gave rise to accounting estimates have changed.
- Accounting policies relating to accounting estimates have changed, as a result of changes to the requirements of the applicable financial reporting framework or otherwise.
- Regulatory or other changes outside the control of management have occurred that may require management to revise, or make new, accounting estimates.
- New conditions or events have occurred that may give rise to the need for new or revised accounting estimates.

A20. During the audit, the auditor may identify transactions, events and conditions that give rise to the need for accounting estimates that management failed to identify. SA 315 provides guidance when the auditor identifies a material weakness in the entity's risk assessment processes.

Considerations Specific to Smaller Entities

A21. Obtaining this understanding for smaller entities is often less complex as their business activities are often limited and transactions are less complex. Further, often a single person, for example the owner-manager, identifies the need to make an accounting estimate and the auditor may focus inquiries accordingly.

Obtaining an Understanding of How Management Makes the Accounting Estimates (Ref: Para. 8(c))

A22. Management is responsible for establishing financial reporting processes for making accounting estimates, including adequate internal control. Such processes include the following:

- Selecting appropriate accounting policies and prescribing estimation processes, including appropriate estimation or valuation methods, including, where applicable, models.
- Developing or identifying relevant data and assumptions that affect accounting estimates.

- Periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting estimates as necessary.

A23. Matters that the auditor may consider in obtaining an understanding of how management makes the accounting estimates include, for example:

- The types of accounts or transactions to which the accounting estimates relate (for example, whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from non-recurring or unusual transactions).
- Whether and, if so, how management has used recognised measurement techniques for making particular accounting estimates.
- Whether the accounting estimates were made based on data available at an interim date and, if so, whether and how management has taken into account the effect of events, transactions and changes in circumstances occurring between that date and the period end.

Method of Measurement, Including the Use of Models (Ref: Para. 8(c)(i))

A24. In some cases, the applicable financial reporting framework may prescribe the method of measurement for an accounting estimate, for example, a particular model that is to be used in measuring a fair value estimate. In many cases, however, the applicable financial reporting framework does not prescribe the method of measurement, or may specify alternative methods for measurement.

A25. When the applicable financial reporting framework does not prescribe a particular method to be used in the circumstances, matters that the auditor may consider in obtaining an understanding of the method or, where applicable the model, used to make accounting estimates include, for example:

- How management selects a particular method considering the nature of the asset or liability being estimated.
- Whether the entity operates in a particular business, industry or environment in which there are methods commonly used to make the particular type of accounting estimate.

A26. There may be greater risks of material misstatement, for example, in cases when management has internally developed a model to be used to make the accounting estimate or is departing from a method commonly used in a

particular industry or environment.

Relevant Controls (Ref: Para. 8(c)(ii))

A27. Matters that the auditor may consider in obtaining an understanding of relevant controls include, for example, the experience and competence of those who make the accounting estimates, and controls related to:

- How management determines the completeness, relevance and accuracy of the data used to develop accounting estimates.
- The review and approval of accounting estimates, including the assumptions or inputs used in their development, by appropriate levels of management and, where appropriate, those charged with governance.
- The segregation of duties between those committing the entity to the underlying transactions and those responsible for making the accounting estimates, including whether the assignment of responsibilities appropriately takes account of the nature of the entity and its products or services (for example, in the case of a large financial institution, relevant segregation of duties may include an independent function responsible for estimation and validation of fair value pricing of the entity's proprietary financial products staffed by individuals whose remuneration is not tied to such products).

A28. Other controls may be relevant to making the accounting estimates depending on the circumstances. For example, if the entity uses specific models for making accounting estimates, management may put into place specific policies and procedures around such models. Relevant controls may include, for example, those established over:

- The design and development, or selection, of a particular model for a particular purpose.
- The use of the model.
- The maintenance and periodic validation of the integrity of the model.

Management's Use of Experts (Ref: Para. 8(c)(iii))

A29. Management may have, or the entity may employ individuals with, the experience and competence necessary to make the required point estimates. In some cases, however, management may need to engage an expert to make, or assist in making, them. This need may arise because of, for example:

- The specialised nature of the matter requiring estimation, for example, the measurement of mineral or hydrocarbon reserves in extractive industries.
- The technical nature of the models required to meet the relevant requirements of the applicable financial reporting framework, as may be the case in certain measurements at fair value.
- The unusual or infrequent nature of the condition, transaction or event requiring an accounting estimate.

Considerations Specific to Smaller Entities

A30. In smaller entities, the circumstances requiring an accounting estimate often are such that the owner-manager is capable of making the required point estimate. In some cases, however, an expert will be needed. Discussion with the owner-manager early in the audit process about the nature of any accounting estimates, the completeness of the required accounting estimates, and the adequacy of the estimating process may assist the owner manager in determining the need to use an expert.

Assumptions (Ref: Para. 8(c)(iv))

A31. Assumptions are integral components of accounting estimates. Matters that the auditor may consider in obtaining an understanding of the assumptions underlying the accounting estimates include, for example:

- The nature of the assumptions, including which of the assumptions are likely to be significant assumptions.
- How management assesses whether the assumptions are relevant and complete (that is, that all relevant variables have been taken into account).
- Where applicable, how management determines that the assumptions used are internally consistent.
- Whether the assumptions relate to matters within the control of management (for example, assumptions about the maintenance programs that may affect the estimation of an asset's useful life), and how they conform to the entity's business plans and the external environment, or to matters that are outside its control (for example, assumptions about interest rates, mortality rates, potential judicial or regulatory actions, or the variability and the timing of future cash flows).
- The nature and extent of documentation, if any, supporting the assumptions.

Assumptions may be made or identified by an expert to assist management in making the accounting estimates. Such assumptions, when used by management, become management's assumptions.

A32. In some cases, assumptions may be referred to as inputs, for example, where management uses a model to make an accounting estimate, though the term inputs may also be used to refer to the underlying data to which specific assumptions are applied.

A33. Management may support assumptions with different types of information drawn from internal and external sources, the relevance and reliability of which will vary. In some cases, an assumption may be reliably based on applicable information from either external sources (for example, published interest rate or other statistical data) or internal sources (for example, historical information or previous conditions experienced by the entity). In other cases, an assumption may be more subjective, for example, where the entity has no experience or external sources from which to draw.

A34. In the case of fair value accounting estimates, assumptions reflect, or are consistent with, what knowledgeable, willing arm's length parties (sometimes referred to as "marketplace participants" or equivalent) would use in determining fair value when exchanging an asset or settling a liability. Specific assumptions will also vary with the characteristics of the asset or liability being valued, the valuation method used (for example, a market approach, or an income approach) and the requirements of the applicable financial reporting framework.

A35. With respect to fair value accounting estimates, assumptions or inputs vary in terms of their source and bases, as follows:

(a) Those that reflect what marketplace participants would use in pricing an asset or liability developed based on market data obtained from sources independent of the reporting entity (sometimes referred to as "observable inputs" or equivalent).

(b) Those that reflect the entity's own judgments about what assumptions marketplace participants would use in pricing the asset or liability developed based on the best information available in the circumstances (sometimes referred to as "unobservable inputs" or equivalent). In practice, however, the distinction between (a) and (b) is not always apparent. Further, it may be necessary for management to select from a number of different assumptions used by different marketplace participants.

A36. The extent of subjectivity, such as whether an assumption or input is observable, influences the degree of estimation uncertainty and thereby the auditor's assessment of the risks of material misstatement for a particular accounting estimate.

Changes in Methods for making Accounting Estimates (Ref: Para. 8(c)(v))

A37. In evaluating how management makes the accounting estimates, the auditor is required to understand whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates. A specific estimation method may need to be changed in response to changes in the environment or circumstances affecting the entity or in the requirements of the applicable financial reporting framework. If management has changed the method for making an accounting estimate, it is important that management can demonstrate that the new method is more appropriate, or is itself a response to such changes. For example, if management changes the basis of making an accounting estimate from a mark-to-market approach to using a model, the auditor challenges whether management's assumptions about the marketplace are reasonable in light of economic circumstances.

Estimation Uncertainty (Ref: Para. 8(c)(vi))

A38. Matters that the auditor may consider in obtaining an understanding of whether and, if so, how management has assessed the effect of estimation uncertainty include, for example:

- Whether and, if so, how management has considered alternative assumptions or outcomes by, for example, performing a sensitivity analysis to determine the effect of changes in the assumptions on an accounting estimate.
- How management determines the accounting estimate when analysis indicates a number of outcome scenarios.
- Whether management monitors the outcome of accounting estimates made in the prior period, and whether management has appropriately responded to the outcome of that monitoring procedure.

Reviewing Prior Period Accounting Estimates (Ref: Para. 9)

A39. The outcome of an accounting estimate will often differ from the accounting estimate recognised in the prior period financial statements. By

performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may obtain:

- Information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process.
- Audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates.
- Audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.

A40. The review of prior period accounting estimates may also assist the auditor, in the current period, in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The auditor's attitude of professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.

A41. A retrospective review of management judgments and assumptions related to significant accounting estimates is also required by SA 240 (Revised).[14] That review is conducted as part of the requirement for the auditor to design and perform procedures to review accounting estimates for biases that could represent a risk of material misstatement due to fraud, in response to the risks of management override of controls. As a practical matter, the auditor's review of prior period accounting estimates as a risk assessment procedure in accordance with this SA may be carried out in conjunction with the review required by SA 240 (Revised).

A42. The auditor may judge that a more detailed review is required for those accounting estimates that were identified during the prior period audit as having high estimation uncertainty, or for those accounting estimates that have changed significantly from the prior period. On the other hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.

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[14] SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", paragraph 32(b)(ii).

A43. For fair value accounting estimates and other accounting estimates based on current conditions at the measurement date, more variation may exist between the fair value amount recognised in the prior period financial statements and the outcome or the amount re-estimated for the purpose of the current period. This is because the measurement objective for such accounting estimates deals with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. The auditor may therefore focus the review on obtaining information that would be relevant to identifying and assessing risks of material misstatement. For example, in some cases obtaining an understanding of changes in marketplace participant assumptions which affected the outcome of a prior period fair value accounting estimate may be unlikely to provide relevant information for audit purposes. If so, then the auditor's consideration of the outcome of prior period fair value accounting estimates may be directed more towards understanding the effectiveness of management's prior estimation process, that is, management's track record, from which the auditor can judge the likely effectiveness of management's current process.

A44. A difference between the outcome of an accounting estimate and the amount recognised in the prior period financial statements does not necessarily represent a misstatement of the prior period financial statements. However, it may do so if, for example, the difference arises from information that was available to management when the prior period's financial statements were finalised, or that could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed.

## Identifying and Assessing the Risks of Material Misstatement

### Estimation Uncertainty (Ref: Para. 10)

A45. The degree of estimation uncertainty associated with an accounting estimate may be influenced by factors such as:

- The extent to which the accounting estimate depends on judgment.
- The sensitivity of the accounting estimate to changes in assumptions.

- The existence of recognised measurement techniques that may mitigate the estimation uncertainty (though the subjectivity of the assumptions used as inputs may nevertheless give rise to estimation uncertainty).
- The length of the forecast period, and the relevance of data drawn from past events to forecast future events.
- The availability of reliable data from external sources.
- The extent to which the accounting estimate is based on observable or unobservable inputs.

The degree of estimation uncertainty associated with an accounting estimate may influence the estimate's susceptibility to bias.

A46. Matters that the auditor considers in assessing the risks of material misstatement may also include:

- The actual or expected magnitude of an accounting estimate.
- The recorded amount of the accounting estimate (that is, management's point estimate) in relation to the amount expected by the auditor to be recorded.
- Whether management has used an expert in making the accounting estimate.
- The outcome of the review of prior period accounting estimates.

High Estimation Uncertainty and Significant Risks (Ref: Para. 11)

A47. Examples of accounting estimates that may have high estimation uncertainty include the following:

- Accounting estimates that are highly dependent upon judgment, for example, judgments about the outcome of pending litigation or the amount and timing of future cash flows dependent on uncertain events many years in the future.
- Accounting estimates that are not calculated using recognised measurement techniques.
- Accounting estimates where the results of the auditor's review of similar accounting estimates made in the prior period financial statements indicate a substantial difference between the original accounting estimate and the actual outcome.
- Fair value accounting estimates for which a highly specialised entity-developed

model is used or for which there are no observable inputs.

A48. A seemingly immaterial accounting estimate may have the potential to result in a material misstatement due to the estimation uncertainty associated with the estimation; that is, the size of the amount recognised or disclosed in the financial statements for an accounting estimate may not be an indicator of its estimation uncertainty.

A49. In some circumstances, the estimation uncertainty is so high that a reasonable accounting estimate cannot be made. The applicable financial reporting framework may, therefore, preclude recognition of the item in the financial statements, or its measurement at fair value. In such cases, the significant risks relate not only to whether an accounting estimate should be recognised, or whether it should be measured at fair value, but also to the adequacy of the disclosures. With respect to such accounting estimates, the applicable financial reporting framework may require disclosure of the accounting estimates and the high estimation uncertainty associated with them (see paragraphs A120-A123).

A50. Where the auditor determines that an accounting estimate gives rise to a significant risk, the auditor is required to obtain an understanding of the entity's controls, including control activities.[15]

A51. In some cases, the estimation uncertainty of an accounting estimate may cast significant doubt about the entity's ability to continue as a going concern. SA 570 [16] establishes requirements and provides guidance in such circumstances.

## Responses to the Assessed Risks of Material Misstatement (Ref: Para. 12)

A52. SA 330 requires the auditor to design and perform audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement in relation to accounting estimates at both the financial statement and assertion levels.[17] Paragraphs A53-A115 focus on specific responses at the

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[15] SA 315, paragraph 28.

[16] Revised SA 570, "Going Concern" has been published in the December, 2008 issue of the Journal. Revised SA 570 is applicable for audits of financial statements for periods beginning on or after April 1, 2009.

[17] SA 330, paragraphs 5-6.

assertion level only.

Application of the Requirements of the Applicable Financial Reporting Framework (Ref: Para. 12(a))

A53. Many financial reporting frameworks prescribe certain conditions for the recognition of accounting estimates and specify the methods for making them and required disclosures. Such requirements may be complex and require the application of judgment. Based on the understanding obtained in performing risk assessment procedures, the requirements of the applicable financial reporting framework that may be susceptible to misapplication or differing interpretations become the focus of the auditor's attention.

A54. Determining whether management has appropriately applied the requirements of the applicable financial reporting framework is based, in part, on the auditor's understanding of the entity and its environment. For example, the measurement of the fair value of some items, such as intangible assets acquired in a business combination, may involve special considerations that are affected by the nature of the entity and its operations.

A55. In some situations, additional audit procedures, such as the inspection by the auditor of the current physical condition of an asset, may be necessary to determine whether management has appropriately applied the requirements of the applicable financial reporting framework.

A56. The application of the requirements of the applicable financial reporting framework requires management to consider changes in the environment or circumstances that affect the entity. For example, the introduction of an active market for a particular class of asset or liability may indicate that the use of discounted cash flows to estimate the fair value of such asset or liability is no longer appropriate.

Consistency in Methods and Basis for Changes (Ref: Para. 12(b))

A57. The auditor's consideration of a change in an accounting estimate, or in the method for making it from the prior period, is important because a change that is not based on a change in circumstances or new information is considered arbitrary. Arbitrary changes in an accounting estimate result in inconsistent financial statements over time and may give rise to a financial statement misstatement or be an indicator of possible management bias.

A58. Management often is able to demonstrate good reason for a change in an accounting estimate or the method for making an accounting estimate from one period to another based on a change in circumstances. What constitutes a good reason, and the adequacy of support for management's contention that there has been a change in circumstances that warrants a change in an accounting estimate or the method for making an accounting estimate, are matters of judgment.

Responses to the Assessed Risks of Material Misstatements (Ref: Para. 13)

A59. The auditor's decision as to which response, individually or in combination, in paragraph 13 to undertake to respond to the risks of material misstatement may be influenced by such matters as:

- The nature of the accounting estimate, including whether it arises from routine or non-routine transactions.
- Whether the procedure(s) is expected to effectively provide the auditor with sufficient appropriate audit evidence.
- The assessed risk of material misstatement, including whether the assessed risk is a significant risk.

A60. For example, when evaluating the reasonableness of the allowance for doubtful accounts, an effective procedure for the auditor may be to review subsequent cash collections in combination with other procedures. Where the estimation uncertainty associated with an accounting estimate is high, for example, an accounting estimate based on a proprietary model for which there are unobservable inputs, it may be that a combination of the responses to assessed risks in paragraph 13 is necessary in order to obtain sufficient appropriate audit evidence.

A61. Additional guidance explaining the circumstances in which each of the responses may be appropriate is provided in paragraphs A62-A95.

Events Occurring Up to the Date of the Auditor's Report (Ref: Para. 13(a))

A62. Determining whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate may be an appropriate response when such events are expected to:

• Occur; and

• Provide audit evidence that confirms or contradicts the accounting estimate.

A63. Events occurring up to the date of the auditor's report may sometimes provide sufficient appropriate audit evidence about an accounting estimate. For example, sale of the complete inventory of a superseded product shortly after the period end may provide audit evidence relating to the estimate of its net realisable value. In such cases, there may be no need to perform additional audit procedures on the accounting estimate, provided that sufficient appropriate evidence about the events is obtained.

A64. For some accounting estimates, events occurring up to the date of the auditor's report are unlikely to provide audit evidence regarding the accounting estimate. For example, the conditions or events relating to some accounting estimates develop only over an extended period. Also, because of the measurement objective of fair value accounting estimates, information after the period-end may not reflect the events or conditions existing at the balance sheet date and therefore may not be relevant to the measurement of the fair value accounting estimate. Paragraph 13 identifies other responses to the risks of material misstatement that the auditor may undertake.

A65. In some cases, events that contradict the accounting estimate may indicate that management has ineffective processes for making accounting estimates, or that there is management bias in the making of accounting estimates.

A66. Even though the auditor may decide not to undertake this approach in respect of specific accounting estimates, the auditor is required to comply with SA 560[18]. The auditor is required to 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[19] and appropriately reflected in the financial statements.[20] Because the measurement of many accounting estimates, other than fair value accounting

[18] Standard on Auditing (SA) 560, "Subsequent Events" has been published in January, 2009 issue of the Journal. Revised SA 560 is applicable for audits of financial statements for periods beginning on or after April 1, 2009.

[19] SA 560 (AAS19), paragraph 4. See footnote 16.

[20] SA 560 (AAS19), paragraph 5. See footnote 16.

estimates, usually depends on the outcome of future conditions, transactions or events, the auditor's work under SA 560 is particularly relevant.

Considerations Specific to Smaller Entities

A67. When there is a longer period between the balance sheet date and the date of the auditor's report, the auditor's review of events in this period may be an effective response for accounting estimates other than fair value accounting estimates. This may particularly be the case in some smaller owner-managed entities, especially when management does not have formalised control procedures over accounting estimates.

Testing how Management made the Accounting Estimate (Ref: Para. 13(b))

A68. Testing how management made the accounting estimate and the data on which it is based may be an appropriate response when the accounting estimate is a fair value accounting estimate developed on a model that uses observable and unobservable inputs. It may also be appropriate when, for example:

- The accounting estimate is derived from the routine processing of data by the entity's accounting system.
- The auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is likely to be effective.
- The accounting estimate is based on a large population of items of a similar nature that individually are not significant.

A69. Testing how management made the accounting estimate may involve, for example:

- Testing the extent to which data on which the accounting estimate is based is accurate, complete and relevant, and whether the accounting estimate has been properly determined using such data and management assumptions.
- Considering the source, relevance and reliability of external data or information, including that received from external experts engaged by management to assist in making an accounting estimate.
- Re-calculating the accounting estimate, and reviewing information about an accounting estimate for internal consistency.

• Considering management's review and approval processes.

Considerations Specific to Smaller Entities

A70. In smaller entities, the process for making accounting estimates is likely to be less structured than in larger entities. Smaller entities with active management involvement may not have extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Even if the entity has no formal established process, it does not mean that management is not able to provide a basis upon which the auditor can test the accounting estimate.

Evaluating the Method of Measurement (Ref: Para. 13(b)(i))

A71. When the applicable financial reporting framework does not prescribe the method of measurement, evaluating whether the method used, including any applicable model, is appropriate in the circumstances is a matter of professional judgment.

A72. For this purpose, matters that the auditor may consider include, for example, whether:

• Management's rationale for the method selected is reasonable.

• Management has sufficiently evaluated and appropriately applied the criteria, if any, provided in the applicable financial reporting framework to support the selected method.

• The method is appropriate in the circumstances given the nature of the asset or liability being estimated and the requirements of the applicable financial reporting framework relevant to accounting estimates.

• The method is appropriate in relation to the business, industry and environment in which the entity operates.

A73. In some cases, management may have determined that different methods result in a range of significantly different estimates. In such cases, obtaining an understanding of how the entity has investigated the reasons for these differences may assist the auditor in evaluating the appropriateness of the method selected.

Evaluating the use of Models

A74. In some cases, particularly when making fair value accounting estimates, management may use a model. Whether the model used is appropriate in the circumstances may depend on a number of factors, such as the nature of the entity and its environment, including the industry in which it operates, and the specific asset or liability being measured.

A75. The extent to which the following considerations are relevant depends on the circumstances, including whether the model is one that is commercially available for use in a particular sector or industry, or a proprietary model. In some cases, an entity may use an expert to develop and test a model.

A76. Depending on the circumstances, matters that the auditor may also consider in testing the model include, for example, whether:

- The model is validated prior to usage, with periodic reviews to ensure it is still suitable for its intended use. The entity's validation process may include evaluation of:
    - The model's theoretical soundness and mathematical integrity, including the appropriateness of model parameters.
    - The consistency and completeness of the model's inputs with market practices.
    - The model's output as compared to actual transactions.
- Appropriate change control policies and procedures exist.
- The model is periodically calibrated and tested for validity, particularly when inputs are subjective.
- Adjustments are made to the output of the model, including in the case of fair value accounting estimates, whether such adjustments reflect the assumptions marketplace participants would use in similar circumstances.
- The model is adequately documented, including the model's intended applications and limitations and its key parameters, required inputs, and results of any validation analysis performed.

Assumptions Used by Management (Ref: Para. 13(b)(ii))

A77. The auditor's evaluation of the assumptions used by management is based only on information available to the auditor at the time of the audit. Audit procedures dealing with management assumptions are performed in the context

of the audit of the entity's financial statements, and not for the purpose of providing an opinion on assumptions themselves.

A78. Matters that the auditor may consider in evaluating the reasonableness of the assumptions used by management include, for example:

- Whether individual assumptions appear reasonable.
- Whether the assumptions are interdependent and internally consistent.
- Whether the assumptions appear reasonable when considered collectively or in conjunction with other assumptions, either for that accounting estimate or for other accounting estimates.
- In the case of fair value accounting estimates, whether the assumptions appropriately reflect observable marketplace assumptions.

A79. The assumptions on which accounting estimates are based may reflect what management expects will be the outcome of specific objectives and strategies. In such cases, the auditor may perform audit procedures to evaluate the reasonableness of such assumptions by considering, for example, whether the assumptions are consistent with:

- The general economic environment and the entity's economic circumstances.
- The plans of the entity.
- Assumptions made in prior periods, if relevant.
- Experience of, or previous conditions experienced by, the entity, to the extent this historical information may be considered representative of future conditions or events.
- Other assumptions used by management relating to the financial statements.

A80. The reasonableness of the assumptions used may depend on management's intent and ability to carry out certain courses of action. Management often documents plans and intentions relevant to specific assets or liabilities and the financial reporting framework may require it to do so. Although the extent of audit evidence to be obtained about management's intent and ability is a matter of professional judgment, the auditor's procedures may include the following:

- Review of management's history of carrying out its stated intentions.

- Review of written plans and other documentation, including, where applicable, formally approved budgets, authorisations or minutes.
- Inquiry of management about its reasons for a particular course of action.
- Review of events occurring subsequent to the date of the financial statements and up to the date of the auditor's report.
- Evaluation of the entity's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its existing commitments.

Certain financial reporting frameworks, however, may not permit management's intentions or plans to be taken into account when making an accounting estimate. This is often the case for fair value accounting estimates because their measurement objective requires that assumptions reflect those used by marketplace participants.

A81. Matters that the auditor may consider in evaluating the reasonableness of assumptions used by management underlying fair value accounting estimates, in addition to those discussed above where applicable, may include, for example:

- Where relevant, whether and, if so, how management has incorporated market specific inputs into the development of assumptions.
- Whether the assumptions are consistent with observable market conditions, and the characteristics of the asset or liability being measured at fair value.
- Whether the sources of market-participant assumptions are relevant and reliable, and how management has selected the assumptions to use when a number of different market participant assumptions exist.
- Where appropriate, whether and, if so, how management considered assumptions used in, or information about, comparable transactions, assets or liabilities.

A82. Further, fair value accounting estimates may comprise observable inputs as well as unobservable inputs. Where fair value accounting estimates are based on unobservable inputs, matters that the auditor may consider include, for example, how management supports the following:

- The identification of the characteristics of marketplace participants relevant to the accounting estimate.

- Modifications it has made to its own assumptions to reflect its view of assumptions marketplace participants would use.
- Whether it has incorporated the best information available in the circumstances.
- Where applicable, how its assumptions take account of comparable transactions, assets or liabilities.

If there are unobservable inputs, it is more likely that the auditor's evaluation of the assumptions will need to be combined with other responses to assessed risks in paragraph 13 in order to obtain sufficient appropriate audit evidence. In such cases, it may be necessary for the auditor to perform other audit procedures, for example, examining documentation supporting the review and approval of the accounting estimate by appropriate levels of management and, where appropriate, by those charged with governance.

A83. In evaluating the reasonableness of the assumptions supporting an accounting estimate, the auditor may identify one or more significant assumptions. If so, it may indicate that the accounting estimate has high estimation uncertainty and may, therefore, give rise to a significant risk. Additional responses to significant risks are described in paragraphs A102-A115.

Testing the Operating Effectiveness of Controls (Ref: Para. 13(c))

A84. Testing the operating effectiveness of the controls over how management made the accounting estimate may be an appropriate response when management's process has been well-designed, implemented and maintained, for example:

- Controls exist for the review and approval of the accounting estimates by appropriate levels of management and, where appropriate, by those charged with governance.
- The accounting estimate is derived from the routine processing of data by the entity's accounting system.

A85. Testing the operating effectiveness of the controls is required when:

(a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls over the process are

operating effectively; or

(b) Substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level.[21]

Considerations Specific to Smaller Entities

A86. Controls over the process to make an accounting estimate may exist in smaller entities, but the formality with which they operate varies. Further, smaller entities may determine that certain types of controls are not necessary because of active management involvement in the financial reporting process. In the case of very small entities, however, there may not be many controls that the auditor can identify. For this reason, the auditor's response to the assessed risks is likely to be substantive in nature, with the auditor performing one or more of the other responses in paragraph 13.

Developing a Point Estimate or Range (Ref: Para. 13(d))

A87. Developing a point estimate or a range to evaluate management's point estimate may be an appropriate response when, for example:

- An accounting estimate is not derived from the routine processing of data by the accounting system.
- The auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is unlikely to be effective.
- The entity's controls within and over management's processes for determining accounting estimates are not well designed or properly implemented.
- Events or transactions between the period end and the date of the auditor's report contradict management's point estimate.
- There are alternative sources of relevant data available to the auditor which can be used in making a point estimate or a range.

A88. Even when the entity's controls are well designed and properly implemented, developing a point estimate or a range may be an effective or efficient response to the assessed risks. In other situations, the auditor may

[21] SA 330, paragraph 8.

consider this approach as part of determining whether further procedures are necessary and, if so, their nature and extent.

A89. The approach taken by the auditor in developing either a point estimate or a range may vary based on what is considered most effective in the circumstances. For example, the auditor may initially develop a preliminary point estimate, and then assess its sensitivity to changes in assumptions to ascertain a range with which to evaluate management's point estimate. Alternatively, the auditor may begin by developing a range for purposes of determining, where possible, a point estimate.

A90. The ability of the auditor to make a point estimate, as opposed to a range, depends on several factors, including the model used, the nature and extent of data available and the estimation uncertainty involved with the accounting estimate. Further, the decision to develop a point estimate or range may be influenced by the applicable financial reporting framework, which may prescribe the point estimate that is to be used after consideration of the alternative outcomes and assumptions, or prescribe a specific measurement method (for example, the use of a discounted probability-weighted expected value).

A91. The auditor may develop a point estimate or a range in a number of ways, for example, by:

- Using a model, for example, one that is commercially available for use in a particular sector or industry, or a proprietary or auditor-developed model.
- Further developing management's consideration of alternative assumptions or outcomes, for example, by introducing a different set of assumptions.
- Employing or engaging a person with specialised expertise to develop or execute the model, or to provide relevant assumptions.
- Making reference to other comparable conditions, transactions or events, or, where relevant, markets for comparable assets or liabilities.

Understanding Management's Assumptions or Method (Ref: Para. 13(d)(i))

A92. When the auditor makes a point estimate or a range and uses assumptions or a method different from those used by management, paragraph 13(d)(i) requires the auditor to obtain a sufficient understanding of the

assumptions or method used by management in making the accounting estimate. This understanding provides the auditor with information that may be relevant to the auditor's development of an appropriate point estimate or range. Further, it assists the auditor to understand and evaluate any significant differences from management's point estimate. For example, a difference may arise because the auditor used different, but equally valid, assumptions as compared with those used by management. This may reveal that the accounting estimate is highly sensitive to certain assumptions and therefore subject to high estimation uncertainty, indicating that the accounting estimate may be a significant risk. Alternatively, a difference may arise as a result of a factual error made by management. Depending on the circumstances, the auditor may find it helpful in drawing conclusions to discuss with management the basis for the assumptions used and their validity, and the difference, if any, in the approach taken to making the accounting estimate.

Narrowing a Range (Ref: Para. 13(d)(ii))

A93. When the auditor concludes that it is appropriate to use a range to evaluate the reasonableness of management's point estimate (the auditor's range), paragraph 13(d)(ii) requires that range to encompass all "reasonable outcomes" rather than all possible outcomes. The range cannot be one that comprises all possible outcomes if it is to be useful, as such a range would be too wide to be effective for purposes of the audit. The auditor's range is useful and effective when it is sufficiently narrow to enable the auditor to conclude whether the accounting estimate is misstated.

A94. Ordinarily, a range that has been narrowed to be equal to or less than the amount lower than the materiality level for the financial statements as a whole determined for purposes of assessing risks of material misstatement and designing further audit procedures[22] is adequate for the purposes of evaluating the reasonableness of management's point estimate. However, particularly in certain industries, it may not be possible to narrow the range to below such an amount. This does not necessarily preclude recognition of the accounting estimate. It may indicate, however, that the estimation uncertainty associated with the accounting estimate is such that it gives rise to a significant risk.

[22] The Exposure Draft of SA 320 (Revised), "Audit Materiality" has been published in January, 2009 issue of the Journal. The last date for sending the comments is March 1, 2009.

Additional responses to significant risks are described in paragraphs A102-A115.

A95. Narrowing the range to a position where all outcomes within the range are considered reasonable may be achieved by:

(a) Eliminating from the range those outcomes at the extremities of the range judged by the auditor to be unlikely to occur; and

(b) Continuing to narrow the range, based on audit evidence available, until the auditor concludes that all outcomes within the range are considered reasonable. In some rare cases, the auditor may be able to narrow the range until the audit evidence indicates a point estimate.

Considering whether Specialised Skills or Knowledge are Required (Ref: Para. 14)

A96. In planning the audit, the auditor is required to ascertain the nature, timing and extent of resources necessary to perform the audit engagement[23]. This may include, as necessary, the involvement of those with specialised skills or knowledge. In addition, SA 220 requires the engagement partner to be satisfied that the engagement team, and any auditor's external experts, collectively have the appropriate capabilities, competence and time to perform the audit engagement.[24] During the course of the audit of accounting estimates the auditor may identify, in light of the experience of the auditor and the circumstances of the engagement, the need for specialised skills or knowledge to be applied in relation to one or more aspects of the accounting estimates.

A97. Matters that may affect the auditor's consideration of whether specialised skills or knowledge is required include, for example:

- The nature of the underlying asset, liability or component of equity in a particular business or industry (for example, mineral deposits, agricultural assets, complex financial instruments).

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[23] SA 300, "Planning an Audit of Financial Statements", paragraph 7(e).

[24] Paragraph 10 of the existing SA 220 (AAS 17), "Quality Control for Audit Work", issued in July, 1999 states "Any delegation of work to assistants would be in a manner that provides reasonable assurance that such work will be performed with due care by persons having the degree of professional competence required in the circumstances". The Standard is being revised in the light of the corresponding International Standard.

- A high degree of estimation uncertainty.
- Complex calculations or specialised models are involved, for example, when estimating fair values when there is no observable market.
- The complexity of the requirements of the applicable financial reporting framework relevant to accounting estimates, including whether there are areas known to be subject to differing interpretation or practice is inconsistent or developing.
- The procedures the auditor intends to undertake in responding to assessed risks.

A98. For the majority of accounting estimates, even when there is estimation uncertainty, it is unlikely that specialised skills or knowledge will be required. For example, it is unlikely that specialised skills or knowledge would be necessary for an auditor to evaluate an allowance for doubtful accounts.

A99. However, the auditor may not possess the specialised skills or knowledge required when the matter involved is in a field other than accounting or auditing and may need to obtain it from an auditor's expert. SA 620[25] establishes requirements and provides guidance in determining the need to employ or engage an auditor's expert and the auditor's responsibilities when using the work of an auditor's expert.

A100. Further, in some cases, the auditor may conclude that it is necessary to obtain specialised skills or knowledge related to specific areas of accounting or auditing. Individuals with such skills or knowledge may be employed by the auditor's firm or engaged from an external organisation outside of the auditor's firm. When such individuals perform audit procedures on the engagement, they are part of the engagement team and accordingly, they are subject to the requirements in SA 220.

A101. Depending on the auditor's understanding and experience of working with the auditor's expert or those other individuals with specialised skills or knowledge, the auditor may consider it appropriate to discuss matters such as the requirements of the applicable financial reporting framework with the

[25] SA 620 (AAS 9), "Using the Work of an Expert", paragraph 2. The Standard is being revised in the light of the corresponding International Standard.

individuals involved to establish that their work is relevant for audit purposes.

## Further Substantive Procedures to Respond to Significant Risks (Ref: Para. 15)

A102. In auditing accounting estimates that give rise to significant risks, the auditor's further substantive procedures are focused on the evaluation of:

(a) How management has assessed the effect of estimation uncertainty on the accounting estimate, and the effect such uncertainty may have on the appropriateness of the recognition of the accounting estimate in the financial statements; and

(b) The adequacy of related disclosures.

### Estimation Uncertainty

#### Management's Consideration of Estimation Uncertainty (Ref: Para. 15(a))

A103. Management may evaluate alternative assumptions or outcomes of the accounting estimates through a number of methods, depending on the circumstances. One possible method used by management is to undertake a sensitivity analysis. This might involve determining how the monetary amount of an accounting estimate varies with different assumptions. Even for accounting estimates measured at fair value there can be variation because different market participants will use different assumptions. A sensitivity analysis could lead to the development of a number of outcome scenarios, sometimes characterised as a range of outcomes by management, such as "pessimistic" and "optimistic" scenarios.

A104. A sensitivity analysis may demonstrate that an accounting estimate is not sensitive to changes in particular assumptions. Alternatively, it may demonstrate that the accounting estimate is sensitive to one or more assumptions that then become the focus of the auditor's attention.

A105. This is not intended to suggest that one particular method of addressing estimation uncertainty (such as sensitivity analysis) is more suitable than another, or that management's consideration of alternative assumptions or outcomes needs to be conducted through a detailed process supported by extensive documentation. Rather, it is whether management has assessed how estimation uncertainty may affect the accounting estimate that is important, not

the specific manner in which it is done. Accordingly, where management has not considered alternative assumptions or outcomes, it may be necessary for the auditor to discuss with management, and request support for, how it has addressed the effects of estimation uncertainty on the accounting estimate.

Considerations Specific to Smaller Entities

A106. Smaller entities may use simple means to assess the estimation uncertainty. In addition to the auditor's review of available documentation, the auditor may obtain other audit evidence of management consideration of alternative assumptions or outcomes by inquiry of management. In addition, management may not have the expertise to consider alternative outcomes or otherwise address the estimation uncertainty of the accounting estimate. In such cases, the auditor may explain to management the process or the different methods available for doing so, and the documentation thereof. This would not, however, change the responsibilities of management for the preparation and presentation of the financial statements.

Significant Assumptions (Ref: Para. 15(b))

A107. An assumption used in making an accounting estimate may be deemed to be significant if a reasonable variation in the assumption would materially affect the measurement of the accounting estimate.

A108. Support for significant assumptions derived from management's knowledge may be obtained from management's continuing processes of strategic analysis and risk management. Even without formal established processes, such as may be the case in smaller entities, the auditor may be able to evaluate the assumptions through inquiries of and discussions with management, along with other audit procedures in order to obtain sufficient appropriate audit evidence.

A109. The auditor's considerations in evaluating assumptions made by management are described in paragraphs A77-A83.

Management Intent and Ability (Ref: Para. 15(c))

A110. The auditor's considerations in relation to assumptions made by management and management's intent and ability are described in paragraphs

A13 and A80.

Development of a Range (Ref: Para. 16)

A111. In preparing the financial statements, management may be satisfied that it has adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks. In some circumstances, however, the auditor may view the efforts of management as inadequate. This may be the case, for example, where, in the auditor's judgment:

- Sufficient appropriate audit evidence could not be obtained through the auditor's evaluation of how management has addressed the effects of estimation uncertainty.
- It is necessary to explore further the degree of estimation uncertainty associated with an accounting estimate, for example, where the auditor is aware of wide variation in outcomes for similar accounting estimates in similar circumstances.
- It is unlikely that other audit evidence can be obtained, for example, through the review of events occurring up to the date of the auditor's report.
- Indicators of management bias in the making of accounting estimates may exist.

A112. The auditor's considerations in determining a range for this purpose are described in paragraphs A87-A95.

Recognition and Measurement Criteria

Recognition of the Accounting Estimates in the Financial Statements (Ref: Para. 17(a))

A113. Where management has recognised an accounting estimate in the financial statements, the focus of the auditor's evaluation is on whether the measurement of the accounting estimate is sufficiently reliable to meet the recognition criteria of the applicable financial reporting framework.

A114. With respect to accounting estimates that have not been recognised, the focus of the auditor's evaluation is on whether the recognition criteria of the

applicable financial reporting framework have in fact been met. Even where an accounting estimate has not been recognised, and the auditor concludes that this treatment is appropriate, there may be a need for disclosure of the circumstances in the notes to the financial statements. The auditor may also determine that there is a need to draw the reader's attention to a significant uncertainty by adding an Emphasis of Matter paragraph to the auditor's report. SA 706[26] establishes requirements and provides guidance concerning such paragraphs.

Measurement Basis for the Accounting Estimates (Ref: Para. 17(b))

A115. With respect to fair value accounting estimates, some financial reporting frameworks presume that fair value can be measured reliably as a prerequisite to either requiring or permitting fair value measurements and disclosures. In some cases, this presumption may be overcome when, for example, there is no appropriate method or basis for measurement. In such cases, the focus of the auditor's evaluation is on whether management's basis for overcoming the presumption relating to the use of fair value set forth under the applicable financial reporting framework is appropriate.

## Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements (Ref: Para. 18)

A116. Based on the audit evidence obtained, the auditor may conclude that the evidence points to an accounting estimate that differs from management's point estimate. Where the audit evidence supports a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. Where the auditor has concluded that using the auditor's range provides sufficient appropriate audit evidence, a management point estimate that lies outside the auditor's range would not be supported by audit evidence. In such cases, the misstatement is no less than the difference between management's point estimate and the nearest point of the auditor's

[26] At present, there is no separate Standard on Auditing (SA) corresponding to International Standards on Auditing (ISA) 706, "Emphasis of Matter Paragraphs and Other Matter(s) Paragraphs in the Independent Auditor's Report". However, the concept of 'emphasis of matter paragraph' has been discussed in SA 700, "The Auditor's Report on Financial Statements". The Standard is being revised in the light of the corresponding International Standard. The Auditing and Assurance Standards Board will issue the Exposure Draft of SA 706 corresponding to ISA 706 in the near future.

range.

A117. Where management has changed an accounting estimate, or the method in making it, from the prior period based on a subjective assessment that there has been a change in circumstances, the auditor may conclude based on the audit evidence that the accounting estimate is misstated as a result of an arbitrary change by management, or may regard it as an indicator of possible management bias (see paragraphs A124-A125).

A118. SA 450[27] provides guidance on distinguishing misstatements for purposes of the auditor's evaluation of the effect of uncorrected misstatements on the financial statements. In relation to accounting estimates, a misstatement, whether caused by fraud or error, may arise as a result of:

- Misstatements about which there is no doubt (factual misstatements).
- Differences arising from management's judgments concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate (judgmental misstatements).
- The auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn (projected misstatements).

In some cases involving accounting estimates, a misstatement could arise as a result of a combination of these circumstances, making separate identification difficult or impossible.

A119. Evaluating the reasonableness of accounting estimates and related disclosures included in the notes to the financial statements, whether required by the applicable financial reporting framework or disclosed voluntarily, involves essentially the same types of considerations applied when auditing an accounting estimate recognised in the financial statements.

## Disclosures Related to Accounting Estimates

Disclosures in accordance with the Applicable Financial Reporting

[27] The Exposure Draft of SA 450, "Evaluation of Misstatements Identified during the Audit", has been published in January, 2009 issue of the Journal. The last date for sending the comments is March 1, 2009.

Framework (Ref: Para. 19)

A120. The presentation of financial statements in accordance with the applicable financial reporting framework includes adequate disclosure of material matters. The applicable financial reporting framework may permit, or prescribe, disclosures related to accounting estimates, and some entities may disclose voluntarily additional information in the notes to the financial statements. These disclosures may include, for example:

- The assumptions used.
- The method of estimation used, including any applicable model.
- The basis for the selection of the method of estimation.
- The effect of any changes to the method of estimation from the prior period.
- The sources and implications of estimation uncertainty.

Such disclosures are relevant to users in understanding the accounting estimates recognised or disclosed in the financial statements, and sufficient appropriate audit evidence needs to be obtained about whether the disclosures are in accordance with the requirements of the applicable financial reporting framework.

A121. In some cases, the applicable financial reporting framework may require specific disclosures regarding uncertainties. For example, some financial reporting frameworks prescribe:

- The disclosure of key assumptions and other sources of estimation uncertainty that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities. Such requirements may be described using terms such as “Key Sources of Estimation Uncertainty” or “Critical Accounting Estimates”.
- The disclosure of the range of possible outcomes, and the assumptions used in determining the range.
- The disclosure of information regarding the significance of fair value accounting estimates to the entity’s financial position and performance.
- Qualitative disclosures such as the exposures to risk and how they arise, the entity’s objectives, policies and procedures for managing the risk and the

methods used to measure the risk and any changes from the previous period of these qualitative concepts.

- Quantitative disclosures such as the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel, including credit risk, liquidity risk and market risk.

### Disclosures of Estimation Uncertainty for Accounting Estimates that give Rise to Significant Risks (Ref: Para. 20)

A122. In relation to accounting estimates having significant risk, even where the disclosures are in accordance with the applicable financial reporting framework, the auditor may conclude that the disclosure of estimation uncertainty is inadequate in light of the circumstances and facts involved. The auditor's evaluation of the adequacy of disclosure of estimation uncertainty increases in importance the greater the range of possible outcomes of the accounting estimate is in relation to materiality (see related discussion in paragraph A95).

A123. In some cases, the auditor may consider it appropriate to encourage management to describe, in the notes to the financial statements, the circumstances relating to the estimation uncertainty. SA 705[28] provides guidance on the implications for the auditor's report when the auditor believes that management's disclosure of estimation uncertainty in the financial statements is inadequate or misleading.

### Indicators of Possible Management Bias (Ref: Para. 21)

A124. During the audit, the auditor may become aware of judgments and decisions made by management which give rise to indicators of possible management bias. Such indicators may affect the auditor's conclusion as to whether the auditor's risk assessment and related responses remain appropriate, and the auditor may need to consider the implications for the rest of the audit. Further, they may affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement, as discussed in SA

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[28] At present, there is no separate Standard on Auditing (SA) corresponding to International Standard on Auditing (ISA) 705, "Modifications to the Opinion in the Independent Auditor's Report". However, the concept of 'modified audit report' has been discussed in SA 700, "The Auditor's Report on Financial Statements". The Standard is being revised in the light of the corresponding International Standard. The Auditing and Assurance Standards Board will issue the Exposure Draft of SA 705 corresponding to ISA 705 in the near future.

700[29]

A125. Examples of indicators of possible management bias with respect to accounting estimates include:

- Changes in an accounting estimate, or the method for making it, where management has made a subjective assessment that there has been a change in circumstances.
- Use of an entity's own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions.
- Selection or construction of significant assumptions that yield a point estimate favourable for management objectives.
- Selection of a point estimate that may indicate a pattern of optimism or pessimism.

## Written Representations (Ref: Para. 22)

A126. SA 580[30] discusses the use of written representations. Depending on the nature, materiality and extent of estimation uncertainty, written representations about accounting estimates recognised or disclosed in the financial statements may include representations:

- About the appropriateness of the measurement processes, including related assumptions and models, used by management in determining accounting estimates in the context of the applicable financial reporting framework, and the consistency in application of the processes.
- That the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity, where relevant to the accounting estimates and disclosures.
- That disclosures related to accounting estimates are complete and appropriate under the applicable financial reporting framework.

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[29] Hitherto known as SA 700 (AAS 28), "The Auditor's Report on Financial Statements". The Standard is being revised in the light of the corresponding International Standard.

[30] Standard on Auditing (SA) 580 (Revised), "Representations by Management" has been published in the October, 2008 issue of the Journal. Revised SA 580 is effective for audits of financial statements for periods beginning on or after 1st April, 2009.

- That no subsequent event requires adjustment to the accounting estimates and disclosures included in the financial statements.

A127. For those accounting estimates not recognised or disclosed in the financial statements, written representations may also include representations about:

- The appropriateness of the basis used by management for determining that the recognition or disclosure criteria of the applicable financial reporting framework have not been met (see paragraph A114).

- The appropriateness of the basis used by management to overcome the presumption relating to the use of fair value set forth under the entity's applicable financial reporting framework, for those accounting estimates not measured or disclosed at fair value (see paragraph A115).

### Documentation (Ref: Para. 23)

A128. Documentation of indicators of possible management bias identified during the audit assists the auditor in concluding whether the auditor's risk assessment and related responses remain appropriate, and in evaluating whether the financial statements as a whole are free from material misstatement. See paragraph A125 for examples of indicators of possible management bias.

## Material Modifications vis a vis ISA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"

### Deletions

1. Paragraph A11 of the Application Section of ISA 540 deals with the application of the requirements of ISA 540 to the audits of public sector entities regarding significant holdings of specialised assets for which there are no readily available and reliable sources of information for purposes of measurement at fair value or other current value bases, or a combination of both. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their

form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even non-public sector entities, may have significant holdings of specialised assets for which there are no readily available and reliable sources of information for purposes of measurement. Accordingly, the spirit of erstwhile A11, highlighting the fact that in case of certain entities, there may be a requirement of estimation at fair value in case of specialised assets, has been retained.

# Appendix

(Ref: Para. A1)

## Fair Value Measurements and Disclosures Under Different Financial Reporting Frameworks

The purpose of this appendix is only to provide a general discussion of fair value measurements and disclosures under different financial reporting frameworks, for background and context.

1. Different financial reporting frameworks require or permit a variety of fair value measurements and disclosures in financial statements. They also vary in the level of guidance that they provide on the basis for measuring assets and liabilities or the related disclosures. Some financial reporting frameworks give prescriptive guidance, others give general guidance, and some give no guidance at all. In addition, certain industry-specific measurement and disclosure practices for fair values also exist.

2. Definitions of fair value may differ among financial reporting frameworks, or for different assets, liabilities or disclosures within a particular framework. For example, Accounting Standard (AS) 30[31] defines fair value as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction". The concept of fair value ordinarily assumes a current transaction, rather than settlement at some past or future date. Accordingly, the process of measuring fair value would be a search for the estimated price at which that transaction would occur. Additionally, different financial reporting frameworks may use such terms as "entity-specific value," "value in use," or similar terms, but may still fall within the concept of fair value in this SA.

3. Financial reporting frameworks may treat changes in fair value measurements that occur over time in different ways. For example, a particular financial reporting framework may require that changes in fair value measurements of certain assets or liabilities be reflected directly in equity, while such changes might be reflected in income under another framework. In some frameworks, the determination of whether to use fair value accounting or how it is

[31] AS 30, "Financial Instruments: Recognition and Measurement".

applied is influenced by management's intent to carry out certain courses of action with respect to the specific asset or liability.

4. Different financial reporting frameworks may require certain specific fair value measurements and disclosures in financial statements and prescribe or permit them in varying degrees. The financial reporting frameworks may:

- Prescribe measurement, presentation and disclosure requirements for certain information included in the financial statements or for information disclosed in notes to financial statements or presented as supplementary information;
- Permit certain measurements using fair values at the option of an entity or only when certain criteria have been met;
- Prescribe a specific method for determining fair value, for example, through the use of an independent appraisal or specified ways of using discounted cash flows;
- Permit a choice of method for determining fair value from among several alternative methods (the criteria for selection may or may not be provided by the financial reporting framework); or
- Provide no guidance on the fair value measurements or disclosures of fair value other than their use being evident through custom or practice, for example, an industry practice.

5. Some financial reporting frameworks presume that fair value can be measured reliably for assets or liabilities as a prerequisite to either requiring or permitting fair value measurements or disclosures. In some cases, this presumption may be overcome when an asset or liability does not have a quoted market price in an active market and for which other methods of reasonably estimating fair value are clearly inappropriate or unworkable. Some financial reporting frameworks may specify a fair value hierarchy that distinguishes inputs for use in arriving at fair values ranging from those that involve clearly "observable inputs" based on quoted prices and active markets and those "unobservable inputs" that involve an entity's own judgments about assumptions that marketplace participants would use.

6. Some financial reporting frameworks require certain specified adjustments or modifications to valuation information, or other considerations unique to a particular asset or liability. For example, accounting for investment properties may require adjustments to be made to an appraised market value,

such as adjustments for estimated closing costs on sale, adjustments related to the property's condition and location, and other matters. Similarly, if the market for a particular asset is not an active market, published price quotations may have to be adjusted or modified to arrive at a more suitable measure of fair value. For example, quoted market prices may not be indicative of fair value if there is infrequent activity in the market, the market is not well established, or small volumes of units are traded relative to the aggregate number of trading units in existence. Accordingly, such market prices may have to be adjusted or modified. Alternative sources of market information may be needed to make such adjustments or modifications. Further, in some cases, collateral assigned (for example, when collateral is assigned for certain types of investment in debt) may need to be considered in determining the fair value or possible impairment of an asset or liability.

7. In most financial reporting frameworks, underlying the concept of fair value measurements is a presumption that the entity is a going concern without any intention or need to liquidate, curtail materially the scale of its operations, or undertake a transaction on adverse terms. Therefore, in this case, fair value would not be the amount that an entity would receive or pay in a forced transaction, involuntary liquidation, or distress sale. On the other hand, general economic conditions or economic conditions specific to certain industries may cause illiquidity in the marketplace and require fair values to be predicated upon depressed prices, potentially significantly depressed prices. An entity, however, may need to take its current economic or operating situation into account in determining the fair values of its assets and liabilities if prescribed or permitted to do so by its financial reporting framework and such framework may or may not specify how that is done. For example, management's plan to dispose of an asset on an accelerated basis to meet specific business objectives may be relevant to the determination of the fair value of that asset.

## Prevalence of Fair Value Measurements

8. Measurements and disclosures based on fair value are becoming increasingly prevalent in financial reporting frameworks. Fair values may occur in, and affect the determination of, financial statements in a number of ways, including the measurement at fair value of the following:

- Specific assets or liabilities, such as marketable securities or liabilities to settle an obligation under a financial instrument, routinely or periodically "marked-to-market".

- Specific components of equity, for example when accounting for the recognition, measurement and presentation of certain financial instruments with equity features, such as a bond convertible by the holder into common shares of the issuer.
- Specific assets or liabilities acquired in a business combination. For example, the initial determination of goodwill arising on the purchase of an entity in a business combination usually is based on the fair value measurement of the identifiable assets and liabilities acquired and the fair value of the consideration given.
- Specific assets or liabilities adjusted to fair value on a one-time basis. Some financial reporting frameworks may require the use of a fair value measurement to quantify an adjustment to an asset or a group of assets as part of an asset impairment determination, for example, a test of impairment of goodwill acquired in a business combination based on the fair value of a defined operating entity or reporting unit, the value of which is then allocated among the entity's or unit's group of assets and liabilities in order to derive an implied goodwill for comparison to the recorded goodwill.
- Aggregations of assets and liabilities. In some circumstances, the measurement of a class or group of assets or liabilities calls for an aggregation of fair values of some of the individual assets or liabilities in such class or group. For example, under an entity's applicable financial reporting framework, the measurement of a diversified loan portfolio might be determined based on the fair value of some categories of loans comprising the portfolio.
- Information disclosed in notes to financial statements or presented as supplementary information, but not recognised in the financial statements.

# SA 550 (AAS 23)

## RELATED PARTIES

***(Effective for all audits relating to accounting periods beginning on or after April 1, 2001)***

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Standard on Auditing (SA) 550*, "Related Parties" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in September, 2001.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard on Auditing (SA) is to establish standards on the auditor's responsibilities and audit procedures regarding related parties and transactions with such parties.

2. The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence regarding the identification and disclosure by management of related parties and the related party transactions that are material to the financial statements. However, an audit cannot be expected to detect all related party transactions.

3. In certain circumstances there are limitations that may affect the persuasiveness of evidence available to the auditor to draw conclusions on particular financial statement assertions. Because of the degree of uncertainty associated with the financial statement assertions regarding the completeness of information of related parties, the procedures identified in this SA will provide sufficient appropriate audit evidence regarding those assertions in the absence of any circumstance identified by the auditor that:

(a) increases the risk of misstatement beyond that which would ordinarily be expected; or

(b) indicates that a material misstatement regarding related parties has occurred.

Where there is any indication that such circumstances exist, the auditor should perform modified, extended or additional procedures as are appropriate in the circumstances.

4. Definitions regarding related parties are given in Accounting Standard (AS) 18, "Related Party Disclosures" and are adopted for the purposes of this SA.[2]

5. Management is responsible for the identification and disclosure of related parties and transactions with such parties. This responsibility

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[2] Definitions of "Related Party" and "Related Party Transactions" from Accounting Standard (AS) 18 "Related Party Disclosures" are:

Related Party – parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

Related Party Transactions – a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

requires management to implement adequate accounting and internal control systems to ensure that transactions with related parties are appropriately identified in the accounting records and disclosed in the financial statements.

6. The auditor needs to have a level of knowledge of the entity's business and industry that will enable identification of the events, transactions and practices that may have a material effect on the financial statements. While the existence of related parties and transactions between such parties are considered ordinary features of business, the auditor needs to be aware of them because:

(a) the financial reporting framework may require disclosure in the financial statements of certain related party relationships and transactions, such as those required by AS 18;

(b) the existence of related parties or related party transactions may affect the financial statements. For example, the entity's tax liability and expense may be affected by the tax laws which require special consideration when related parties exist;

(c) the source of audit evidence affects the auditor's assessment of its reliability. A greater degree of reliance may be placed on audit evidence that is obtained from unrelated third parties; and

(d) a related party transaction may be motivated by other than ordinary business considerations, for example, profit sharing or even fraud.

## Existence and Disclosure of Related Parties

7. The auditor should review information provided by the management of the entity, identifying the names of all known related parties and should perform the following procedures in respect of the completeness of this information:

(a) review his working papers for the prior years for names of known related parties;

(b) review the entity's procedures for identification of related parties;

(c) inquire as to the affiliation of directors and key management

personnel[3], officers with other entities;

(d) review shareholder records to determine the names of principal shareholders or, if appropriate, obtain a list of principal shareholders from the share register;

(e) review memorandum and articles of association, minutes of the meetings of shareholders and the board of directors and its committees and other relevant statutory records such as the register of directors' interests;

(f) inquire of other auditors[4] of the entity as to their knowledge of additional related parties and review the report of the predecessor auditors;

(g) review the entity's income tax returns and other information supplied to regulatory agencies; and

(h) review the joint venture and other relevant agreements entered into by the entity.

If, in the auditor's judgement, the risk of significant related parties remaining undetected is low, these procedures may be reduced or modified as appropriate.

8. Where the financial reporting framework requires disclosure of related party relationships, the auditor should satisfy himself that the disclosure is adequate.

## Transactions with Related Parties

9. The auditor should review information provided by directors and key management personnel of the entity identifying related party transactions and should be alert for other material related party transactions.

10. When obtaining an understanding of the accounting and internal control systems and making a preliminary assessment of control risk,

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[3] Definition of "Key Management Personnel" from AS 18 is:
Key Management Personnel - those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprises.

[4] The term "Other Auditors" includes internal auditor, special auditors appointed under any statute, cost auditors, and concurrent auditors.

the auditor should consider the adequacy of control procedures over the authorisation and recording of related party transactions.

11. During the course of the audit, the auditor needs to be alert for transactions which appear unusual in the circumstances and may indicate the existence of previously unidentified related parties. Examples include:

- Transactions which have abnormal terms of trade, such as, unusual prices, interest rates, guarantees, and repayment terms.
- Transactions which lack an apparent logical business reason for their occurrence.
- Transactions in which substance differs from form.
- Transactions processed in an unusual manner.
- High volume or significant transactions with certain customers or suppliers as compared with others.
- Rendition of services without receipt or provision of management services at no charge.

12. During the course of the audit, the auditor carries out procedures which may identify the existence of transactions with related parties. Examples include:

- Performing detailed tests of transactions and balances.
- Reviewing minutes of meetings of shareholders and directors.
- Reviewing accounting records for large or unusual transactions or balances, paying particular attention to transactions recognised at or near the end of the reporting period.
- Reviewing the entity's income tax returns and other information supplied to regulatory agencies.
- Reviewing confirmations of loans receivable and payable and confirmations from banks. Such a review may indicate guarantor relationship and other related party transactions.
- Reviewing investment transactions, for example, purchase or sale of an equity interest in a joint venture or other entity.

## Examining Identified Related Party Transactions

13. In examining the identified related party transactions, the auditor should obtain sufficient appropriate audit evidence as to whether these

transactions have been properly recorded and disclosed.

14. Given the nature of related party relationships, evidence of a related party transactions may be limited, for example, regarding the existence of inventory held by a related party on consignment or an instruction from a parent company to a subsidiary to record a royalty expense. Because of the limited availability of appropriate evidence about such transactions, the auditor would consider performing procedures such as:

- Confirming the terms and amount of the transaction with the related party.
- Obtaining confirmation from persons associated with the transaction, such as, banks, lawyers, guarantors and agents.

## Management Representations

15. The auditor should obtain a written representation from management concerning:

(a) the completeness of information provided regarding the identification of related parties; and

(b) the adequacy of related party disclosures in the financial statements.

16. An example of a written representation to be obtained from management is given as an Appendix to this Standard.

## Audit Conclusions and Reporting

17. If the auditor is unable to obtain sufficient appropriate audit evidence concerning related parties and transactions with such parties or concludes that their disclosure in the financial statements is not adequate, the auditor should express a qualified opinion or a disclaimer of opinion in the audit report, as may be appropriate.

## Effective Date

18. This Standard on Auditing becomes operative for all audits related to accounting periods beginning on or after 1st April, 2001.

# Appendix

## Example of a Management Representation Letter Regarding Related Parties

(Refer Paragraph 16)

The following letter is for use as a general guide in conjunction with the considerations set forth in this Statement. Representations by management will vary from one entity to another, and from one year to the next. Therefore, this letter is not intended to be a standard letter and should be adapted in the light of individual requirements and circumstances.

[Letterhead of Entity]

[Date]

[Name and Address of the Auditor]

Dear Sir,

This representation letter is provided in connection with your audit of the financial statements of _____ for the year ended _____. We acknowledge our responsibility for preparation of financial statements in accordance with the requirements of the Companies Act, 1956 and recognised accounting policies and practices, including the Accounting Standards issued by the Institute of Chartered Accountants of India.

We confirm the following representation in respect of related parties:

1. We have identified all the related parties and transactions with all such parties. The information provided to you is complete in all respects.
2. The disclosures made in the financial statements are adequate having regard to the framework under which the financial statements have been drawn.
3. The financial statements are free from material misstatements, including omissions with regard to related parties and transactions with related parties.

{Signature of the Authorised Person(s) of the Entity}

# Standard on Auditing (SA) 550*(Revised) Related Parties

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* Hitherto known as Standard on Auditing (SA) 550 (AAS 23), "Related Parties".

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Standard on Auditing (SA) 550 (Revised), "Related Parties" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[2], which sets out the authority of SAs.

[2] Published in the July, 2007 issue of the Journal.

# Introduction

## Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements. Specifically, it expands on how SA 315[3], SA 330[4] and SA 240[5] are to be applied in relation to risks of material misstatement associated with related party relationships and transactions.

### Nature of Related Party Relationships and Transactions

2. 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:

- 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.
- Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.
- 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.

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[3] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

[4] SA 330, "The Auditor's Responses to Assessed Risks".

[5] SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" is effective for audits of financial statements for periods beginning on or after April 1, 2009.

## Responsibilities of the Auditor

3. Because related parties are not independent of each other, many financial reporting frameworks establish specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and actual or potential effects on the financial statements. Where the applicable financial reporting framework establishes such requirements, the auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for or disclose related party relationships, transactions or balances in accordance with the requirements of the framework.

4. Even if the applicable financial reporting framework establishes minimal or no related party requirements, the auditor nevertheless needs to obtain an understanding of the entity's related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions: (Ref: Para. A1)

(a) Achieve a true and fair presentation (for fair presentation frameworks); or (Ref: Para. A2)

(b) Are not misleading (for compliance frameworks). (Ref: Para. A3)

5. In addition, an understanding of the entity's related party relationships and transactions is relevant to the auditor's evaluation of whether one or more fraud risk factors are present as required by SA 240[6] because fraud may be more easily committed through related parties.

6. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs[7]. In the context of related parties, the potential effects of

[6] SA 240 (Revised), paragraph 24.

[7] Presently, SA 200 (AAS 1), "Basic Principles Governing an Audit" and SA 200A (AAS 2), "Objective and Scope of an Audit of Financial Statements" correspond to International Standard on Auditing (ISA) 200 (Revised and Redrafted). Both the SAs are currently being revised in the light of the ISA 200 (Revised and Redrafted).

inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- Management may be unaware of the existence of all related party relationships and transactions, particularly if the applicable financial reporting framework does not establish related party requirements.
- Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

7. Planning and performing the audit with professional skepticism as required by SA 200[8] is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement associated with related party relationships and transactions, and in designing audit procedures to respond to the assessed risks.

### Effective Date

8. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

## Objectives

9. The objectives of the auditor are:

(a) Irrespective of whether the applicable financial reporting framework establishes related party requirements, to obtain an understanding of related party relationships and transactions sufficient to be able:

(i) To recognise fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and

(ii) To conclude whether the financial statements, insofar as they are affected by those relationships and transactions:

[8] See footnote 6.

a. Achieve a true and fair presentation (for fair presentation frameworks); or

b. Are not misleading (for compliance frameworks); and

(b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework.

## Definitions

10. For purposes of the SAs, the following terms have the meanings attributed below:

(a) Arm's length transaction – A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.

(b) Related party – A party that is either: (Ref: Para. A4-A7)

(i) A related party as defined in the applicable financial reporting framework[9]; 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

[9] In Indian context, definitions of "Related Party" and "Related Party Transactions" as given in Accounting Standard (AS) 18, "Related Party Disclosures", issued by the Institute of Chartered Accountants of India, will be applicable for the purposes of this SA, and the said definitions also meet the tests laid down in paragraph 10(b)(ii) of this SA.

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.

## Requirements

### Risk Assessment Procedures and Related Activities

11. As part of the risk assessment procedures and related activities that SA 315 and SA 240 require the auditor to perform during the audit,[10] the auditor shall perform the audit procedures and related activities set out in paragraphs 12-17 to obtain information relevant to identifying the risks of material misstatement associated with related party relationships and transactions. (Ref: Para. A8)

### Understanding the Entity's Related Party Relationships and Transactions

12. The engagement team discussion that SA 315 and SA 240 require[11] shall include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions. (Ref: Para. A9-A10)

13. The auditor shall inquire of management regarding:

(a) The identity of the entity's related parties, including changes from the prior period; (Ref: Para. A11-A14)

(b) The nature of the relationships between the entity and these related parties; and

[10] SA 315, paragraph 5; and SA 240 (Revised), paragraph 16.

[11] SA 315, paragraph 10; and SA 240 (Revised), paragraph 15.

(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.

14. 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: (Ref: Para. A15-A20)

(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 (Ref: Para. A21)

(c) Authorise and approve significant transactions and arrangements outside the normal course of business.

## Maintaining Alertness for Related Party Information When Reviewing Records or Documents

15. During the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. (Ref: Para. A22-A23)

In particular, the auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

(a) Bank, legal and third party confirmations obtained as part of the auditor's procedures;

(b) Minutes of meetings of shareholders and of those charged with governance; and

(c) Such other records or documents as the auditor considers necessary in the circumstances of the entity.

16. If the auditor identifies significant transactions outside the entity's normal course of business when performing the audit procedures required by paragraph 15 or through other audit procedures, the auditor shall inquire of management about: (Ref: Para. A24-A25)

(a) The nature of these transactions; and (Ref: Para. A26)

(b) Whether related parties could be involved. (Ref: Para. A27)

### Sharing Related Party Information with the Engagement Team

17. The auditor shall share relevant information obtained about the entity's related parties with the other members of the engagement team. (Ref: Para. A28)

## Identification and Assessment of the Risks of Material Misstatement Associated with Related Party Relationships and Transactions

18. In meeting the SA 315 requirement to identify and assess the risks of material misstatement,[12] the auditor shall identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are significant risks. In making this determination, the auditor shall treat identified significant related party transactions outside the entity's normal course of business as giving rise to significant risks.

19. If the auditor identifies fraud risk factors (including circumstances relating to the existence of a related party with dominant influence) when performing the risk assessment procedures and related activities in connection with related parties, the auditor shall consider such information when identifying and assessing the risks of material misstatement due to fraud in accordance with SA 240. (Ref: Para. A6 and A29-A30)

[12] SA 315, paragraph 24.

## Responses to the Risks of Material Misstatement Associated with Related Party Relationships and Transactions

20. As part of the SA 330 requirement that the auditor respond to assessed risks,[13] the auditor designs and performs further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions. These audit procedures shall include those required by paragraphs 21-24. (Ref: Para. A31-A34)

### Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions

21. If the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor, the auditor shall determine whether the underlying circumstances confirm the existence of those relationships or transactions.

22. If the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor shall:

(a) Promptly communicate the relevant information to the other members of the engagement team; (Ref: Para. A35)

(b) Where the applicable financial reporting framework establishes related party requirements:

(i) Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation; and

(ii) Inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;

(c) Perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions; (Ref: Para. A36)

[13] SA 330, paragraphs 5-6.

(d) Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor, and perform additional audit procedures as necessary; and

(e) If the non-disclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit. (Ref: Para. A37)

### Identified Significant Related Party Transactions outside the Entity's Normal Course of Business

23. For identified significant related party transactions outside the entity's normal course of business, the auditor shall:

(a) Inspect the underlying contracts or agreements, if any, and evaluate whether:

(i) The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;[14] (Ref: Para. A38-A39)

(ii) The terms of the transactions are consistent with management's explanations; and

(iii) The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and

(b) Obtain audit evidence that the transactions have been appropriately authorised and approved. (Ref: Para. A40-A41)

### Assertions That Related Party Transactions Were Conducted on Terms Equivalent to Those Prevailing in an Arm's Length Transaction

24. When management has made an assertion in the financial statements to the effect that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction, the auditor shall obtain sufficient appropriate audit evidence about the assertion. (Ref: Para. A42-A45)

[14] SA 240 (Revised), paragraph 32(c).

## Evaluation of the Accounting for and Disclosure of Identified Related Party Relationships and Transactions

25. In forming an opinion on the financial statements in accordance with SA 700,[15] the auditor shall evaluate: (Ref: Para. A46)

(a) Whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and (Ref: Para. A47)

(b) Whether the effects of the related party relationships and transactions:

(i) Prevent the financial statements from achieving true and fair presentation (for fair presentation frameworks); or

(ii) Cause the financial statements to be misleading (for compliance frameworks).

## Written Representations

26. Where the applicable financial reporting framework establishes related party requirements, the auditor shall obtain written representations from management and, where appropriate, those charged with governance that: (Ref: Para. A48-A49)

(a) They have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware; and

(b) They have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.

## Communication with Those Charged with Governance

27. Unless all of those charged with governance are involved in managing the entity, the auditor shall communicate with those charged with governance significant matters arising during the audit in connection with the entity's related parties. (Ref: Para. A50)

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[15] Hitherto known as the Auditing and Assurance Standard (AAS 28), "The Auditor's Report on Financial Statements". The Standard is being revised in the light of the corresponding International Standard.

### Documentation

28. In meeting the documentation requirements of SA 230[16] and other SAs, the auditor shall include in the audit documentation the names of the identified related parties and the nature of the related party relationships.

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## Application and Other Explanatory Material

### Responsibilities of the Auditor

#### Financial Reporting Frameworks That Establish Minimal Related Party Requirements (Ref: Para. 4)

A1. An applicable financial reporting framework that establishes minimal related party requirements is one that defines the meaning of a related party but that definition has a substantially narrower scope than the definition set out in paragraph 10(b)(ii) of this SA, so that a requirement in the framework to disclose related party relationships and transactions would apply to substantially fewer related party relationships and transactions.

#### Fair Presentation Frameworks (Ref: Para. 4(a))

A2. In the context of a fair presentation framework,[17] related party relationships

[16] SA 230 (Revised), "Audit Documentation" has been published in January, 2009 issue of Journal.

[17] ISA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing" defines the meaning of fair presentation and compliance frameworks as follows:

"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 acknowledgements in (i) or (ii) above."

and transactions may cause the financial statements to fail to achieve true and fair presentation if, for example, the economic reality of such relationships and transactions is not appropriately reflected in the financial statements. For instance, true and fair presentation may not be achieved if the sale of a property by the entity to a controlling shareholder at a price above or below fair market value has been accounted for as a transaction involving a profit or loss for the entity when it may constitute a contribution or return of capital or the payment of a dividend.

Compliance Frameworks (Ref: Para. 4(b))

A3. In the context of a compliance framework, whether related party relationships and transactions cause the financial statements to be misleading as discussed in SA 700 depends upon the particular circumstances of the engagement. For example, even if non-disclosure of related party transactions in the financial statements is in compliance with the framework and applicable law or regulation, the financial statements could be misleading if the entity derives a very substantial portion of its revenue from transactions with related parties, and that fact is not disclosed. However, it will be extremely rare for the auditor to consider financial statements that are prepared and presented in accordance with a compliance framework to be misleading if in accordance with SA 210[18] the auditor determined that the framework is acceptable[19].

Definition of a Related Party (Ref: Para. 10(b))

A4. Many financial reporting frameworks discuss the concepts of control and significant influence. Although they may discuss these concepts using different terms, they generally explain that:

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[18] [Proposed] SA 210 (Revised), "Agreeing the Terms of Audit Engagements," paragraph 4(a). Exposure Draft of SA 210 (Revised) has been published in November, 2008 issue of the Journal.

[19] [Proposed] ISA 700 (Redrafted), "Forming an Opinion and Reporting on Financial Statements", issued by the IAASB, paragraph 19 states as follows:

"When the financial statements are prepared and presented in accordance with a compliance framework, the auditor is not required to evaluate whether the financial statements achieve fair presentation. However, if in extremely rare circumstances the auditor concludes that such financial statements are misleading, the auditor shall discuss the matter with management and, depending on how it is resolved, shall determine whether, and how, to communicate it in the auditor's report".

(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.

A5. The existence of the following relationships may indicate the presence of control or significant influence:

(a) Direct or indirect equity holdings or other financial interests in the entity.

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

(c) 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).

(d) Being a close family member of any person referred to in subparagraph (c).

(e) Having a significant business relationship with any person referred to in subparagraph (c).

Related Parties with Dominant Influence

A6. 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 behavior is relevant when identifying and assessing the risks of material misstatement due to fraud, as further explained in paragraphs A29-A30.

Special-Purpose Entities as Related Parties

A7. In some circumstances, a special-purpose entity[20] may be a related party of

[20] SA 315, paragraphs A23a-A23b, provides guidance regarding the nature of a special-purpose entity, to be inserted as a limited revision to the Standard when the final Revised SA 550 comes into effect. These paragraphs A23a and A23b have been published at the end of this Standard.

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.

## Risk Assessment Procedures and Related Activities

### Risks of Material Misstatement Associated with Related Party Relationships and Transactions (Ref: Para. 11)

A8. In case of certain entities, auditor's responsibilities regarding related party relationships and transactions may be affected by the audit mandate, or by obligations on those entities arising from legislation, regulation, ministerial directives, government policy requirements, or resolutions of the legislature. Consequently, in such cases the auditor's responsibilities may not be limited to addressing the risks of material misstatement associated with related party relationships and transactions, but may also include a broader responsibility to address the risks of non-compliance with laws and regulations governing such entities that lay down specific requirements in the conduct of business with related parties. Further, in such cases the auditor may need to have regard to any specific financial reporting requirements for related party relationships and transactions that may differ from other entities.

### Understanding the Entity's Related Party Relationships and Transactions

Discussion among the Engagement Team (Ref: Para. 12)

A9. Matters that may be addressed in the discussion among the engagement team include:

- The nature and extent of the entity's relationships and transactions with related parties (using, for example, the auditor's record of identified related parties updated after each audit).
- An emphasis on the importance of maintaining an attitude of professional skepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions.
- The circumstances or conditions of the entity that may indicate the existence of related party relationships or transactions that management has not identified or disclosed to the auditor (e.g., a complex organisational structure, use of

special-purpose entities for off-balance sheet transactions, or an inadequate information system).

- The records or documents that may indicate the existence of related party relationships or transactions.
- The importance that management and those charged with governance attach to the identification, appropriate accounting for, and disclosure of related party relationships and transactions (if the applicable financial reporting framework establishes related party requirements), and the related risk of management override of relevant controls.

A10. In addition, the discussion in the context of fraud may include specific consideration of how related parties may be involved in fraud. For example:

- How special-purpose entities controlled by management might be used to facilitate earnings management.
- How transactions between the entity and a known business partner of a key member of management could be arranged to facilitate misappropriation of the entity's assets.

The Identity of the Entity's Related Parties (Ref: Para. 13(a))

A11. Where the applicable financial reporting framework establishes related party requirements, information regarding the identity of the entity's related parties is likely to be readily available to management because the entity's information systems will need to record, process and summarise related party relationships and transactions to enable the entity to meet the accounting and disclosure requirements of the framework. Management is therefore likely to have a comprehensive list of related parties and changes from the prior period. For recurring engagements, making the inquiries provides a basis for comparing the information supplied by management with the auditor's record of related parties noted in previous audits.

A12. However, where the framework does not establish related party requirements, the entity may not have such information systems in place. Under such circumstances, it is possible that management may not be aware of the existence of all related parties. Nevertheless, the requirement to make the

inquiries specified by paragraph 13 still applies because management may be aware of parties that meet the related party definition set out in this SA.

In such a case, however, the auditor's inquiries regarding the identity of the entity's related parties are likely to form part of the auditor's risk assessment procedures and related activities performed in accordance with SA 315 to obtain information regarding:

- The entity's ownership and governance structures;
- The types of investments that the entity is making and plans to make; and
- The way the entity is structured and how it is financed.

In the particular case of common control relationships, as management is more likely to be aware of such relationships if they have economic significance to the entity, the auditor's inquiries are likely to be more effective if they are focused on whether parties with which the entity engages in significant transactions, or shares resources to a significant degree, are related parties.

A13. In the context of a group audit, SA 600 requires the group engagement team to provide each component auditor with a list of related parties prepared by group management and any other related parties of which the group engagement team is aware.[21] Where the entity is a component within a group, this information provides a useful basis for the auditor's inquiries of management regarding the identity of the entity's related parties.

A14. The auditor may also obtain some information regarding the identity of the entity's related parties through inquiries of management during the engagement acceptance or continuance process.

The Entity's Controls over Related Party Relationships and Transactions (Ref: Para. 14)

[21] Currently, SA 600 (AAS 10), "Using the Work of Another Auditor" is in force. The Standard is being revised in the light of the corresponding International Standard.

A15. Others within the entity are those considered likely to have knowledge of the entity's related party relationships and transactions, and the entity's controls over such relationships and transactions. These may include, to the extent that they do not form part of management:

- Those charged with governance;
- Personnel in a position to initiate, process, or record transactions that are both significant and outside the entity's normal course of business, and those who supervise or monitor such personnel;
- Internal auditors;
- In-house legal counsel; and
- The chief ethics officer or equivalent person.

A16. The audit is conducted on the premise that management and, where appropriate, those charged with governance have responsibility for the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework. This includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error.[22] Accordingly, where the framework establishes related party requirements, management, with oversight from those charged with governance, is responsible for the design, implementation and maintenance of adequate controls over related party relationships and transactions so that these are identified and appropriately accounted for and disclosed in accordance with the framework. In their oversight role, those charged with governance are responsible for monitoring how management is discharging its responsibility for such controls. Regardless of any related party requirements the framework may establish, those charged with governance may, in order to fulfill their oversight responsibilities, obtain information from management to enable them to understand the nature and business rationale of the entity's related party relationships and transactions.

A17. In meeting the SA 315 requirement to obtain an understanding of the

[22] SA 200 [See footnote 6].

control environment,[23] the auditor may consider features of the control environment relevant to mitigating the risks of material misstatement associated with related party relationships and transactions, such as:

- Internal ethical codes, appropriately communicated to the entity's personnel and enforced, governing the circumstances in which the entity may enter into specific types of related party transactions.
- Policies and procedures for open and timely disclosure of the interests that management and those charged with governance have in related party transactions.
- The assignment of responsibilities within the entity for identifying, recording, summarising, and disclosing related party transactions.
- Timely disclosure and discussion between management and those charged with governance of significant related party transactions outside the entity's normal course of business, including whether those charged with governance have appropriately challenged the business rationale of such transactions (for example, by seeking advice from external professional advisors).
- Clear guidelines for the approval of related party transactions involving actual or perceived conflicts of interest, such as approval by a subcommittee of those charged with governance comprising individuals independent of management.
- Periodic reviews by internal auditors, where applicable.
- Proactive action taken by management to resolve related party disclosure issues, such as by seeking advice from the auditor or external legal counsel.
- The existence of whistle-blowing policies and procedures, where applicable.

A18. Controls over related party relationships and transactions within some entities may be weak, ineffective or non-existent for a number of reasons, such as:

[23] SA 315, paragraph 14.

- The low importance attached by management to identifying and disclosing related party relationships and transactions.
- The lack of appropriate oversight by those charged with governance.
- An intentional disregard for such controls because related party disclosures may reveal information that management considers sensitive, for example, the existence of transactions involving family members of management.
- An insufficient understanding by management of the related party requirements of the applicable financial reporting framework.
- The absence of disclosure requirements under the applicable financial reporting framework.

Where such controls are ineffective or non-existent, the auditor may be unable to obtain sufficient appropriate audit evidence about related party relationships and transactions. If this were the case, the auditor would, in accordance with SA 705[24], consider the implications for the audit, including the auditor's report.

A19. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.[25] The risk of management override of controls is higher if management has relationships that involve control or significant influence with parties with which the entity does business because these relationships may present management with greater incentives and opportunities to perpetrate fraud. For example, management's financial interests in certain related parties may provide incentives for management to override controls by (a) directing the entity, against its interests, to conclude transactions for the benefit of these parties, or (b) colluding with such parties or controlling their actions. Examples of possible fraud include:

- Creating fictitious terms of transactions with related parties designed to misrepresent the business rationale of these transactions.

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[24] At present, there is no separate Standard on Auditing (SA) corresponding to International Standard on Auditing (ISA) 705, "Modifications to the Opinion in the Independent Auditor's Report" and the concept of 'modified audit report' has been discussed in SA 700, "The Auditor's Report on Financial Statements" (Hitherto known as AAS 28). SA 700 is being revised in the light of the corresponding International Standard.

[25] SA 240 (Revised), paragraphs 31 and A4.

- Fraudulently organizing the transfer of assets from or to management or others at amounts significantly above or below market value.
- Engaging in complex transactions with related parties, such as special-purpose entities, that are structured to misrepresent the financial position or financial performance of the entity.

Considerations specific to smaller entities

A20. 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.

Authorisation and approval of significant transactions and arrangements (Ref: Para. 14(b))

A21. Authorisation involves the granting of permission by a party or parties with the appropriate authority (whether management, those charged with governance or the entity's shareholders) for the entity to enter into specific transactions in accordance with pre-determined criteria, whether judgmental or not. Approval involves those parties' acceptance of the transactions the entity has entered into as having satisfied the criteria on which authorisation was granted. Examples of controls the entity may have established to authorise and approve significant transactions and arrangements with related parties or significant transactions and arrangements outside the normal course of business include:

- Monitoring controls to identify such transactions and arrangements for authorisation and approval.

- Approval of the terms and conditions of the transactions and arrangements by management, those charged with governance or, where applicable, shareholders.

## Maintaining Alertness for Related Party Information When Reviewing Records or Documents

### Records or Documents That the Auditor May Inspect (Ref: Para. 15)

A22. During the audit, the auditor may inspect records or documents that may provide information about related party relationships and transactions, for example:

- Entity income tax returns.
- Information supplied by the entity to regulatory authorities.
- Shareholder registers to identify the entity's principal shareholders.
- Statements of conflicts of interest from management and those charged with governance.
- Records of the entity's investments and those of its pension plans.
- Contracts and agreements with key management or those charged with governance.
- Significant contracts and agreements not in the entity's ordinary course of business.
- Specific invoices and correspondence from the entity's professional advisors.
- Life insurance policies acquired by the entity.
- Significant contracts re-negotiated by the entity during the period.
- Internal auditors' reports.
- Documents associated with the entity's filings with a securities regulator (e.g, prospectuses).

Arrangements that may indicate the existence of previously unidentified or

undisclosed related party relationships or transactions

A23. An arrangement involves a formal or informal agreement between the entity and one or more other parties for such purposes as:

- The establishment of a business relationship through appropriate vehicles or structures.
- The conduct of certain types of transactions under specific terms and conditions.
- The provision of designated services or financial support.

Examples of arrangements that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor include:

- Participation in unincorporated partnerships with other parties.
- Agreements for the provision of services to certain parties under terms and conditions that are outside the entity's normal course of business.
- Guarantees and guarantor relationships.

Identification of Significant Transactions outside the Normal Course of Business (Ref: Para. 16)

A24. Obtaining further information on significant transactions outside the entity's normal course of business enables the auditor to evaluate whether fraud risk factors, if any, are present and, where the applicable financial reporting framework establishes related party requirements, to identify the risks of material misstatement.

A25. Examples of transactions outside the entity's normal course of business may include:

- Complex equity transactions, such as corporate restructurings or acquisitions.
- Transactions with offshore entities in jurisdictions with weak corporate laws.

- The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged.
- Sales transactions with unusually large discounts or returns.
- Transactions with circular arrangements, for example, sales with a commitment to repurchase.
- Transactions under contracts whose terms are changed before expiry.

Understanding the nature of significant transactions outside the normal course of business (Ref: Para. 16(a))

A26. Inquiring into the nature of the significant transactions outside the entity's normal course of business involves obtaining an understanding of the business rationale of the transactions, and the terms and conditions under which these have been entered into.

Inquiring into whether related parties could be involved (Ref: Para. 16(b))

A27. A related party could be involved in a significant transaction outside the entity's normal course of business not only by directly influencing the transaction through being a party to the transaction, but also by indirectly influencing it through an intermediary. Such influence may indicate the presence of a fraud risk factor.

Sharing Related Party Information with the Engagement Team (Ref: Para. 17)

A28. Relevant related party information that may be shared among the engagement team members includes, for example:

- The identity of the entity's related parties.
- The nature of the related party relationships and transactions.
- Significant or complex related party relationships or transactions that may require special audit consideration, in particular transactions in which management or those charged with governance are financially involved.

## Identification and Assessment of the Risks of Material Misstatement Associated with Related Party Relationships and Transactions

Fraud Risk Factors Associated with a Related Party with Dominant Influence (Ref: Para. 19)

A29. Domination of management by a single person or small group of persons without compensating controls is a fraud risk factor.[26] Indicators of dominant influence exerted by a related party include:

- The related party has vetoed significant business decisions taken by management or those charged with governance.
- Significant transactions are referred to the related party for final approval.
- There is little or no debate among management and those charged with governance regarding business proposals initiated by the related party.
- Transactions involving the related party (or a close family member of the related party) are rarely independently reviewed and approved.

Dominant influence may also exist in some cases if the related party has played a leading role in founding the entity and continues to play a leading role in managing the entity.

A30. In the presence of other risk factors, the existence of a related party with dominant influence may indicate significant risks of material misstatement due to fraud. For example:

- An unusually high turnover of senior management or professional advisors may suggest unethical or fraudulent business practices that serve the related party's purposes.
- The use of business intermediaries for significant transactions for which there appears to be no clear business justification may suggest that the related party could have an interest in such transactions through control of such intermediaries for fraudulent purposes.
- Evidence of the related party's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates may suggest the possibility of fraudulent financial reporting.

[26] SA 240 (Revised), Appendix 1.

## Responses to the Risks of Material Misstatement Associated with Related Party Relationships and Transactions (Ref: Para. 20)

A31. The nature, timing and extent of the further audit procedures that the auditor may select to respond to the assessed risks of material misstatement associated with related party relationships and transactions depend upon the nature of those risks and the circumstances of the entity.[27]

A32. Examples of substantive audit procedures that the auditor may perform when the auditor has assessed a significant risk that management has not appropriately accounted for or disclosed specific related party transactions in accordance with the applicable financial reporting framework (whether due to fraud or error) include:

- Confirming or discussing specific aspects of the transactions with intermediaries such as banks, law firms, guarantors, or agents, where practicable and not prohibited by law, regulation or ethical rules.
- Confirming the purposes, specific terms or amounts of the transactions with the related parties (this audit procedure may be less effective where the auditor judges that the entity is likely to influence the related parties in their responses to the auditor).
- Where applicable, reading the financial statements or other relevant financial information, if available, of the related parties for evidence of the accounting of the transactions in the related parties' accounting records.

A33. If the auditor has assessed a significant risk of material misstatement due to fraud as a result of the presence of a related party with dominant influence, the auditor may, in addition to the general requirements of SA 240, perform audit procedures such as the following to obtain an understanding of the business relationships that such a related party may have established directly or indirectly with the entity and to determine the need for further appropriate substantive audit procedures:

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[27] SA 330 provides further guidance on considering the nature, timing and extent of further audit procedures. SA 240 (Revised) establishes requirements and provides guidance on appropriate responses to assessed risks of material misstatement due to fraud.

- Inquiries of, and discussion with, management and those charged with governance.
- Inquiries of the related party.
- Inspection of significant contracts with the related party.
- Appropriate background research, such as through the Internet or specific external business information databases.
- Review of employee whistle-blowing reports where these are retained.

A34. Depending upon the results of the auditor's risk assessment procedures, the auditor may consider it appropriate to obtain audit evidence without testing the entity's controls over related party relationships and transactions. In some circumstances, however, it may not be possible to obtain sufficient appropriate audit evidence from substantive audit procedures alone in relation to the risks of material misstatement associated with related party relationships and transactions. For example, where intra-group transactions between the entity and its components are numerous and a significant amount of information regarding these transactions is initiated, recorded, processed or reported electronically in an integrated system, the auditor may determine that it is not possible to design effective substantive audit procedures that by themselves would reduce the risks of material misstatement associated with these transactions to an acceptably low level. In such a case, in meeting the SA 330 requirement to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls,[28] the auditor is required to test the entity's controls over the completeness and accuracy of the recording of the related party relationships and transactions.

### Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions

#### Communicating Newly Identified Related Party Information to the Engagement Team (Ref: Para. 22(a))

A35. Communicating promptly any newly identified related parties to the other members of the engagement team assists them in determining whether this

[28] SA 330, paragraph 8(b).

information affects the results of, and conclusions drawn from, risk assessment procedures already performed, including whether the risks of material misstatement need to be reassessed.

Substantive Procedures Relating to Newly Identified Related Parties or Significant Related Party Transactions (Ref: Para. 22(c))

A36. Examples of substantive audit procedures that the auditor may perform relating to newly identified related parties or significant related party transactions include:

- Making inquiries regarding the nature of the entity's relationships with the newly identified related parties, including (where appropriate and not prohibited by law, regulation or ethical rules) inquiring of parties outside the entity who are presumed to have significant knowledge of the entity and its business, such as legal counsel, principal agents, major representatives, consultants, guarantors, or other close business partners.

- Conducting an analysis of accounting records for transactions with the newly identified related parties. Such an analysis may be facilitated using computer-assisted audit techniques.

- Verifying the terms and conditions of the newly identified related party transactions, and evaluating whether the transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.

Intentional Non-Disclosure by Management (Ref: Para. 22(e))

A37. The requirements and guidance in SA 240 regarding the auditor's responsibilities relating to fraud in an audit of financial statements are relevant where management appears to have intentionally failed to disclose related parties or significant related party transactions to the auditor. The auditor may also consider whether it is necessary to re-evaluate the reliability of management's responses to the auditor's inquiries and management's representations to the auditor.

## Identified Significant Related Party Transactions outside the Entity's Normal Course of Business

### Evaluating the Business Rationale of Significant Related Party Transactions (Ref: Para. 23)

A38. In evaluating the business rationale of a significant related party transaction outside the entity's normal course of business, the auditor may consider the following:

- Whether the transaction:
  - Is overly complex (e.g., it may involve multiple related parties within a consolidated group).
  - Has unusual terms of trade, such as unusual prices, interest rates, guarantees and repayment terms.
  - Lacks an apparent logical business reason for its occurrence.
  - Involves previously unidentified related parties.
  - Is processed in an unusual manner.
- Whether management has discussed the nature of, and accounting for, such a transaction with those charged with governance.
- Whether management is placing more emphasis on a particular accounting treatment rather than giving due regard to the underlying economics of the transaction.

If management's explanations are materially inconsistent with the terms of the related party transaction, the auditor is required, in accordance with SA 500,[29] to consider the reliability of management's explanations and representations on other significant matters.

A39. The auditor may also seek to understand the business rationale of such a transaction from the related party's perspective, as this may help the auditor to better understand the economic reality of the transaction and why it was carried out. A business rationale from the related party's perspective that appears inconsistent with the nature of its business may represent a fraud risk factor.

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[29] Exposure Draft of SA 500, "Considering the Relevance and Reliability of Audit Evidence," has been published in the August, 2008 issue of the Journal.

Authorization and Approval of Significant Related Party Transactions (Ref: Para. 23(b))

A40. Authorisation and approval by management, those charged with governance, or, where applicable, the shareholders of significant related party transactions outside the entity's normal course of business may provide audit evidence that these have been duly considered at the appropriate levels within the entity and that their terms and conditions have been appropriately reflected in the financial statements. The existence of transactions of this nature that were not subject to such authorisation and approval, in the absence of rational explanations based on discussion with management or those charged with governance, may indicate risks of material misstatement due to error or fraud. In these circumstances, the auditor may need to be alert for other transactions of a similar nature. Authorisation and approval alone, however, may not be sufficient in concluding whether risks of material misstatement due to fraud are absent because authorisation and approval may be ineffective if there has been collusion between the related parties or if the entity is subject to the dominant influence of a related party.

Considerations specific to smaller entities

A41. A smaller entity may not have the same controls provided by different levels of authority and approval that may exist in a larger entity. Accordingly, when auditing a smaller entity, the auditor may rely to a lesser degree on authorization and approval for audit evidence regarding the validity of significant related party transactions outside the entity's normal course of business. Instead, the auditor may consider performing other audit procedures such as inspecting relevant documents, confirming specific aspects of the transactions with relevant parties, or observing the owner-manager's involvement with the transactions.

Assertions That Related Party Transactions Were Conducted on Terms Equivalent to Those Prevailing in an Arm's Length Transaction (Ref: Para. 24)

A42. Although audit evidence may be readily available regarding how the price of a related party transaction compares to that of a similar arm's length transaction, there are ordinarily practical difficulties that limit the auditor's ability

to obtain audit evidence that all other aspects of the transaction are equivalent to those of the arm's length transaction. For example, although the auditor may be able to confirm that a related party transaction has been conducted at a market price, it may be impracticable to confirm whether other terms and conditions of the transaction (such as credit terms, contingencies and specific charges) are equivalent to those that would ordinarily be agreed between independent parties. Accordingly, there may be a risk that management's assertion that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction may be materially misstated.

A43. Management is responsible for the substantiation of an assertion that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction. Management's support for the assertion may include:

- Comparing the terms of the related party transaction to those of an identical or similar transaction with one or more unrelated parties.
- Engaging an external expert to determine a market value and to confirm market terms and conditions for the transaction.
- Comparing the terms of the transaction to known market terms for broadly similar transactions on an open market.

A44. Evaluating management's support for this assertion may involve one or more of the following:

- Considering the appropriateness of management's process for supporting the assertion.
- Verifying the source of the internal or external data supporting the assertion, and testing the data to determine their accuracy, completeness and relevance.
- Evaluating the reasonableness of any significant assumptions on which the assertion is based.

A45. Some financial reporting frameworks require the disclosure of related party transactions not conducted on terms equivalent to those prevailing in arm's length transactions. In these circumstances, if management has not disclosed a related party transaction in the financial statements, there may be an implicit assertion that the transaction was conducted on terms equivalent to those prevailing in an arm's length transaction.

## Evaluation of the Accounting for and Disclosure of Identified Related Party Relationships and Transactions

### Materiality Considerations in Evaluating Misstatements (Ref: Para. 25)

A46. SA 450 requires the auditor to consider both the size and the nature of a misstatement, and the particular circumstances of its occurrence, when evaluating whether the misstatement is material.[30] The significance of the transaction to the financial statement users may not depend solely on the recorded amount of the transaction but also on other specific relevant factors, such as the nature of the related party relationship.

### Evaluation of Related Party Disclosures (Ref: Para. 25(a))

A47. Evaluating the related party disclosures in the context of the disclosure requirements of the applicable financial reporting framework means considering whether the facts and circumstances of the entity's related party relationships and transactions have been appropriately summarized and presented so that the disclosures are understandable. Disclosures of related party transactions may not be understandable if:

(a) The business rationale and the effects of the transactions on the financial statements are unclear or misstated; or

(b) Key terms, conditions, or other important elements of the transactions necessary for understanding them are not appropriately disclosed.

### Written Representations (Ref: Para. 26)

A48. Circumstances in which it may be appropriate to obtain written representations from those charged with governance include:

- When they have approved specific related party transactions that (a) materially affect the financial statements, or (b) involve management.
- When they have made specific oral representations to the auditor on

[30] Proposed SA 450, "Evaluation of Misstatements Identified during the Audit," paragraph 11(a). Paragraph A16 of SA 450 provides guidance on the circumstances that may affect the evaluation of a misstatement. Exposure Draft of SA 450 has been published in January, 2009 issue of the Journal.

details of certain related party transactions.

- When they have financial or other interests in the related parties or the related party transactions.
- Management's assertion of responsibility that related party transactions were conducted on terms equivalent to those prevailing in an arm's length transaction.

A49. The auditor may also decide to obtain written representations regarding specific assertions that management may have made, such as a representation that specific related party transactions do not involve undisclosed side agreements.

## Communication with Those Charged with Governance (Ref: Para. 27)

A50. Communicating significant matters arising during the audit[31] in connection with the entity's related parties helps the auditor to establish a common understanding with those charged with governance of the nature and resolution of these matters. Examples of significant related party matters include:

- Non-disclosure (whether intentional or not) by management to the auditor of related parties or significant related party transactions, which may alert those charged with governance to significant related party relationships and transactions of which they may not have been previously aware.
- The identification of significant related party transactions that have not been appropriately authorised and approved, which may give rise to suspected fraud.
- Disagreement with management regarding the accounting for and disclosure of significant related party transactions in accordance with the applicable financial reporting framework.
- Non-compliance with applicable law or regulations prohibiting or restricting specific types of related party transactions.
- Difficulties in identifying the party that ultimately controls the entity.

[31] SA 230 (Revised), "Audit Documentation", paragraph A8 provides further guidance on the nature of significant matters arising during the audit.

## Material Modifications vis a vis ISA 550, "Related Parties"

### Additions

1. In paragraph A20 of the Application Section, the lines, "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" have been added so to explain the difference between the control environment in the larger entities and smaller entities.

2. In paragraph A48 of the Application Section, it has been added that a written representation may be obtained by the auditor regarding management's assertion of responsibility that related party transactions were conducted on terms equivalent to those prevailing in an arm's length transaction.

### Deletions

1. Paragraph A8 of the Application Section of ISA 550 deals with the application of the requirement of ISA 550 to the audits of public sector entities regarding the effect of laws and regulations governing the public sector bodies on the auditor's responsibilities with regard to related party relationships and transactions. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of certain entities, the laws and regulations may also include a broader responsibility to address the risks of non-compliance with laws and regulations that lay down specific requirements in the conduct of business with related parties. Accordingly, the spirit of erstwhile A8, highlighting such additional responsibilities of the auditor, has been retained.

## Limited Revision Consequential to issuance of Revised Standard on Auditing (SA) 550, "Related Parties"

The proposed amendments to Standard on Auditing (SA) 315 have been shown in track change mode.

## SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment"

The Entity and Its Environment

11. The auditor shall obtain an understanding of the following:

(a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A15-A20)

(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. (Ref: Para. A21-A23)

(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. (Ref: Para. A24)

(d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A25-A31)

(e) The measurement and review of the entity's financial performance. (Ref: Para. A32- A37)

The following paragraphs are inserted after paragraph A23 in the Application and Other Explanatory Material section:

Nature of Special-Purpose Entities

A23a. A special-purpose entity (sometimes referred to as a special purpose vehicle) is an entity that is generally established for a narrow and well-defined purpose, such as to effect a lease or a securitisation of financial assets, or to carry out research and development activities. It may take the form of a corporation, trust, partnership or unincorporated entity. The entity on behalf of which the special-purpose entity has been created may often transfer assets to the latter (e.g., as part of a de-recognition transaction involving financial assets), obtain the right to use the latter's assets, or perform services for the latter, while other parties may provide the funding to the latter. As SA 550 indicates, in some circumstances, a special-purpose entity may be a related party of the entity.[32]

A23b. Financial reporting frameworks often specify detailed conditions that are deemed to amount to control, or circumstances under which the special-purpose entity should be considered for consolidation. The interpretation of the requirements of such frameworks often demands a detailed knowledge of the relevant agreements involving the special- purpose entity.

[32] Exposure Draft of SA 550, "Related Parties," paragraph A7.

# SA 560 (AAS 19)

## SUBSEQUENT EVENTS

***(Effective for all audits commencing on or after 1st April, 2000)***

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Standard on Auditing (SA) 560*, "Subsequent Events", should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in April, 2000.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard on Auditing (SA) is to establish standards on the auditor's responsibility regarding subsequent events. In this SA, the term "subsequent events" is used to refer to significant events occurring between the balance sheet date and the date of the auditor's report. In the context of audit of a component, such as a branch or division, of an entity "subsequent events" would refer to significant events upto the date of the report of the auditor of that component of the entity.

2. The auditor should consider the effect of subsequent events on the financial statements and on the auditor's report.

3. Accounting Standard (AS) 4, "Contingencies and Events Occurring After the Balance Sheet Date", issued by the Institute of Chartered Accountants of India, deals with the treatment in financial statements of events, both favourable and unfavourable, occurring between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company, and, by the corresponding approving authority in the case of any other entity. AS 4 identifies two types of events:

(a) those which provide further evidence of conditions that existed at the balance sheet date; and

(b) those which are indicative of conditions that arose subsequent to the balance sheet date.

## Audit Procedures

4. The auditor should perform procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified. These procedures are in addition to routine procedures which may be applied to specified transactions occurring after the balance sheet date to obtain audit evidence as to account balances as at the balance sheet date, for example, the testing of inventory cut-off and payments to creditors. The auditor is not, however, expected to conduct a continuing review of all matters to which previously applied procedures have provided satisfactory conclusions.

5. The procedures to identify events that may require adjustment of, or

disclosure in, the financial statements would be performed as near as practicable to the date of the auditor's report and ordinarily include the following:

- Reviewing procedures that the management has established to ensure that subsequent events are identified.
- Reading minutes of the meetings of shareholders, the board of directors and audit and executive committees held after the balance sheet date and inquiring about matters discussed at meetings for which minutes are not yet recorded.
- Reading the entity's latest available interim financial statements and, as considered necessary and appropriate, budgets, cash flow forecasts and other related management reports.
- Inquiring, or extending previous oral or written inquiries, of the entity's lawyers concerning litigation and claims.
- Inquiring of management as to whether any subsequent events have occurred after the balance sheet date which might affect the financial statements. Examples of inquiries of management on specific matters are:
  - The current status of items that were accounted for on the basis of preliminary or inconclusive data.
  - Whether there have been any developments regarding risk areas and contingencies.
  - Whether any unusual accounting adjustments have been made or are contemplated.
  - Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.

6. When a component, such as a division or a branch, of an entity, has already been audited by another auditor, the principal auditor would make similar enquiries as set out in para 5 in respect of events, occurring between the date of signing of the report of the auditor of the component of the entity and signing of his report.

7. When the auditor becomes aware of events which materially affect the financial statements, the auditor should consider whether such events are properly accounted for in the financial statements. When the management does not account for such events that the auditor believes should be accounted for, the auditor should express a qualified opinion or an adverse opinion, as appropriate.

## Effective Date

8. This Standard on Auditing becomes operative for all audits commencing on or after 1st April, 2000.

# Standard on Auditing (SA) 560 (Revised)*
# Subsequent Events

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Standard on Auditing (SA) 560 (Revised), "Subsequent Events" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services[1]," which sets out the authority of SAs.

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* Earlier known as Standard on Auditing (SA) 560 (AAS 19), "Subsequent Events".

[1] Published in the July, 2007 issue of the Journal.

# Introduction

## Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. (Ref: Para. A1)

2. Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks[2] 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.

[Proposed] SA 700 (Revised) explains that the date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor becomes aware and that occurred up to that date.[3]

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[2] ISA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with International Standards on Auditing", Paragraph 13 (a) defines the applicable financial reporting framework as "The financial reporting framework adopted by management and, where appropriate, those charged with governance 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.

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".

[3] Standard on Auditing (SA) 700 (AAS 28), "The Auditor's Report on Financial Statements," paragraph 25.

### Effective Date

3. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

## Objectives

4. 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.

## Definitions

5. For purposes of the SAs, the following terms have the meanings attributed below:

(a) Date of the financial statements – The date of the end of the latest period covered by the financial statements.

(b) Date of approval of the financial statements – The date on which all the statements that comprise the financial statements have been prepared and those with the recognised authority have asserted that they have taken responsibility for those financial statements. (Ref: Para. A2)

(c) Date of the auditor's report – The date the auditor dates the report on the financial statements in accordance with SA 700 (Revised). (Ref: Para. A3)

(d) Date the financial statements are issued – The date that the auditor's report and audited financial statements are made available to third parties. (Ref: Para. A4-A5)

(e) 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.

## Requirements

### Events Occurring Between the Date of the Financial Statements and the Date of the Auditor's Report

6. 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. (Ref: Para. A6)

7. The auditor shall perform the procedures required by paragraph 6 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: (Ref: Para. A7-A8)

(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. (Ref: Para. A9)

(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. (Ref: Para. A10)

(d) Reading the entity's latest subsequent interim financial statements, if any.

8. When, as a result of the procedures performed as required by paragraphs 6 and 7, 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.

## Written Representations

9. The auditor shall request management and, where appropriate, those charged with governance, to provide a written representation in accordance with SA 580[4] (Revised), "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.

## Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued

10. 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: (Ref: Para. A11)

(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.

[4] Published in October, 2008 issue of the Journal.

11. 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 paragraph 12 apply:

(i) Extend the audit procedures referred to in paragraphs 6 and 7 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.

12. 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 required in paragraph 11(b)(i) 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 (Ref: Para. A12)

(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.

13. 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: (Ref: Para. A13-A14)

(a) If the auditor's report has not yet been provided to the entity, the auditor shall modify the opinion as required by [proposed] SA 705[5] 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. (Ref: Para. A15-A16)

## Facts Which Become Known to the Auditor After the Financial Statements have been Issued

14. 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,

[5] At present, there is no separate Standard on Auditing (SA) corresponding to International Standard on Auditing (ISA) 705. However, the concept of modified audit report has been discussed in SA 700, "The Auditor's Report on Financial Statements". The Auditing and Assurance Standards Board will issue an Exposure Draft of the Standard on Auditing (SA) corresponding to International Standard on Auditing (ISA) 705, "Modifications to the Opinion in the Independent Auditor's Report" in the near future.

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

15. If the management amends the financial statements, the auditor shall: (Ref: Para. A17)

(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 the circumstances in paragraph 12 apply:

(i) Extend the audit procedures referred to in paragraphs 6 and 7 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 in paragraph 12 apply, amend the auditor's report, or provide a new auditor's report as required by paragraph 12.

16. 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.

17. 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. (Ref: Para. A18)

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## Application and Other Explanatory Material

### Introduction (Ref: Para. 1)

A1. When the audited financial statements are included in other documents subsequent to the issuance of the financial statements, the auditor may have additional responsibilities relating to subsequent events that the auditor may need to consider, such as legal or regulatory requirements involving the offering of securities to the public in jurisdictions in which the securities are being offered. For example, the auditor may be required to perform additional audit procedures to the date of the final offering document. These procedures may include those referred to in paragraphs 6 and 7 performed up to a date at or near the effective date of the final offering document, and reading the offering document to assess whether the other information in the offering document is consistent with the financial information with which the auditor is associated.

### Definitions

#### Date of Approval of the Financial Statements (Ref: Para. 5(b))

A2. In some entities, the applicable law or regulation identifies the individuals or bodies (for example, management or those charged with governance) that are responsible for concluding that all the statements comprising the financial statements have been prepared, and specifies the necessary approval process. In some other entities, the approval process is not prescribed in law or regulation and the entity follows its own procedures in preparing and finalising its financial statements in view of its management and

governance structures. In some cases, final approval of the financial statements by shareholders is required. In such cases, final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements has been obtained. The date of approval of the financial statements for purposes of the SAs is the earlier date on which those with the recognised authority have asserted that all the statements comprising the financial statements have been prepared and that those with the recognised authority have taken responsibility for those financial statements.

Date of the Auditor's Report (Ref: Para. 5(c))

A3. The auditor's report cannot be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements.[6] Sufficient appropriate audit evidence includes evidence that all the statements that comprise the financial statements have been prepared and that those with the recognised authority have asserted that they have taken responsibility for those financial statements. Consequently, the date of the auditor's report cannot be earlier than the date of approval of the financial statements as defined in paragraph 5(b). A time period may elapse due to administrative issues between the date of the auditor's report as defined in paragraph 5(c) and the date the auditor's report is provided to the entity.

Date the Financial Statements are Issued (Ref: Para. 5(d))

A4. 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

[6] Standard on Auditing (SA) 700 (AAS 28), paragraph [24] states that in addition to an opinion on the true and fair view, the auditor's report may need to include an opinion as to whether the financial statements comply with other requirements specified by relevant statutes or law.

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.

A5. In the case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the date the financial statements are issued may be the date the audited financial statements and the auditor's report thereon are presented to the legislature or otherwise made public.

## Events Occurring Between the Date of the Financial Statements and the Date of the Auditor's Report (Ref: Para. 6-9)

A6. Depending on the auditor's risk assessment, the audit procedures required by paragraph 6 may include procedures, necessary to obtain sufficient appropriate audit evidence, involving the review or testing of accounting records or transactions occurring between the date of the financial statements and the date of the auditor's report. The audit procedures required by paragraphs 6 and 7 are in addition to procedures that the auditor may perform for other purposes that, nevertheless, may provide evidence about subsequent events (for example, to obtain audit evidence for account balances as at the date of the financial statements, such as cut-off procedures or procedures in relation to subsequent receipts of accounts receivable).

A7. Paragraph 7 stipulates certain audit procedures in this context that the auditor is required to perform pursuant to paragraph 6. The subsequent events procedures that the auditor performs may, however, depend on the information that is available and, in particular, the extent to which the accounting records have been prepared since the date of the financial statements. When the accounting records are not up-to-date, and accordingly no interim financial statements (whether for internal or external purposes) have been prepared, or minutes of meetings of management or those charged with governance have not been prepared, relevant audit procedures may take the form of inspection of available books and records, including bank statements. Paragraph A8 gives examples of some of the additional matters that the auditor may consider in the course of these inquiries.

A8. In addition to the audit procedures required by paragraph 7, the auditor may consider it necessary and appropriate to:

- Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements;

- Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims; or
- Consider whether written representations covering particular subsequent events may be necessary to support other audit evidence and thereby obtain sufficient appropriate audit evidence.

Inquiry (Ref: Para. 7(b))

A9. In inquiring of management and, where appropriate, those charged with governance, as to whether any subsequent events have occurred that might affect the financial statements, the auditor may inquire as to the current status of items that were accounted for on the basis of preliminary or inconclusive data and may make specific inquiries about the following matters:

- Whether new commitments, borrowings or guarantees have been entered into.

- Whether sales or acquisitions of assets have occurred or are planned.
- Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
- Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.
- Whether there have been any developments regarding contingencies.
- Whether any unusual accounting adjustments have been made or are contemplated.

- Whether any events have occurred or are likely to occur that will bring into question the appropriateness of accounting policies used in the financial statements, as would be the case, for example, if such events call into question the validity of the going concern assumption.
- Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
- Whether any events have occurred that are relevant to the recoverability of assets.

Reading Minutes (Ref: Para. 7(c))

A10. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the auditor may read the official records of relevant proceedings of the legislature and inquire about matters addressed in proceedings for which official records are not yet available.

## Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued

Management Responsibility Towards Auditor (Ref: Para. 10)

A11. As agreed in the terms of the audit engagement, management has a responsibility to inform the auditor of relevant facts of which it becomes aware during the period from the date of the auditor's report to the date the financial statements are issued.[7]

Dual Dating (Ref: Para. 12(a))

A12. When, in the circumstances described in paragraph 12(a), the auditor

[7] Currently Standard on Auditing (SA) 210 (AAS 26), "Terms of Audit Engagements" is in force. The Auditing and Assurance Standards Board (AASB) has issued the Exposure Draft of Revised SA 210, "Agreeing the Terms of Audit Engagements", which has been published in the November, 2008 issue of the Journal and has also been hosted at the website of the Institute.

amends the auditor's report to include an additional date restricted to that amendment, the date of the auditor's report on the financial statements prior to their subsequent amendment by management remains unchanged because this date informs the reader as to when the audit work on those financial statements was completed. However, an additional date is included in the auditor's report to inform users that the auditor's procedures subsequent to that date were restricted to the subsequent amendment of the financial statements. The following is an illustration of such an additional date:

> "(Date of auditor's report), except as to Note Y, which is as of (date of completion of audit procedures restricted to amendment described in Note Y)".

No Amendment of Financial Statements by Management (Ref: Para. 13)

A13. In some entities, management may not be required by the applicable law, regulation or the financial reporting framework to issue amended financial statements. This is often the case when issuance of the financial statements for the following period is imminent, provided appropriate disclosures are made in such statements.

A14. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the actions taken in accordance with paragraph 13 when management does not amend the financial statements may also include reporting separately to the legislature, or other relevant body in the reporting hierarchy, on the implications of the subsequent event for the financial statements and the auditor's report.

Auditor Action to Seek to Prevent Reliance on Auditor's Report (Ref: Para. 13(b))

A15. The auditor may need to fulfill additional legal obligations even when the auditor has notified management not to issue the financial statements and management has agreed to this request.

A16. When management has issued the financial statements despite the auditor's notification not to issue the financial statements to third parties, the auditor's course of action to prevent reliance on the auditor's report on the financial statements depends upon the auditor's legal rights and obligations. Consequently, the auditor may consider it appropriate to seek legal advice.

### Facts Which Become Known to the Auditor After the Financial Statements have been Issued

#### No Amendment of Financial Statements by Management (Ref: Para. 15)

A17. In some circumstances, the entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions) may be prevented from issuing amended financial statements by law or regulation. In such circumstances, the appropriate course of action for the auditor may be to report to the appropriate statutory body.

#### Auditor Action to Seek to Prevent Reliance on Auditor's Report (Ref: Para. 17)

A18. When the auditor believes that management, or those charged with governance, have failed to take the necessary steps to prevent reliance on the auditor's report on financial statements previously issued by the entity despite the auditor's prior notification that the auditor will take action to seek to prevent such reliance, the auditor's course of action depends upon the auditor's legal rights and obligations. Consequently, the auditor may consider it appropriate to seek legal advice.

## Material Modifications to ISA 560, "Subsequent Events"

### Deletion

1. Paragraph A5 of ISA 560 provides that in the case of public sector entities, the date the financial statements are issued may be the date the audited financial statements and the auditor's report thereon are presented to the legislature or otherwise made public. Paragraph A10 of ISA 560 provides

that in the case of public sector, the auditor may read the official records of relevant proceedings of the legislature and inquire about matters addressed in proceedings for which official records are not yet available. Paragraph A14 of ISA 560 provides that in the case of public sector, the actions taken in accordance with paragraph 13 of ISA when management does not amend the financial statements may also include reporting separately to the legislature, or other relevant body in the reporting hierarchy, on the implications of the subsequent event for the financial statements and the auditor's report. Paragraph A17 of ISA 560 provides that in some circumstances, the entities in the public sector may be prevented from issuing amended financial statements by law or regulation. In such circumstances, the appropriate course of action for the auditor may be to report to the appropriate statutory body. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such situations may also exist in case of certain entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A5, A10, A14 and A17, highlighting such fact, has been retained though a specific reference to public sector entities has been deleted.

# SA 570 (AAS 16)

## GOING CONCERN

***(Effective for all audits relating to accounting periods beginning on or after April 1, 1999)***

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Standard on Auditing (SA) 570*, "Going Concern" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in October, 1998.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard on Auditing (SA) is to establish standards on the auditor's responsibilities in the audit of financial statements regarding the appropriateness of the going concern assumption as a basis for the preparation of the financial statements.

2. When planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption underlying the preparation of the financial statements.

3. The auditor's report helps establish the credibility of the financial statements. However, the auditor's report is not a guarantee as to the future viability of the entity.

4. An entity's continuance as a going concern for the foreseeable future, generally a period not to exceed one year after the balance sheet date, is assumed in the preparation of financial statements in the absence of information to the contrary. Accordingly, 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. If this assumption is unjustified, the entity may not be able to realize its assets at the recorded amounts and there may be changes in the amounts and maturity dates of liabilities. As a consequence, the amounts and classification of assets and liabilities in the financial statements may need to be adjusted.

## Appropriateness of the Going Concern Assumption

5. The auditor should consider the risk that the going concern assumption may no longer be appropriate.

6. Indications of risk that continuance as a going concern may be questionable could come from the financial statements or from other sources. Examples of such indications that would be considered by the auditor are listed below. This listing is not all-inclusive nor does the existence of one or more always signify that the going concern assumption needs to be questioned.

### Financial Indications

- Negative net worth or negative working capital.

- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment, or excessive reliance on short-term borrowings to finance long-term assets.
- Adverse key financial ratios.
- Substantial operating losses.
- Substantial negative cash flows from operations.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Difficulty in complying 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.
- Entering into a scheme of arrangement with creditors for reduction of liability.

Operating Indications

- Loss of key management without replacement.
- Loss of a major market, franchise, licence, or principal supplier.
- Labour difficulties or shortages of important supplies.

Other Indications

- Non-compliance with capital or other statutory requirements.
- Pending legal proceedings against the entity that may, if successful, result in judgments that could not be met.
- Changes in legislation or government policy.
- Sickness of the entity under any statutory definition.

7. The significance of such indications can often be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counterbalanced by management's plans to maintain adequate cash flows by alternative means, such as by disposal of assets, rescheduling of loan repayments, obtaining additional capital or

having funding arrangements backed by government. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

## Audit Evidence

8. When a question arises regarding the appropriateness of the going concern assumption, the auditor should gather sufficient appropriate audit evidence to attempt to resolve, to the auditor's satisfaction, the question regarding the entity's ability to continue in operation for the foreseeable future.

9. During the course of the audit, the auditor carries out audit procedures designed to obtain audit evidence as the basis for the expression of an opinion on the financial statements. When a question arises regarding the going concern assumption, certain of these procedures may take on additional significance or it may be necessary to perform additional procedures or to update information obtained earlier. Procedures that are relevant in this connection may include:

- Analyse and discuss cash flow, profit and other relevant forecasts with management.
- Review events after the balance sheet date for items affecting the entity's ability to continue as a going concern.
- Analyse and discuss the entity's latest available interim financial statements.
- Review the terms of debentures and loan agreements and determine whether any have been breached.
- Read minutes of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties.
- Review the status of matters under litigation and claims.
- Confirm the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assess the financial ability of such parties to provide additional funds.
- Consider the entity's position concerning unfilled customer orders.

10. When analysing cash flow, profit and other relevant forecasts, the

auditor would consider the reliability of the entity's system for generating such information. The auditor would also consider whether the assumptions underlying the forecast appear appropriate in the circumstances. In addition, the auditor would compare the prospective data for recent prior periods with historical results, and would compare the prospective data for the current period with results achieved to date.

11. The auditor would also consider and discuss with management its plans for future action, such as plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditure, or increase capital. The relevance of such plans to an auditor generally decreases as the time period for planned actions and anticipated events increases. Particular emphasis is ordinarily placed on plans that might have a significant effect on the entity's solvency within the foreseeable future. The auditor would obtain sufficient appropriate audit evidence that these plans are feasible, are likely to be implemented and that the outcome of these plans will improve the situation. The auditor would ordinarily seek written representations from management regarding these plans.

## Audit Conclusions and Reporting

12. After the procedures considered necessary have been carried out, all the information required has been obtained, and the effect of any plans of management and other mitigating factors have been considered, the auditor would decide whether the question raised regarding the going concern assumption has been satisfactorily resolved.

### Going Concern Assumption Considered Appropriate

13. If, in the auditor's judgement, sufficient appropriate audit evidence has been obtained to support the going concern assumption, the auditor would not qualify his report on this account.

14. If, in the auditor's judgement, the going concern assumption is appropriate because of mitigating factors, in particular management's plans for future action, the auditor should consider whether such plans or other factors need to be disclosed in the financial statements. Where the auditor concludes that such plans or other factors need to be disclosed, but have not been adequately disclosed, the auditor should express a qualified or adverse opinion, as appropriate.

Going Concern Question not Resolved

15. If, in the auditor's judgement, the going concern question is not satisfactorily resolved, the auditor would consider whether the financial statements:

(a) adequately describe the principal conditions that raise substantial doubt about the entity's ability to continue in operation for the foreseeable future;

(b) state that there is significant uncertainty that the entity will be able to continue as a going concern and, therefore, may be unable to realise its assets and discharge its liabilities in the normal course of business; and

(c) state that the financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts, or to amounts and classification of liabilities that may be necessary if the entity is unable to continue as a going concern.

Provided the disclosure is considered adequate, the auditor would not express a qualified or adverse opinion.

16. If adequate disclosure is made in the financial statements, the auditor should ordinarily express an unqualified opinion. However, he should, in his report, add a paragraph that highlights the going concern problem by drawing attention to the note in the financial statements that discloses the matters set out in paragraph 15. The following is an example of such a paragraph:

> "We draw attention to Note X in the financial statements. The Company incurred a net loss of Rs. XXX during the year ended March 31, 19X1 and, as of that date, the Company's current liabilities exceeded its current assets by Rs. XXX and its total liabilities exceeded its total assets by Rs. XXX. These factors, along with other matters as set forth in Note X, raise substantial doubt that the Company will be able to continue as a going concern."

The auditor is not precluded from expressing a disclaimer of opinion for a going concern uncertainty.

17. If adequate disclosure is not made in the financial statements, the auditor should express a qualified or adverse opinion, as appropriate.

The following is an example of the explanation and opinion paragraphs when a qualified opinion is to be expressed:

> "The Company has been unable to renegotiate its borrowings from its bankers. Without such financial support there is substantial doubt that it will be able to continue as a going concern. Consequently, adjustments may be required to the recorded asset amounts and classification of liabilities. The financial statements (and notes thereto) do not disclose this fact.
>
> In our opinion, subject to the omission of the information dealt with in the preceding paragraph, the financial statements give a true and fair view of the financial position of the Company at March 31, 19X1 and the results of its operations for the year then ended."

### Going Concern Assumption Considered Inappropriate

18. If, on the basis of the additional procedures carried out and the information obtained, including the effect of mitigating circumstances, the auditor's judgment is that the entity will not be able to continue in operation for the foreseeable future, the auditor would conclude that the going concern assumption used in the preparation of the financial statements is inappropriate. If the result of the inappropriate assumption used in the preparation of the financial statements is so material and pervasive as to make the financial statements misleading, the auditor should express an adverse opinion.

## Effective Date

19. This Standard on Auditing becomes operative for all audits relating to accounting periods beginning on or after April 1, 1999.

# GENERAL CLARIFICATION (GC)–AASB/3/2004 ON SA 570

## Standard on Auditing (SA) 570, "Going Concern"

{The following is the General Clarification (GC)–AASB/3/2004 issued by the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India on Standard on Auditing (SA) 570, "Going Concern".}

1. The Companies (Amendment) Act, 2000 has mandated that every private company existing on 13th December 2000 with a paid-up capital of less than one lakh rupees, shall, within a period of two years from such commencement enhance its paid up capital to one lakh rupees. Similarly, every public company existing on 13th December 2000 with a paid-up capital of less than five lakh rupees, shall, within a period of two years from such commencement enhance its paid up capital to five lakh rupees. Where a private company or a public company fails to enhance the paid-up capital to the statutory minimum, as mentioned above, such company shall be deemed a defunct company within the meaning of section 560 of the Companies Act, 1956 and its name shall be struck off from the register by the Registrar.

2. Paragraphs 5 and 6 of Standard on Auditing (SA) 570, "Going Concern" provide as follows:

> "5. The auditor should consider the risk that the going concern assumption may no longer be appropriate.
>
> 6. Indications of risk that continuance as a going concern may be questionable could come from the financial statements or from other sources."

3. Further, SA 570 also mentions that non-compliance with capital or other statutory requirements could be an example of an indication of risk that the going concern assumption may no longer be appropriate.

4. If a company fails to enhance its paid-up capital up to the statutory minimum, such company shall be deemed a defunct company within the meaning of section 560 of the Companies Act, 1956 and therefore, its name shall be struck off from the register by the Registrar of Companies. However,

such an entity may decide not to carry on business or may decide to carry on the business in some other form of organisation, e.g., partnership, etc. This situation gives rise to the risk that the going concern assumption may no longer be appropriate.

5. The auditor, in such a situation, performs the audit procedures as required by the Standard on Auditing (SA) 570, "Going Concern". Unless, the entity under audit demonstrates otherwise, the auditor should consider the going concern assumption as inappropriate and report in accordance with paragraph 18 of SA 570.

# Standard on Auditing (SA) 570 (Revised)
# Going Concern[3]

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[3] Hitherto known as SA 570 (AAS 16), "Going Concern".

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Material Modifications to ISA 570, Going Concern

Standard on Auditing (SA) 570 (Revised), "Going Concern" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[4] which sets out the authority of SAs.

[4] Published in the July, 2007 issue of the Journal.

# Introduction

## Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility in the audit of financial statements with respect to management's use of the going concern assumption in the preparation and presentation of the financial statements.

## Going Concern Assumption

2. Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. Special purpose financial statements[5] may or may not be prepared in accordance with a financial reporting framework[6] for which the going concern basis is relevant. When

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[5] Financial Statements prepared and presented in accordance with a financial reporting framework designed to meet the financial information needs of specific users are referred to as special purpose financial statements. Examples of special purpose financial statements include:

(i) financial statements which are prepared in addition to general purpose financial statements;

(ii) financial statements prepared in compliance with requirements of any agreement or statute or regulation; or

(iii) financial information given in special purpose formats or schedules.

[6] ISA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing" defines the term, 'Applicable financial reporting framework' as follows:

"The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation and presentation of the financial statements that is acceptable in view of the nature of the entity and the objectives of the financial statements, or that is required by law or regulation.

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 acknowledgements in (i) or (ii) above."

the use of the going concern assumption 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. (Ref: Para. A1)

## Responsibilities of Management

3. Some financial reporting frameworks contain an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern, and standards regarding matters to be considered and disclosures to be made in connection with going concern. The financial reporting framework may require the management to make an assessment of the entity's ability to continue as a going concern and prepare the financial statements on a going concern basis unless the management intends to liquidate the entity or cease operations, or has no realistic alternative but to do so. In case the financial statements have not been prepared on a going concern basis, the fact would need to be appropriately disclosed, together with the basis on which the financial statements are prepared and the reason why the entity is not regarded as a going concern[7].The detailed requirements regarding management's responsibility to assess the entity's ability to continue as a going concern and related financial statement disclosures may also be set out in law or regulation.

4. In other financial reporting frameworks, there may be no explicit requirement for management to make a specific assessment of the entity's ability

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[5] In India, Section 217(2AA) of the Companies Act, 1956 inter alia requires the directors to make a specific assertion in their Directors' Responsibility Statement under this section that "the directors had prepared the annual accounts on a going concern basis". Further, paragraph 9 of the Accounting Standard (AS) 1, "Disclosure of Accounting Policies", states as follows:

"Fundamental Accounting Assumptions

9. Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed".

Further, paragraph 10 of AS 1 states as follows:

"The following have been generally accepted as fundamental accounting assumptions:-

a. Going Concern

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…."

to continue as a going concern. Nevertheless, since the going concern assumption is a fundamental principle in the preparation of financial statements as discussed in paragraph 2, management's responsibility for the preparation and presentation of the financial statements includes a responsibility 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.

5. 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. For that reason, financial reporting frameworks normally require an explicit management assessment specify the period for which management is required to take into account all available information.

- 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.

## Responsibilities of the Auditor

6. The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. This responsibility exists 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.

7. However, as described in SA 200,[8] 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 going concern uncertainty in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

### Effective Date

8. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

## Objectives

9. The objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation 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 determine the implications for the auditor's report.

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[8] SA 200 (AAS 1), "Basic Principles Governing an Audit" and SA 200A (AAS 2), "Objective and Scope of the Audit of Financial Statements" correspond to International Standard on Auditing (ISA) 200 (Revised and Redrafted). Both the SAs are currently being revised in the light of the ISA 200 (Revised and Redrafted). Post this revision, the principles covered by SA 200 (AAS 1) and SA 200A (AAS 2) will be merged into one standard, i.e., SA 200.

## Requirements

### Risk Assessment Procedures and Related Activities

10. When performing risk assessment procedures as required by SA 315,[9] the auditor shall consider whether there are events or conditions 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: (Ref: Para. A2-A5)

(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 assumption, 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.

11. 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. (Ref: Para. A6)

### Evaluating Management's Assessment

12. The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern. (Ref: Para. A7-A9; A11-A12)

13. 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

[9] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 5.

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 as defined in SA 560,[10] the auditor shall request management to extend its assessment period to at least twelve months from that date. (Ref: Para. A10-A12)

14. In evaluating management's assessment, the auditor shall consider whether management's assessment includes all relevant information of which the auditor is aware as a result of the audit.

## Period Beyond Management's Assessment

15. The auditor shall inquire of management as to its knowledge of events or conditions beyond the period of management's assessment that may cast significant doubt on the entity's ability to continue as a going concern. (Ref: Para. A13-A14)

## Additional Audit Procedures When Events or Conditions Are Identified

16. When 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 through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include: (Ref: Para. A15)

(a) When management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.

[10] The Council at its 282nd meeting held in November, 2008 has approved Revised SA 560, "Subsequent Events" which is effective for audits of financial statements for periods beginning on or after April 1, 2009.

(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. (Ref: Para. A16)

(c) When 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 action: (Ref: Para. A17-A18)

(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 or, where appropriate, those charged with governance, regarding their plans for future action and the feasibility of these plans.

## Audit Conclusions and Reporting

17. 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 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. (Ref: Para. A19)

## Use of Going Concern Assumption Appropriate but a Material Uncertainty Exists

18. When the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:

(a) Adequately describe 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 realise its assets and discharge its liabilities in the normal course of business. (Ref: Para. A20)

19. If adequate disclosure is made in the financial statements, the auditor shall express an unmodified opinion and include an Emphasis of Matter paragraph in the auditor's report to:

(a) Highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and to

(b) Draw attention to the note in the financial statements that discloses the matters set out in paragraph 18. (See SA 706[11]) (Ref: Para. A21-A22)

20. If adequate disclosure is not made in the financial statements, the auditor shall express a qualified or adverse opinion, as appropriate (See SA 705 [12]). The

[11] Presently, SA 700 (AAS 28), "The Auditor's Report on Financial Statements" deals with this aspect. The AASB proposes to issue an Exposure Draft of the proposed new Standard SA 706, "Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report" based on the corresponding International Standard on Auditing in the near future.

[12] Presently, SA 700 (AAS 28), "The Auditor's Report on Financial Statements" deals with this aspect. The AASB proposes to issue an Exposure Draft of the proposed new Standard SA 705, "Modifications to the Opinion in the Independent Auditor's Report" based on the corresponding International Standard on Auditing in the near future.

auditor shall state in the auditor's report that there is a material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern. (Ref: Para. A23-A24)

### Use of Going Concern Assumption Inappropriate

21. If the financial statements have been prepared on a going concern basis but, in the auditor's judgment, management's use of the going concern assumption in the financial statements is inappropriate, the auditor shall express an adverse opinion. (Ref: Para. A25-A26)

### Management Unwilling to Make or Extend Its Assessment

22. 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. (Ref: Para. A27)

### Communication with Those Charged with Governance

23. Unless all those charged with governance are involved in managing the entity, the auditor shall communicate with those charged with governance events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern. Such communication with those charged with governance shall include the following:

(a) Whether the events or conditions constitute a material uncertainty;

(b) Whether the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements; and

(c) The adequacy of related disclosures in the financial statements.

### Significant Delay in the Approval of Financial Statements

24. When there is significant delay in the approval of the financial statements by management or those charged with governance after the date of the financial statements, the auditor shall inquire as to the reasons for the delay. When the

auditor believes that the delay could be related to events or conditions relating to the going concern assessment, the auditor shall perform those additional audit procedures necessary, as described in paragraph 16, as well as consider the effect on the auditor's conclusion regarding the existence of a material uncertainty, as described in paragraph 17.

## Application and Other Explanatory Material

### Introduction

#### Going Concern Assumption (Ref: Para. 2)

A1. In some enterprises, for example, those where the funding arrangements are guaranteed by the Central Government, going concern risks may arise, but are not limited to, situations where such type of entities operate on a for-profit basis, where government support may be reduced or withdrawn, or in the case of privatisation. Events or conditions that may cast significant doubt on an entity's ability to continue as a going concern may include situations where such type of entity lacks funding for its continued existence or when policy decisions are made that affect the services provided by such an entity.

### Risk Assessment Procedures and Related Activities

#### Events or Conditions That May Cast Doubt about Going Concern Assumption (Ref: Para. 10)

A2. The following are examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. This listing is not all-inclusive nor does the existence of one or more of the items always signify that a material uncertainty exists.

Financial

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of

renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.

- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating

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

Other

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if

successful, result in claims that the entity is unlikely to be able to satisfy.

- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

A3. The risk assessment procedures required by paragraph 10 help the auditor to determine whether management's use of the going concern assumption is likely to be an important issue and its impact on planning the audit. These procedures also allow for more timely discussions with management, including a discussion of management's plans and resolution of any identified going concern issues.

Considerations Specific to Smaller Entities

A4. The size of an entity may affect its ability to withstand adverse conditions. Small entities may be able to respond quickly to exploit opportunities, but may lack reserves to sustain operations.

A5. Conditions of particular relevance to small entities include the risk that banks and other lenders may cease to support the entity, as well as the possible loss of a principal supplier, major customer, key employee, or the right to operate under a license, franchise or other legal agreement.

Remaining Alert throughout the Audit for Audit Evidence about Events or Conditions (Ref: Para. 11)

A6. SA 315 requires the auditor to revise the auditor's risk assessment and modify the further planned audit procedures accordingly when additional audit evidence is obtained during the course of the audit that affects the auditor's assessment of risk.[13] If events or conditions that may cast significant doubt on the entity's ability to continue as a going concern are identified after the auditor's risk assessments are made, in addition to performing the procedures in paragraph 16, the auditor's assessment of the risks of material misstatement may need to be revised. The existence of such events or conditions may also affect the nature, timing and extent of the auditor's further procedures in response to the assessed risks. SA 330[14] establishes requirements and provides guidance on this issue.

## Evaluating Management's Assessment

### Management's Assessment and Supporting Analysis and the Auditor's Evaluation (Ref: Para. 12)

A7. 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 assumption.

A8. 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 assumption 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

[13] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 30.

[14] SA 330, "The Auditor's Responses to Assessed Risks".

management's use of the going concern assumption in the preparation of the financial statements is appropriate in the circumstances.

A9. In other circumstances, evaluating management's assessment of the entity's ability to continue as a going concern, as required by paragraph 12, 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.

The Period of Management's Assessment (Ref: Para. 13)

A10. Most financial reporting frameworks requiring an explicit management assessment specify the period for which management is required to take into account all available information.

Considerations Specific to Smaller Entities (Ref: Para. 12-13)

A11. In many cases, the management of smaller entities may not have prepared a detailed assessment of the entity's ability to continue as a going concern, but instead may rely on in-depth knowledge of the business and anticipated future prospects. Nevertheless, in accordance with the requirements of this SA, the auditor needs to evaluate management's assessment of the entity's ability to continue as a going concern. For smaller entities, it may be appropriate to discuss the medium and long-term financing of the entity with management, provided that management's contentions can be corroborated by sufficient documentary evidence and are not inconsistent with the auditor's understanding of the entity. Therefore, the requirement in paragraph 13 for the auditor to request management to extend its assessment may, for example, be satisfied by discussion, inquiry and inspection of supporting documentation, for example, orders received for future supply, evaluated as to their feasibility or otherwise substantiated.

A12. Continued support by owner-managers is often important to smaller entities' ability to continue as a going concern. Where a small entity is largely

financed by a loan from the owner-manager, it may be important that these funds are not withdrawn. For example, the continuance of a small entity in financial difficulty may be dependent on the owner-manager subordinating a loan to the entity in favour of banks or other creditors, or the owner-manager supporting a loan for the entity by providing a guarantee with his or her personal assets as collateral. In such circumstances the auditor may obtain appropriate documentary evidence of the subordination of the owner-manager's loan or of the guarantee. Where an entity is dependent on additional support from the owner-manager, the auditor may evaluate the owner-manager's ability to meet the obligation under the support arrangement. In addition, the auditor may request written confirmation of the terms and conditions attaching to such support and the owner-manager's intention or understanding.

### Period Beyond Management's Assessment (Ref: Para. 15)

A13. As required by paragraph 11, the auditor remains alert to the possibility that there may be known events, scheduled or otherwise, or conditions that will occur beyond the period of assessment used by management that may bring into question the appropriateness of management's use of the going concern assumption in preparing the financial statements. Since the degree of uncertainty associated with the outcome of an event or condition increases as the event or condition is further into the future, in considering events or conditions further in the future, the indications of going concern issues need to be significant before the auditor needs to consider taking further action. If such events or conditions are identified, the auditor may need to request management to evaluate the potential significance of the event or condition on its assessment of the entity's ability to continue as a going concern. In these circumstances the procedures in paragraph 16 apply.

A14. Other than inquiry of management, the auditor does not have a responsibility to perform any other audit procedures to identify events or conditions that may cast significant doubt on the entity's ability to continue as a going concern beyond the period assessed by management, which, as discussed in paragraph 13, would be at least twelve months from the date of the financial statements.

## Additional Audit Procedures When Events or Conditions Are Identified (Ref: Para. 16)

A15. Audit procedures that are relevant to the requirement in paragraph 16 may include the following:

- Analysing and discussing cash flow, profit and other relevant forecasts with management.
- Analysing and discussing the entity's latest available interim financial statements.
- Reading the terms of debentures and loan agreements and determining whether any have been breached.
- Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
- Inquiring of the entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.
- Evaluating the entity's plans to deal with unfilled customer orders.
- Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.
- Confirming the existence, terms and adequacy of borrowing facilities.
- Obtaining and reviewing reports of regulatory actions.
- Determining the adequacy of support for any planned disposals of assets.

### Evaluating Management's Plans for Future Actions (Ref: Para. 16(b))

A16. Evaluating management's plans for future actions may include inquiries of

management as to its plans for future action, including, for example, its plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital.

The Period of Management's Assessment (Ref: Para. 16(c))

A17. In addition to the procedures required in paragraph 16(c), the auditor may compare:

- The prospective financial information for recent prior periods with historical results; and
- The prospective financial information for the current period with results achieved to date.

A18. Where management's assumptions include continued support by third parties, whether through the subordination of loans, commitments to maintain or provide additional funding, or guarantees, and such support is important to an entity's ability to continue as a going concern, the auditor may need to consider requesting written confirmation (including of terms and conditions) from those third parties and to obtain evidence of their ability to provide such support.

## Audit Conclusions and Reporting (Ref: Para. 17)

A19. The phrase "material uncertainty" means the uncertainties related to events or conditions which may cast significant doubt on the entity's ability to continue as a going concern that should be disclosed in the financial statements. In some other financial reporting frameworks the phrase "significant uncertainty" is used in similar circumstances.

## Use of Going Concern Assumption Appropriate but a Material Uncertainty Exists

Adequacy of Disclosure of Material Uncertainty (Ref: Para. 18)

A20. The determination of the adequacy of the financial statement disclosure may involve determining whether the information explicitly draws the reader's

attention to the possibility that the entity may be unable to continue realising its assets and discharging its liabilities in the normal course of business.

Audit Reporting When Disclosure of Material Uncertainty Is Adequate (Ref: Para. 19)

A21. The following is an illustration of an Emphasis of Matter paragraph when the auditor is satisfied as to the adequacy of the note disclosure:

Emphasis of Matter

Without qualifying our opinion, we draw attention to Note X in the financial statements which indicates that the Company incurred a net loss of ZZZ during the year ended March 31, 20X1 and, as of that date, the Company's current liabilities exceeded its total assets by YYY. These conditions, along with other matters as set forth in Note X, indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern.

A22. In situations involving multiple material uncertainties that are significant to the financial statements as a whole, the auditor may consider it appropriate in extremely rare cases to express a disclaimer of opinion instead of adding an Emphasis of Matter paragraph. SA 705[15] provides guidance on this issue.

Audit Reporting When Disclosure of Material Uncertainty Is Inadequate (Ref: Para. 20)

A23. The following is an illustration of the relevant paragraphs when a qualified opinion is to be expressed:

Basis for Qualified Opinion

The Company's financing arrangements expire and amounts outstanding are payable on May 19, 20X1. The Company has been unable to re-negotiate or

[15] See footnote 10.

obtain replacement financing. This situation indicates the existence of a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore the Company may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not fully disclose this fact.

Qualified Opinion

In our opinion, except for the incomplete disclosure of the information referred to in the Basis for Qualified Opinion paragraph, the financial statements give the information required by the Companies Act, 1956, in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the Balance Sheet, of the state of affairs of the company as at March 31, 20X1;

(b) in the case of the Profit and Loss Account, of the profit/ loss for the year ended on that date; and

(c) in the case of the cash flow statement, of the cash flows for the year ended on that date.

A24. The following is an illustration of the relevant paragraphs when an adverse opinion is to be expressed:

Basis for Adverse Opinion

The Company's financing arrangements expired and the amount outstanding was payable on March 31, 20X0. The Company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore it may be unable to realise its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact.

Adverse Opinion

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion paragraph, the financial statements do not give the information required by the Companies Act, 1956, in the manner so required and also do not give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the Balance Sheet, of the state of affairs of the company as at March 31, 20X0; and

(b) in the case of the Profit and Loss Account, of the profit/loss for the year ended on that date; and

(c) in the case of the cash flow statement, of the cash flows for the year ended on that date.

## Use of Going Concern Assumption Inappropriate (Ref: Para. 21)

A25. If the financial statements have been prepared on a going concern basis but, in the auditor's judgment, management's use of the going concern assumption in the financial statements is inappropriate, the requirement of paragraph 21 for the auditor to express an adverse opinion applies regardless of whether or not the financial statements include disclosure of the inappropriateness of management's use of the going concern assumption.

A26. If the entity's management is required, or elects, to prepare financial statements when the use of the going concern assumption is not appropriate in the circumstances, the financial statements are prepared on an alternative basis (e.g., liquidation basis). The auditor may be able to perform an audit of those financial statements provided that the auditor determines that the alternative basis is an acceptable financial reporting framework in the circumstances. The auditor may be able to express an unmodified opinion on those financial statements, provided there is adequate disclosure therein but may consider it appropriate or necessary to include an Emphasis of Matter paragraph in the auditor's report to draw the user's attention to that alternative basis and the reasons for its use.

### Management Unwilling to Make or Extend Its Assessment (Ref: Para. 22)

A27. In certain circumstances, the auditor may believe it necessary to request management to make or extend its assessment. If management is unwilling to do so, 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 the use of the going concern assumption in the preparation of the financial statements, such as audit evidence regarding the existence of plans management has put in place or the existence of other mitigating factors.

## Material Modifications to ISA 570, "Going Concern"

### Addition

1. In Paragraph 3, the responsibilities of management to make an assessment of the entity's ability to continue as a going concern have been made more country specific.

### Deletion

1. Paragraph A1 of the Application Section of ISA 570 deals with the application of the requirements of ISA 570 to the audits of public sector entities in the context of going concern risks that may arise, but are not limited to, situations where public sector entities operate on a for-profit basis, where government support may be reduced or withdrawn, or in the case of privatisation. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a situation may arise in the case of non-

public sector enterprise. Accordingly, the spirit of erstwhile A1, highlighting the appropriateness of the going concern assumption in the preparation of the financial statements where the funding arrangements are guaranteed by the Central Government has been retained.

# Standard on Auditing (SA) 580 (Revised)

# Written Representations*

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* Earlier known as the Auditing and Assurance Standard (AAS) 11, "Representations by Management".

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Standard on Auditing (SA) 580 (Revised), "Written Representations" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services[2]", which sets out the authority of SAs.

[2] Published in the July, 2007 issue of the Journal.

# Introduction

## Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance.

## Written Representations as Audit Evidence

2. Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based.[3] 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. (Ref: Para. A1)

3. 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 fulfillment of management's responsibilities, or about specific assertions.

## Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after 1st April, 2009.

# Objectives

5. The objectives of the auditor are:

[3] SA 500,"Audit Evidence", (earlier known as AAS 5), refer paragraphs 2 and 3. The Standard is being revised in the light of the corresponding International Standard.

(a) To obtain written representations from management that management believes that it has fulfilled the fundamental responsibilities that constitute the premise on which an audit is conducted; (Ref: Para. A2-A3)

(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 or if management does not provide the written representations requested by the auditor.

## Definition

6. For purposes of the SAs, the following term has the meaning attributed below:

Written representations – 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.

7. For purposes of this SA, references to "management" should be read as "management and, where appropriate, those charged with governance." Furthermore, in the case of a fair presentation framework, management is responsible for the preparation and fair presentation of the financial statements in accordance with the financial reporting framework; or the preparation of financial statements that give a true and fair view in accordance with the financial reporting framework.

## Requirements

### Management from Whom Written Representations Requested

8. The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned. (Ref: Para. A4-A8)

## Written Representations about Management's Responsibilities

### Preparation and Presentation of the Financial Statements

9. The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation and presentation of the financial statements as set out in the terms of the audit engagement[4] and, in particular, whether the financial statements are prepared and presented in accordance with the applicable financial reporting framework. (Ref: Para. A9-A11, A16, A24)

### Information Provided to the Auditor

10. The auditor shall request management to provide a written representation that it has provided the auditor with all relevant information agreed in the terms of the audit engagement,[5] and that all transactions have been recorded and are reflected in the financial statements. (Ref: Para. A9-A11, A16, A24)

## Description of Management's Responsibilities in the Written Representations

11. Management's responsibilities shall be described in the written representations required by paragraphs 9 and 10 in the manner in which these responsibilities are described in the terms of the audit engagement. (Ref: Para. A3)

## Other Written Representations

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[4] SA 210, "Terms of Audit Engagement", (earlier known as AAS 26), refer paragraph 6. The Standard is being revised in the light of the corresponding International Standard.

[4] Refer footnote 3.

12. 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. (Ref: Para. A12-A15, A16, A24)

### Date of and Period(s) Covered by Written Representations

13. 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. (Ref: Para. A17-A20)

### Form of Written Representations

14. 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 by paragraphs 9 or 10, the relevant matters covered by such statements need not be included in the representation letter. (Ref: Para. A21-A23)

## Doubt as to the Reliability of Written Representations and Requested Written Representations Not Provided

### Doubt as to the Reliability of Written Representations

15. 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 (oral or written) and audit evidence in general. (Ref: Para. A26-A27)

16. 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 (oral or written) and audit evidence in general. (Ref: Para. A25)

17. 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 (Proposed) SA 705[6], having regard to the requirement in paragraph 19 of this SA.

Requested Written Representations Not Provided

18. If management does not provide one or more of the requested written representations, the auditor shall:

(a) Discuss the matter with management;

(b) Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and

(c) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with [Proposed] SA 705, having regard to the requirement in paragraph 19 of this SA.

Written Representations about Management's Responsibilities

19. The auditor shall disclaim an opinion on the financial statements in accordance with [Proposed] SA 705 if: (Ref: Para. A28-A29)

(a) The auditor concludes that there is sufficient doubt about the integrity of management such that the written representations required by paragraphs 9 and 10 are not reliable; or

[6] SA 705, "Modifications to the Opinion in the Independent Auditor's Report". The Auditing and Assurance Standards Board will issue an Exposure Draft of the proposed new Standard based on the corresponding International Standard on Auditing in the near future. Presently, the concept of modified opinion in the auditor's report is dealt in SA 700, "The Auditor's Report on Financial Statements", hitherto AAS 28.

(b) Management does not provide the written representations required by paragraphs 9 and 10.

## Application and Other Explanatory Material

### Written Representations as Audit Evidence (Ref: Para. 2)

A1. 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.

### Premise, relating to Management's Responsibilities, on which an Audit is Conducted (Ref: Para. 5(a), 11)

A2. Law or regulation may establish management's responsibilities in relation to financial reporting. However, the extent of these responsibilities, or the way in which they are described, may differ under each law or regulation. Despite these differences, an audit in accordance with the SAs is conducted on the premise that management has responsibility:

(a) for the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework; this includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; and

(b) To provide the auditor with:

(i) All information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements;

(ii) Any additional information that the auditor may request from management; and

(iii) Unrestricted access to those within the entity from whom the auditor determines it necessary to obtain audit evidence.[7]

A3. SA 210 (Revised) requires the auditor to obtain the agreement of management that it acknowledges and understands those responsibilities as a precondition for accepting the audit engagement[8] by him. If management's responsibilities prescribed by law or regulation are equivalent in effect to those described in paragraph A2, the auditor may use the wording of the law or regulation to describe them in the terms of the audit engagement.[9]

## Management from Whom Written Representations Requested (Ref: Para. 8)

A4. Written representations are requested from those responsible for the preparation and presentation of the financial statements. Those individuals may vary depending on the governance structure of the entity, and relevant law or regulation; however, management (rather than those charged with governance) is often the responsible party. Written representations may therefore be requested from the entity's chief executive officer and chief financial officer, or other equivalent persons in entities that do not use such titles. In some circumstances, however, other parties, such as those charged with governance, are also responsible for the preparation and presentation of the financial statements.

A5. 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

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[7] SA 200, "Basic Principles Governing an Audit" (earlier known as AAS1), refer paragraphs18 and 19. The Standard is being revised in the light of the corresponding International Standard.

[8] Refer footnote 3.

[9] Refer footnote 3.

followed by the entity in preparing and presenting the financial statements and the assertions therein on which to base the written representations.

A6. 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.

A7. 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.

A8. 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. It is not expected that such inquiries would usually require a formal internal process beyond those already established by the entity.

## Written Representations about Management's Responsibilities (Ref: Para. 9-10)

A9. Audit evidence obtained during the audit that management is fulfilling the responsibilities that it agreed to in the terms of the audit engagement 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 the information described in paragraph A2(b) without asking it whether, and receiving confirmation that, such information has been provided.

A10. The written representations required by paragraphs 9 and 10 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.

Consistent with the requirement of [proposed] SA 210(Revised),[10] such reconfirmation of management's acknowledgement and understanding of its responsibilities is not made subject to the best of management's knowledge and belief (as discussed in paragraph A7 of this SA).

[10] Refer footnote 3.

A11. The mandates for audits of the financial statements of certain entities may be broader than those of other entities. As a result, the premise, relating to management's responsibilities, on which an audit of the financial statements of such an entity is conducted may give rise to additional written representations. These may include written representations confirming that transactions and events have been carried out in accordance with legislation or proper authority.

## Other Written Representations (Ref: Para. 12)

### Additional Written Representations about the Financial Statements

A12. In addition to the written representation required by paragraph 9, 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 required by paragraph 9. 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.

### Additional Written Representations about Information Provided to the Auditor

A13. In addition to the written representation required by paragraph 10, 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.

### Written Representations about Specific Assertions

A14. 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.

A15. 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.

## Communicating a Threshold Amount (Ref: Para. 9-10, 12)

A16. (Proposed) SA 450 (Revised)[11] requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly

[11] SA 450, "Evaluation of Misstatements Identified During the Audit". The Auditing and Assurance Standards Board will issue an Exposure Draft of the proposed new Standard based on the

trivial. The auditor may determine a threshold above which misstatements cannot be regarded as clearly trivial. In the same way, the auditor may consider communicating to management a threshold for purposes of the requested written representations.

### Date of and Period(s) Covered by Written Representations (Ref: Para. 13)

A17. 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.

A18. In some circumstances it may be appropriate for the auditor to obtain a written representation about a specific assertion in the financial statements during the course of the audit. Where this is the case, it may be necessary to request an updated written representation.

A19. The written representations are for all periods referred to in the auditor's report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate. The auditor and management may agree to a form of written representation that updates written representations relating to the prior periods by addressing whether there are any changes to such written representations and, if so, what they are.

A20. 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

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corresponding International Standard on Auditing in the near future. Presently, the concept of audit materiality is dealt within SA 320, "Audit Materiality", hitherto AAS 13.

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.

### Form of Written Representations (Ref: Para. 14)

A21. Written representations are required to be included in a representation letter addressed to the auditor. Some laws or regulations may, however, require management to make a written public statement about its responsibilities. Although such statement is a representation to the users of the financial statements, or to relevant authorities, the auditor may determine that it is an appropriate form of written representation in respect of some or all of the representations required by paragraph 9 or 10. Consequently, the relevant matters covered by such statement need not be included in the representation letter. Factors that may affect the auditor's determination include:

- Whether the statement includes confirmation of the fulfillment of responsibilities that are equivalent to some or all of those set out in the terms of the audit engagement.
- Whether the statement has been given or approved by those from whom the auditor requests the relevant written representations.
- Whether a copy of the statement is provided to the auditor as near as practicable to, but not after, the date of the auditor's report on the financial statements (see paragraph 13).

A22. A formal statement of compliance with law or regulation, or of approval of the financial statements, would not contain sufficient information for the auditor to be satisfied that all necessary representations have been consciously made. The expression of management's responsibilities in law or regulation is also not a substitute for the requested written representations.

A23. The Appendix to this Standard provides an illustrative example of a representation letter.

## Communication with Those Charged with Governance (Ref: Para. 9-10, 12)

A24. SA 260 (Revised)[12] requires the auditor to communicate with those charged with governance the written representations which the auditor has requested from management.

## Doubt as to the Reliability of Written Representations and Requested Written Representations Not Provided

### Doubt as to the Reliability of Written Representations (Ref: Para. 15-16)

A25. In the case of identified inconsistencies between one or more written representations and audit evidence obtained from another source, the auditor may consider whether the risk assessment remains appropriate and, if not, revise the risk assessment and determine the nature, timing and extent of further audit procedures to respond to the assessed risks.

A26. Concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, may cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted. In such a case, the auditor may consider, where possible, withdrawing from the engagement, unless those charged with governance put in place appropriate corrective measures. Such measures, however, may not be sufficient to enable the auditor to issue an unmodified audit opinion.

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[12]The Exposure Draft of Revised SA 260, "Communication with Those Charged with Governance", (hitherto known as AAS 27) has been published in May, 2008 issue of the Journal. Refer paragraph 12(c)(iii) of the said Exposure Draft.

A27. SA 230 (Revised)[13] requires the auditor to document significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. The auditor may have identified significant issues relating to the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, but concluded that the written representations are nevertheless reliable. In such a case, this significant matter is documented in accordance with SA 230 (Revised).

Written Representations about Management's Responsibilities (Ref: Para. 19)

A28. As explained in paragraph A9, 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. Therefore, if, as described in paragraph 19(a), the auditor concludes that the written representations about these matters are unreliable, or if management does not provide those written representations, the auditor is unable to obtain sufficient appropriate audit evidence. The possible effects on the financial statements of such inability are not confined to specific elements, accounts or items of the financial statements and are hence pervasive. [Proposed] SA 705 requires the auditor to disclaim an opinion on the financial statements in such circumstances.

A29. A written representation that has been modified from that requested by the auditor does not necessarily mean that management did not provide the written representation. However, the underlying reason for such modification may affect the opinion in the auditor's report. For example:

- The written representation about management's fulfillment of its responsibility for the preparation and presentation of the financial statements may state that management believes that, except for material non-compliance

[13] SA 230 (Revised), "Audit Documentation" (hitherto known as AAS 3), refer paragraph 8. The Standard is being revised in the light of the corresponding International Standard.

with a particular requirement of the applicable financial reporting framework, the financial statements are prepared and presented in accordance with that framework. The requirement in paragraph 19 does not apply because the auditor concluded that management has provided reliable written representations. However, the auditor is required to consider the effect of the non-compliance on the opinion in the auditor's report in accordance with [Proposed] SA 705.

- The written representation about the responsibility of management to provide the auditor with all relevant information agreed in the terms of the audit engagement may state that management believes that, except for information destroyed in a fire, it has provided the auditor with such information. The requirement in paragraph 19 does not apply because the auditor concluded that management has provided reliable written representations. However, the auditor is required to consider the effects of the pervasiveness of the information destroyed in the fire on the financial statements and the effect thereof on the opinion in the auditor's report in accordance with [Proposed] SA 705.

## Material Modifications to ISA 580, "Written Representations"

### Deletions

1. Paragraph A11 of the Application Section of ISA 580 deals with the application of the requirements of ISA 580 to the audits of public sector entities regarding the premise, relating to management's responsibilities which may give rise to additional written representations. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Since it is also possible that even in case of non public sector entities, management responsibilities may give rise to additional representations, accordingly, the spirit of erstwhile A11, highlighting the fact that in case of certain entities, the need of additional representations may arise, has been retained.

## Appendix

(Ref: Para. A23)

## Illustrative Representation Letter

The following illustrative letter includes written representations that are required by this and other SAs in effect as at [date]. It is assumed in this illustration that the applicable financial reporting framework is applicable accounting standards in India; the requirement of SA 570 (Revised)[14] to obtain a written representation is not relevant; and that there are no exceptions to the requested written representations. If there were exceptions, the representations would need to be modified to reflect the exceptions.

(Entity Letterhead)

(To Auditor) (Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Company for the year ended December 31, 20XX[15] for the purpose of expressing an opinion as to whether the financial statements are presented fairly, in all material respects, (or 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 ):

[14] The Exposure Draft of Revised SA 570, "Going Concern" (hitherto known as AAS 16) has been published in the October, 2007 issue of the Journal.

[15] Where the auditor reports on more than one period, the auditor adjusts the date so that the letter pertains to all periods covered by the auditor's report.

Financial Statements

- We have fulfilled our responsibilities for the preparation and presentation of the financial statements as set out in the terms of the audit engagement dated [insert date] and, in particular, the financial statements are fairly presented (or 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. (SA 540 (Revised))
- 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 (Revised))[16]
- 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 (Revised))
- 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. ([Proposed] SA 450 (Revised))
- [Any other matters that the auditor may consider appropriate (see paragraph A12 of this SA).]

Information Provided

- We have provided you with:
  - All information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements;
  - Additional information that you have requested from us; and
  - Unrestricted access to those within the entity.

[16] SA 550, "Related Parties" (hitherto known as AAS 23). The Standard is being revised in the light of the corresponding International Standard.

- 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. (SA 240 (Revised)).
- 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. (SA 240 (Revised))
- 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. (SA 240 (Revised))
- 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. (SA 250 (Revised))[17]
- 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 (Revised))[18]
- [Any other matters that the auditor may consider necessary (see paragraph A13 of this SA).]

Management Management

[17] The Exposure Draft of Revised SA 250, "The Auditor's Responsibilities Relating to Laws and Regulations in an Audit of Financial Statements" has been published in the February, 2008 issue of the Journal.

[18] SA 550, "Related Parties" (hitherto known as AAS 23). The Standard is being revised in the light of the corresponding International Standard.

# SA 600 (AAS 10)

## USING THE WORK OF ANOTHER AUDITOR

***(Effective for all audits relating to accounting periods beginning on or after April 1, 2002)***

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Standard on Auditing (SA) 600*, "Using the Work of Another Auditor" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in April, 1995. Revised in September, 2002.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The Standard on Auditing (SA) 200, "Basic Principles Governing an Audit", states (paragraph 9):

> "When the auditor delegates work to assistants or uses work performed by other auditors and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. In the case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, such as in the case of the work of branch auditors appointed under the Companies Act, 1956 the auditor's report should expressly state the fact of such reliance."

2. The purpose of this Standard on Auditing (SA) is to establish standards to be applied in situations where an auditor (referred to herein as the 'principal auditor'), reporting on the financial information of an entity, uses the work of another auditor (referred to herein as the 'other auditor') with respect to the financial information of one or more components included in the financial information of the entity. This Standard also discusses the principal auditor's responsibility in relation to his use of the work of the other auditor. In this Standard, the term 'financial information' encompasses 'financial statements'.

3. This Standard does not deal with those instances where two or more auditors are appointed as joint auditors[2] nor does it deal with the auditor's relationship with a predecessor auditor.

4. When the principal auditor concludes that the financial information of a component is immaterial, the procedures outlined in this Statement do not apply. When several components, immaterial in themselves, are together material in relation to the financial information of the entity as a whole, the procedures outlined in this Statement should be considered.

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[2] Standard on Auditing (SA) 299, "Responsibility of Joint Auditors", deals with the audit procedures to be employed where two or more auditors are appointed as joint auditors.

5. 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.

6. "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.

7. "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.

8. "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.

## Acceptance as Principal Auditor

9. The auditor should consider whether the auditor's own participation is sufficient to be able to act as the principal auditor. For this purpose the auditor would consider:

(a) the materiality of the portion of the financial information which the principal auditor audits;

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

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

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

## The Principal Auditor's Procedures

10. 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.

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

12. 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 areas 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.

13. 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.

14. The principal auditor may conclude that it is not necessary to apply procedures such as those described in paragraph 13 because sufficient appropriate audit evidence previously obtained that acceptable quality control policies and procedures are complied with in the conduct of other auditor's practice.

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

16. The principal auditor may consider it appropriate to discuss with the other auditor and the management of the component, the audit findings or other matters affecting the financial information of the components. He may also decide that supplemental tests of the records or the financial statements of the component are necessary. Such tests may, depending upon the circumstances, be performed by the principal auditor or the other auditor.

17. In certain circumstances, the other auditor may happen to be a person other than a professionally qualified auditor. This may happen, for instance, where a component is situated in a foreign country and the applicable laws permit a person other than a professionally qualified auditor to audit the financial statements of such component. In such circumstances, the procedures outlined in paragraphs 10 to 16 assume added importance.

18. The principal auditor should document in his working papers the components whose financial information was audited by other auditors; their significance to the financial information of the entity as a whole; the names of the other auditors; and any conclusions reached that individual components are not material. The principal auditor should also document the procedures performed and the conclusions reached. For example, the auditor would document the results of discussions with the other auditor and review of the written summary of the other auditor's procedures. However, the principal auditor need not document the reasons for limiting the procedures in the circumstances described at 14 above, provided those reasons are summarised elsewhere in the documentation maintained by the principal auditor. Where the other auditor's report is other than unmodified[3], the principal auditor should also document how he has dealt with the qualifications or adverse remarks contained in the other auditor's report in framing his own report.

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[3] Standard on Auditing (SA) 700, "The Auditor's Report on Financial Statements", deals with the concept of "modified audit report". An auditor's report is considered to be modified when it includes:
Matters that do not affect the auditor 's opinion
(a) emphasis of matter
Matters that do affect the auditor 's opinion
(a) qualified opinion,
(b) disclaimer of opinion, or
(c) adverse opinion.

## Co-ordination Between Auditors

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

20. The other auditor, knowing the context in which his work is to be used by the principal auditor, should co-ordinate with the principal auditor. For example, by bringing to the principal auditor's immediate attention any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc. He should ensure compliance with the relevant statutory requirements. Similarly, the principal auditor should advise the other auditor of any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.

21. When considered necessary by him, the principal auditor may require the other auditor to answer a detailed questionnaire regarding matters on which the principal auditor requires information for discharging his duties. The other auditor should respond to such questionnaire on a timely basis.

## Reporting Considerations

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

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

## Division of Responsibility

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

25. When the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/branches/subsidiaries or other components audited by other auditors.

## Effective Date

26. This Standard on Auditing becomes operative for all audits relating to accounting periods beginning on or after April 1, 2002.

## Compatibility with International Standard on Auditing (ISA) 600

The auditing standards established in this Standard on Auditing (SA) are generally consistent, in all material respects, with those set out in ISA 600 "Using the Work of Another Auditor".

# SA 610 (AAS 7)

## RELYING UPON THE WORK OF AN INTERNAL AUDITOR

***(Effective for all audits relating to accounting periods beginning on or after April 1, 1989)***

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Standard on Auditing (SA) 610*, "Relying upon the Work of an Internal Auditor" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs. This Standard on Auditing supersedes the Guidance Note on Co-ordination between the Internal Auditor and Statutory Auditors, issued by the Institute in 1979.

* Issued in January, 1989.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. Standard on Auditing (SA) 400**, "Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit", states (paragraph 8):

> "Internal Control System means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. The internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly operated."

2. The purpose of this Standard is to provide guidance as to the procedures which should be applied by the external auditor in assessing the work of the internal auditor for the purpose of placing reliance upon that work.

3. With the introduction of the Manufacturing and Other Companies (Auditor's Report) Order, 1988***, internal audit function has acquired special significance as the statutory auditor is required to state, in relation to a company having a paid-up capital exceeding Rs. 25 lakhs or having an average annual turnover exceeding Rs. 2 crore for a period of three consecutive financial years immediately preceding the financial year concerned to which the Order applies, whether the internal audit system is commensurate with the size and nature of its business.[2]

4. In this Standard, "financial information" encompasses financial statements.

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** Paragraph 6 of SA 400, "Risk Assessments and Internal Controls" is the paragraph corresponding to paragraph 8 of the erstwhile Standard, "Study and Evaluation of the Accounting System and Related Internal Controls in connection with an Audit", issued in May, 1988.

*** The Order has been replaced by the Companies (Auditor's) Report Order, 2003, issued by the Department of Company Affairs in June, 2003 under section 227(4A) of the Companies Act, 1956.

[2] Readers' attention is also drawn to the Statement on the Companies (Auditor's Report) Order, 2003, issued by the Institute of Chartered Accountants of India, for a study of various factors to be considered by the auditor in evaluating the adequacy of the internal audit system for the purposes of reporting under the Order.

5. While the external auditor has sole responsibility for his report and for the determination of the nature, timing and extent of the auditing procedures, much of the work of the internal audit function may be useful to him in his examination of the financial information.

## Scope and Objectives of the Internal Audit Function

6. The scope and objectives of internal audit vary widely and are dependent upon the size and structure of the entity and the requirements of its management.

Normally, however, internal audit operates in one or more of the following areas:

(a) Review of accounting system and related internal controls: The establishment of an adequate accounting system and the related controls is the responsibility of management which demands proper attention on a continuous basis. The internal audit function is often assigned specific responsibility by management for reviewing the accounting system and related internal controls, monitoring their operation and recommending improvements thereto.

(b) Examination for management of financial and operating information: This may include review of the means used to identify, measure, classify and report such information and specific inquiry into individual items including detailed testing of transactions, balances and procedures.

(c) Examination of the economy, efficiency and effectiveness of operations including non-financial controls of an organisation: Generally, the external auditor is interested in the results of such audit work only when it has an important bearing on the reliability of the financial records.

(d) Physical examination and verification: This would generally include examination and verification of physical existence and condition of the tangible assets of the entity.

## Relationship between Internal and External Auditors

7. The role of the internal audit function within an entity is determined by management and its prime objective differs from that of the external auditor

who is appointed to report independently on financial information. Nevertheless, some of the means of achieving their respective objectives are often similar and, thus, much of the work of the internal auditor may be useful to the external auditor in determining the nature, timing and extent of his procedures.

8. The external auditor should, as part of his audit, evaluate the internal audit function to the extent he considers that it will be relevant in determining the nature, timing and extent of his compliance and substantive procedures. Depending upon such evaluation, the external auditor may be able to adopt less extensive procedures than would otherwise be required.

9. By its very nature, the internal audit function cannot be expected to have the same degree of independence as is essential when the external auditor expresses his opinion on the financial information. The report of the external auditor is his sole responsibility, and that responsibility is not by any means reduced because of the reliance he places on the internal auditor's work.

## General Evaluation of Internal Audit Function

10. The external auditor's general evaluation of the internal audit function will assist him in determining the extent to which he can place reliance upon the work of the internal auditor. The external auditor should document his evaluation and conclusions in this respect. The important aspects to be considered in this context are:

(a) Organisational Status: Whether internal audit is undertaken by an outside agency or by an internal audit department within the entity itself, the internal auditor reports to the management. In an ideal situation, he reports to the highest level of management and is free of any other operating responsibility. Any constraints or restrictions placed upon his work by management should be carefully evaluated. In particular, the internal auditor should be free to communicate fully with the external auditor.

(b) Scope of Function: The external auditor should ascertain the nature and depth of coverage of the assignment which the internal auditor discharges for management. He should also ascertain to what extent the management considers, and where appropriate, acts upon internal audit recommendations.

(c) Technical Competence: The external auditor should ascertain that internal audit work is performed by persons having adequate technical training and proficiency. This may be accomplished by reviewing the experience and professional qualifications of the persons undertaking the internal audit work.

(d) Due Professional Care: The external auditor should ascertain whether internal audit work appears to be properly planned, supervised, reviewed and documented. An example of the exercise of due professional care by the internal auditor is the existence of adequate audit manuals, audit programmes, and working papers.

## Coordination

11. Having decided in principle that he intends to rely upon the work of the internal auditor, it is desirable that the external auditor ascertains the internal auditor's tentative plan for the year and discusses it with him at as early a stage as possible to determine areas where he considers that he could rely upon the internal auditor's work. Where internal audit work is to be a factor in determining the nature, timing and extent of the external auditor's procedures, it is desirable to plan in advance the timing of such work, the extent of audit coverage, test levels and proposed methods of sample selection, documentation of the work performed, and review and reporting procedures.

12. Coordination with the internal auditor is usually more effective when meetings are held at appropriate intervals during the year. It is desirable that the external auditor is advised of, and has access to, relevant internal audit reports and in addition is kept informed, along with management, of any significant matter that comes to the internal auditor's attention and which he believes may affect the work of the external auditor. Similarly, the external auditor should ordinarily inform the internal auditor of any significant matters which may affect his work.

## Evaluating Specific Internal Audit Work

13. Where, following the general evaluation described in paragraph 10, the external auditor intends to rely upon specific internal audit work as a basis for modifying the nature, timing and extent of his procedures, he should review the internal auditor's work, taking into account the following factors:

(a) The scope of work and related audit programmes are adequate for the external auditor's purpose.

(b) The work was properly planned and the work of assistants was properly supervised, reviewed, and documented.

(c) Sufficient appropriate evidence was obtained to afford a reasonable basis for the conclusions reached.

(d) Conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed.

(e) Any exceptions or unusual matters disclosed by the internal auditor's procedures have been properly resolved.

The external auditor should document his conclusions in respect of the specific work which he has reviewed.

14. The external auditor should also test the work of the internal auditor on which he intends to rely. The nature, timing and extent of the external auditor's tests will depend upon his judgement as to the materiality of the area concerned to the financial statements taken as a whole and the results of his evaluation of the internal audit function and of the specific internal audit work. His tests may include examination of items already examined by the internal auditor, examination of other similar items, and observation of the internal auditor's procedures.

## Effective Date

15. This Standard on Auditing becomes operative for all audits relating to accounting periods beginning on or after April 1, 1989.

# SA 620 (AAS 9)

## USING THE WORK OF AN EXPERT

***(Effective for all audits relating to accounting periods beginning on or after April 1, 1991)***

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Standard on Auditing (SA) 620*, "Using the Work of an Expert" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in December, 1991.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. Standard on Auditing (SA) 200, "Basic Principles Governing an Audit", states (paragraphs 9-10):

> "When the auditor delegates work to assistants, or uses work performed by other auditors and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. In the case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, such as in the case of the work of branch auditors appointed under the Companies Act, 1956, the auditor's report should expressly state the fact of such reliance."
>
> "The auditor should carefully direct, supervise and review work delegated to assistants. The auditor should obtain reasonable assurance that work performed by other auditors or experts is adequate for his purpose."

This Standard discusses the auditor's responsibility in relation to, and the procedures the auditor should consider in, using the work of an expert as audit evidence. In this Standard, the term 'financial information' encompasses financial statements.

2. The auditor's education and experience enable him to be knowledgeable about business matters in general, but he is not expected to have the expertise of a person trained for, or qualified to engage in, the practice of another profession or occupation, such as an actuary or engineer.

3. An expert (or a specialist), for the purpose of this Statement, is a person, firm or other association of persons possessing special skill, knowledge and experience in a particular field other than accounting and auditing. An 'expert' may be:

- engaged by the client,
- engaged by the auditor,
- employed by the client, or

- employed by the auditor.

4. When the auditor uses the work of an expert employed by him, he is using that work in the employee's capacity as an expert rather than delegating the work to an assistant on the audit. Accordingly, in such circumstances, he should apply relevant procedures described in this Statement in satisfying himself as to his employee's work and findings.

## Determining the Need to Use the Work of an Expert

5. During the audit, the auditor may seek to obtain, in conjunction with the client or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert. Examples are:

- Valuations of certain types of assets, for example, land and buildings, plant and machinery, works of art, and precious stones.
- Determination of quantities or physical condition of assets, for example, minerals stored in stockpiles, mineral and petroleum reserves, and the remaining useful life of plant and machinery.
- Determination of amounts using specialised techniques or methods, for example, an actuarial valuation.
- The measurement of work completed and to be completed on contracts in progress for the purpose of revenue recognition.
- Legal opinions concerning interpretations of agreements, statutes, regulations, notifications, circulars, etc.

6. When determining whether to use the work of an expert or not, the auditor should consider:

- the materiality of the item being examined in relation to the financial information as a whole,
- the nature and complexity of the item including the risk of error therein, and
- the other audit evidence available with respect to the item.

### Skills and Competence of the Expert

7. When the auditor plans to use the expert's work as audit evidence, he should satisfy himself as to the expert's skills and competence by considering the expert's:

- professional qualifications, licence or membership in an appropriate

professional body, and

- experience and reputation in the field in which the evidence is sought.

However, when the auditor uses the work of an expert employed by him, he will not need to inquire into his skills and competence.

## Objectivity of the Expert

8. The auditor should also consider the objectivity of the expert. The risk that an expert's objectivity will be impaired increases when the expert is:

- employed by the client, or
- related in some other manner to the client.

Accordingly, in these circumstances, the auditor should (after taking into account the factors in paragraphs 6 and 7) consider performing more extensive procedures than would otherwise have been planned, or he might consider engaging another expert.

### Evaluating the Work of an Expert

9. When the auditor intends to use the work of an expert, he should examine evidence to gain knowledge regarding the terms of the expert's engagement and such other matters as :

- the objectives and scope of the expert's work,
- a general outline as to the specific items in the expert's report,
- confidentiality of the expert's work, including the possibility of its communication to third parties,
- the expert's relationship with the client, if any,
- confidentiality of the client's information used by the expert.

10. The auditor should seek reasonable assurance that the expert's work constitutes appropriate audit evidence in support of the financial information, by considering:-

- the source data used,
- the assumptions and methods used and, if appropriate, their consistency with the prior period, and
- the results of the expert's work in the light of the auditor's overall knowledge of the business and of the results of his audit procedures.

The auditor should also satisfy himself that the substance of the expert's findings is properly reflected in the financial information.

11. The auditor should consider whether the expert has used source data which are appropriate in the circumstances. The procedures to be applied by the auditor should include:

- making inquiries of the expert to determine how he has satisfied himself that the source data are sufficient, relevant and reliable, and
- conducting audit procedures on the data provided by the client to the expert to obtain reasonable assurance that the data are appropriate.

12. The appropriateness and reasonableness of assumptions and methods used and their application are the responsibility of the expert. The auditor does not have the same expertise and, therefore, cannot always challenge the expert's assumptions and methods. However, the auditor should obtain an understanding of those assumptions and methods to determine that they are reasonable based on the auditor's knowledge of the client's business and on the results of his audit procedures.

13. Normally, completion of the above procedures will provide the auditor with reasonable assurance that he has obtained appropriate audit evidence in support of the financial information. In exceptional cases where the work of an expert does not support the related representations in the financial information, the auditor should attempt to resolve the inconsistency by discussions with the client and the expert. Applying additional procedures, including possibly engaging another expert, may also assist the auditor in resolving the inconsistency.

14. If, after performing these procedures, the auditor concludes that:

- the work of the expert is inconsistent with the information in the financial statements, or that
- the work of the expert does not constitute sufficient appropriate audit evidence (e.g., where the work of the expert involves highly technical matters or where, on grounds of confidentiality, the expert refuses to make available to the auditor the source data used by him),

he should express a qualified opinion, a disclaimer of opinion or an adverse opinion, as may be appropriate.

## Reference to an Expert in the Auditor's Report

15. When expressing an unqualified opinion, the auditor should not refer to the work of an expert in his report. If, as a result of the work of an expert, the auditor decides to express other than an unqualified opinion, it may in some circumstances benefit the reader of his report if the auditor, in explaining the nature of his reservation, refers to or describes the work of the expert. Where, in doing so, the auditor considers it appropriate to disclose the identity of the expert, he should obtain prior consent of the expert for such disclosure if such consent has not already been obtained.

## Effective Date

16. This Standard on Auditing becomes operative for all audits relating to accounting periods beginning on or after April 1, 1991.

# GENERAL CLARIFICATION (GC)–AASB/1/2002 ON SA 620

## Standard on Auditing (SA) 620, Using the Work of an Expert

{The following is the General Clarification (GC)-AASB/1/2002 issued by the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India on Standard on Auditing (SA) 620, "Using the Work of an Expert."}

1. Paragraph 12 of SA 620 provide as under:

   "12. The appropriateness and reasonableness of assumptions and methods used and their application are the responsibility of the expert. The auditor does not have the same expertise and, therefore, cannot always challenge the expert's assumptions and methods. However, the auditor should obtain an understanding of those assumptions and methods to determine that they are reasonable based on the auditor's knowledge of the client's business and on the results of his audit procedures."

2. The auditor while verifying the accrued liability for retirement benefits or for Group Gratuity Schemes has to use the work of an another expert, i.e., actuary or the insurer itself. In such a case, the issue to be considered is whether it is sufficient for the auditor to rely on the certificate given by insurer or actuary without establishing the reasonableness of the assumptions made by the actuary or the insurer based on the auditor's knowledge of the client's business. It is clarified that the auditor should, while using the certificate issued by the actuary or the insurer, obtain an understanding of the methods used by the actuary or the insurer in determining the liability and should also judge the appropriateness and reasonableness of assumptions, for example, with regard to the following:

   (i) Rate of Return
   (ii) Number of Employees
   (iii) Retirement Age
   (iv) Salaries
   (v) Promotion Policies
   (vi) Age of Employees

# SA 700 (AAS 28)

## THE AUDITOR'S REPORT ON FINANCIAL STATEMENTS

***(Effective for all audits relating to accounting periods beginning on or after April 1, 2003)***

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Standard on Auditing (SA) 700*, "The Auditor's Report on Financial Statements" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in January, 2003. From the date this SA becomes effective, the Format of Audit Report (Revised), (published in April, 2002 issue of the 'The Chartered Accountant, p.1229) and the Announcement regarding revision of Format of Audit Report, (published in December, 2002 issue of the 'The Chartered Accountant', p.616) shall stand withdrawn. Further, the Council, at its 269th meeting held from July 18 to 20, 2007, decided to withdraw paragraphs 3.1 to 4.10 of the "Statement on Qualifications in Auditor's Report" enunciating the principles involved in issuing other than unqualified reports as well as examples of situations that may give rise to other than a unqualified opinion and suggested wordings therefore considering the fact that these aspects have been amply covered in SA 700 and it also contains sufficient examples of situations giving rise to other than unqualified opinions as well as suggested wordings.

[1] Published in the July, 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard on Auditing (SA) is to establish standards on the form and content of the auditor's report issued as a result of an audit performed by an auditor of the financial statements of an entity. Much of the standards laid down by this SA can be adapted to auditor's reports on financial information other than financial statements.

2. The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements.

3. This review and assessment involves considering whether the financial statements have been prepared in accordance with an acceptable financial reporting framework applicable to the entity under audit. It is also necessary to consider whether the financial statements comply with the relevant statutory requirements.

4. The auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole.

## Basic Elements of the Auditor's Report

5. The auditor's report includes the following basic elements, ordinarily, in the following layout:

(a) Title;

(b) Addressee;

(c) Opening or introductory paragraph

  (i) identification of the financial statements audited;

  (ii) a statement of the responsibility of the entity's management and the responsibility of the auditor;

(d) Scope paragraph (describing the nature of an audit)

  (i) a reference to the auditing standards generally accepted in India;

  (ii) a description of the work performed by the auditor;

(e) Opinion paragraph containing

(i) a reference to the financial reporting framework used to prepare the financial statements; and

(ii) an expression of opinion on the financial statements;

(f) Date of the report;

(g) Place of signature; and

(h) Auditor's signature.

A measure of uniformity in the form and content of the auditor's report is desirable because it helps to promote the reader's understanding of the auditor's report and to identify unusual circumstances when they occur.

6. A statute governing the entity or a regulator may require the auditor to include certain matters in the audit report or prescribe the form in which the auditor should issue his report. In such a case, the auditor should incorporate in his audit report, the matters specified by the statute or regulator and/or report in the form prescribed by them in addition to the requirements of this SA.

Title

7. The auditor's report should have an appropriate title. It may be appropriate to use the term "Auditor's Report" in the title to distinguish the auditor's report from reports that might be issued by others, such as by the officers of the entity, the board of directors, or from the reports of others.

Addressee

8. The auditor's report should be appropriately addressed as required by the circumstances of the engagement and applicable laws and regulations. Ordinarily, the auditor's report is addressed to the authority appointing the auditor.

Opening or Introductory Paragraph

9. The auditor's report should identify the financial statements[2] of the

[2] The Council of the Institute has made Accounting Standard (AS) 3, Cash Flow Statements, mandatory for certain entities in respect of accounting periods commencing on or after 1.4.2001. Further, the Council has also decided that AS 3 should also be treated as a "specified" accounting standard for the purpose of section 211 of the Companies Act, 1956 thereby making the Cash Flow Statements a part of the Balance Sheet and Profit and Loss Account. However, irrespective of the

entity that have been audited, including the date of and period covered by the financial statements.

10. The report should include a statement that the financial statements are the responsibility of the entity's management and a statement that the responsibility of the auditor is to express an opinion on the financial statements based on the audit.

11. Financial statements are the representations of management. The preparation of such statements requires management to make significant accounting estimates and judgments, as well as to determine the appropriate accounting principles and methods used in preparation of the financial statements. This determination will be made in the context of the financial reporting framework that management chooses, or is required to use. In contrast, the auditor's responsibility is to audit these financial statements in order to express an opinion thereon.

12. An illustration of these matters in an opening (introductory) paragraph is:

> "We have audited the attached Balance Sheet of ……. (Name of the entity) as at 31st March 2XXX and also the Profit and Loss Account for the year ended on that date annexed thereto. These financial statements are the responsibility of the entity's management. Our responsibility is to express an opinion on these financial statements based on our audit."

Scope Paragraph

13. The auditor's report should describe the scope of the audit by stating that the audit was conducted in accordance with auditing standards generally accepted in India. The reader needs this as an

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fact that the cash flow statement is considered to be a part of the Balance Sheet and Profit and Loss Account, the opening or the introductory paragraph of the auditor's report on financial statements of such companies and other entities for which AS 3 has been made mandatory, would also identify the Cash Flow Statement as a part of the financial statements audited apart from the Balance Sheet and Profit and Loss Account. Similar reporting considerations would also apply to the entities which, though not required to comply with AS 3 in view of its not being mandatory for them, voluntarily prepare the cash flow statements. Further, in the above mentioned cases, the auditor's report on financial statements would also contain an expression of opinion on the true and fair view of the cash flows for the period under audit (refer to Appendix for an illustrative auditor's report on the financial statements in the case of a company for which AS 3 has been made mandatory).

assurance that the audit has been carried out in accordance with established standards.

14. "Scope" refers to the auditor's ability to perform audit procedures deemed necessary in the circumstances. Standard on Auditing (SA) 200A, "Objective and Scope of the Audit of Financial Statements", with regard to the determination of the "scope" states (paragraph 5):

> "The scope of an audit of financial statements will be determined by the auditor having regard to the terms of the engagement, the requirements of relevant legislation and the pronouncements of the Institute. The terms of engagement cannot, however, restrict the scope of an audit in relation to matters which are prescribed by legislation or by the pronouncements of the Institute."

15. The Auditing and Assurance Standards issued by the Institute of Chartered Accountants of India establish the auditing standards generally accepted in India.

16. The report should include a statement that the audit was planned and performed to obtain reasonable assurance whether the financial statements are free of material misstatement.

17. The auditor's report should describe the audit as including:

(a) examining, on a test basis, evidence to support the amounts and disclosures in financial statements;

(b) assessing the accounting principles used in the preparation of the financial statements;

(c) assessing the significant estimates made by management in the preparation of the financial statements; and

(d) evaluating the overall financial statement presentation.

18. The report should include a statement by the auditor that the audit provides a reasonable basis for his opinion.

19. An illustration of these matters in a scope paragraph is:

> "We conducted our audit in accordance with the auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance whether the

financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion."

Opinion Paragraph

20. The opinion paragraph of the auditor's report should clearly indicate the financial reporting framework used to prepare the financial statements and state the auditor's opinion as to whether the financial statements give a true and fair view in accordance with that financial reporting framework and, where appropriate, whether the financial statements comply with the statutory requirements.

21. The term used to express the auditor's opinion, "give a true and fair view", indicates, amongst other things, that the auditor considers only those matters that are material to the financial statements.

22. Paragraph 3 of "Framework of Statements on Standard Auditing Practices and Guidance Notes on Related Services"[**], issued by the Institute of Chartered Accountants of India, discusses the financial reporting framework. The paragraph reads as under:

"Financial Reporting Framework

Financial statements are ordinarily prepared and presented annually and are directed towards the common information needs of a wide range of users. Many of those users rely on financial statements as their major source of information because they do not have the power to obtain additional information to meet their specific information needs. Thus, financial statements need to be prepared in accordance with one, or a combination of:

(a) relevant statutory requirements, e.g., the Companies Act, 1956, for companies;

[**] The Framework issued in 2001 has been withdrawn pursuant to the issuance of the "Framework for Assurance Engagements", by the Institute of Chartered Accountants of India, in July, 2007. The Revised Framework is applicable from April 1, 2008. The text of the Revised Framework is reproduced elsewhere in this Handbook.

(b) accounting standards issued by the Institute of Chartered Accountants of India; and

(c) other recognised accounting principles and practices, e.g., those recommended in the Guidance Notes issued by the Institute of Chartered Accountants of India."

23. An illustration of these matters in an opinion paragraph is:

"In our opinion and to the best of our information and according to the explanations given to us, the financial statements give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the Balance Sheet, of the state of affairs of the ……. (name of the entity) as at 31st March 2XXX; and

(b) in the case of the Profit and Loss Account, of the profit/loss for the year ended on that date."

24. In addition to an opinion on the true and fair view, the auditor's report may need to include an opinion as to whether the financial statements comply with other requirements specified by relevant statutes or law. For example, in the case of companies incorporated under the Companies Act, 1956, section 227(2) of the said Act requires that the auditor's report should state in his audit report, whether in the auditor's opinion and to the best of his information and according to the explanations given to the auditor, the financial statements give the information required by the Companies Act, 1956 in the manner so required[3].

Date of Report

25. The date of an auditor's report on the financial statements is the date on which the auditor signs the report expressing an opinion on the financial statements. The date of report informs the reader that the auditor has considered the effect on the financial statements and on the report of the events and transactions of which the auditor became aware and that occurred up to that date.

[3] Refer to Appendix for an illustration of the opinion paragraph in the case of a company incorporated under the Companies Act, 1956. Also refer footnote 1 for applicability of AS 3 to an entity and the auditor's duties and responsibilities in this regard.

26. Since the auditor's responsibility is to report on the financial statements as prepared and presented by management, the auditor should not date the report earlier than the date on which the financial statements are signed or approved by management.

Place of Signature

27. The report should name specific location, which is ordinarily the city where the audit report is signed.

Auditor's Signature

28. The report should be signed by the auditor in his personal name. Where the firm is appointed as the auditor, the report should be signed in the personal name of the auditor and in the name of the audit firm. The partner/proprietor signing the audit report should also mention the membership number assigned by the Institute of Chartered Accountants of India.

## The Auditor's Report

29. An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the financial statements. An unqualified opinion indicates, implicitly, that any changes in the accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements. An unqualified opinion also indicates that:

(a) the financial statements have been prepared using the generally accepted accounting principles, which have been consistently applied;

(b) the financial statements comply with relevant statutory requirements and regulations; and

(c) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

30. The following is an illustration of a complete auditor's report incorporating the basic elements set forth and illustrated above. This report illustrates the expression of an unqualified opinion.

## "Auditor's Report

(Appropriate Addressee)

We have audited the attached Balance Sheet of …….. (Name of the entity) as at 31st March 2XXX and also the Profit and Loss Account for the year ended on that date annexed thereto[4]. These financial statements are the responsibility of the entity's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion and to the best of our information and according to the explanations given to us, the financial statements give a true and fair view in conformity with the accounting principles generally accepted in India[5]:

(a) in the case of the Balance Sheet, of the state of affairs of ……. (Name of the entity) as at 31st March 2XXX; and

(b) in the case of the Profit and Loss Account, of the profit/loss for the year ended on that date.

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[4] Refer to footnote 1.

[5] ibid.

For ABC and Co.,
Chartered Accountants

Auditor's Signature
(Name of Member signing the Audit Report)
(Designation[6])
(Membership Number)

Place of Signature

Date

An illustration of auditor's report on the financial statements in the case of a company incorporated under the Companies Act, 1956 to which AS 3 is applicable is given in the Appendix.

## Modified Reports[7]

31. An auditor's report is considered to be modified when it includes:

(a) Matters That Do Not Affect the Auditor's Opinion

- ♦ emphasis of matter

(b) Matters That Do Affect the Auditor's Opinion

- ♦ qualified opinion
- ♦ disclaimer of opinion
- ♦ adverse opinion

Uniformity in the form and content of each type of modified report will enhance the user's understanding of such reports. Accordingly, this SA includes suggested wordings to express an unqualified opinion as well as examples of modifying phrases for use when issuing modified reports.

### Matters That Do Not Affect the Auditor's Opinion

32. In certain circumstances, an auditor's report may be modified by adding an emphasis of matter paragraph to highlight a matter affecting the financial

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6 Partner or proprietor, as the case may be.

7 This SA lays down the basic principles that govern the auditor's report on financial statements. The reporting requirements contained in other SAs issued by the Council of the Institute would also be applicable.

statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such an emphasis of matter paragraph does not affect the auditor's opinion. The paragraph would preferably be included preceding the opinion paragraph and would ordinarily refer to the fact that the auditor's opinion is not qualified in this respect.

33. The auditor should modify the auditor's report by adding a paragraph to highlight a material matter regarding a going concern problem where the going concern question is not resolved and adequate disclosures have been made in the financial statements.

34. The auditor should consider modifying the auditor's report by adding a paragraph if there is a significant uncertainty (other than going concern problem), the resolution of which is dependent upon future events and which may affect the financial statements. An uncertainty is a matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements.

35. An illustration of an emphasis of matter paragraph for a significant uncertainty in an auditor's report is as follows:

> "Without qualifying our opinion, we draw attention to Note X of Schedule …… to the financial statements. The entity is the defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The entity has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.
>
> In our opinion…… (remaining words are the same as illustrated in the opinion paragraph-paragraph 30 above ."
>
> (An illustration of an emphasis of matter paragraph relating to going concern is set out in SA 570, "Going Concern.")

36. The addition of a paragraph emphasising a going concern problem or significant uncertainty is ordinarily adequate to meet the auditor's reporting responsibilities regarding such matters. However, in extreme cases, such as situations involving multiple uncertainties that are significant to the financial

statements, the auditor may consider it appropriate to express a disclaimer of opinion instead of adding an emphasis of matter paragraph.

Matters that Do Affect the Auditor's Opinion

37. An auditor may not be able to express an unqualified opinion when either of the following circumstances exists and, in the auditor's judgment, the effect of the matter is or may be material to the financial statements:

(a) there is a limitation on the scope of the auditor's work; or

(b) there is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.

The circumstances described in (a) could lead to a qualified opinion or a disclaimer of opinion. The circumstances described in (b) could lead to a qualified opinion or an adverse opinion. These circumstances are discussed in paragraphs 42 - 47.

38. A qualified opinion should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management is not so material and pervasive as to require an adverse opinion, or limitation on scope is not so material and pervasive as to require a disclaimer of opinion. A qualified opinion should be expressed as being 'subject to' or 'except for' the effects of the matter to which the qualification relates.

39. A disclaimer of opinion should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and is, accordingly, unable to express an opinion on the financial statements.

40. An adverse opinion should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

41. Whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable,

a quantification of the possible effect(s), individually and in aggregate, on the financial statements should be mentioned in the auditor's report. In circumstances where it is not practicable to quantify the effect of modifications made in the audit report accurately, the auditor may do so on the basis of estimates made by the management after carrying out such audit tests as are possible and clearly indicate the fact that the figures are based on management estimates. Ordinarily, this information would be set out in a separate paragraph preceding the opinion or disclaimer of opinion and may include a reference to a more extensive discussion, if any, in a note to the financial statements.

## Circumstances That May Result in Other Than an Unqualified Opinion

Limitation on Scope

42. A limitation on the scope of the auditor's work may sometimes be imposed by the entity, for example, when the terms of the engagement specify that the auditor will not carry out an audit procedure that the auditor believes is necessary. However, when the limitation in the terms of a proposed engagement is such that the auditor believes the need to express a disclaimer of opinion exists; the auditor should ordinarily not accept such a limited engagement as an audit engagement, unless required by statute. Also, a statutory auditor should not accept such an audit engagement when the limitation infringes on the auditor's statutory duties.

43. A scope limitation may be imposed by circumstances, for example, when the timing of the auditor's appointment is such that the auditor is unable to observe the counting of physical inventories. It may also arise when, in the opinion of the auditor, the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed to be desirable. In these circumstances, the auditor would attempt to carry out reasonable alternative procedures to obtain sufficient appropriate audit evidence to support an unqualified opinion.

44. When there is a limitation on the scope of the auditor's work that requires expression of a qualified opinion or a disclaimer of opinion, the auditor's report should describe the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.

45. Illustrations of these matters are set out below :

Limitation on Scope — Qualified Opinion

"We have audited ……. (remaining words are the same as illustrated in the introductory paragraph —paragraph 30 above).

Except as discussed in the following paragraph, we conducted our audit in accordance with ……. (remaining words are the same as illustrated in the scope paragraph — paragraph 30 above).

We did not observe the counting of the physical inventories as at 31st March 2XXX since that date was prior to the time we were appointed as auditors of ……(Name of the entity). Owing to the nature of the entity's records, we were unable to satisfy ourselves as to inventory quantities by other audit procedures.

In our opinion and to the best of our information and according to the explanations given to us, subject to the effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to physical inventory quantities, the financial statements give a ……. (remaining words are the same as illustrated in the opinion paragraph —paragraph 30 above)."

Limitation on Scope — Disclaimer of Opinion

"We were engaged to audit the attached Balance Sheet of ……..(Name of the entity) as at 31st March 2XXX and also the Profit and Loss Account for the year ended on that date annexed thereto. These financial statements are the responsibility of the entity's management. (Omit the sentence stating the responsibility of the auditor).

(The paragraph discussing the scope of the audit would either be omitted or amended according to the circumstances.)

(Add a paragraph discussing the scope limitation as follows:)

We were not able to observe all physical inventories and confirm accounts receivable due to limitations placed on the scope of our work by the entity.

Because of the significance of the matters discussed in the preceding paragraph, we do not express an opinion on the financial statements. "

Disagreement with Management

46. The auditor may disagree with management about matters such as the acceptability of accounting policies selected, the method of their application, or the adequacy of disclosures in the financial statements. If such disagreements are material to the financial statements, the auditor should express a qualified or an adverse opinion.

47. Illustrations of these matters are set out below:

Disagreement on Accounting Policies-Inappropriate Accounting Method—Qualified Opinion

"We have audited ……. (remaining words are the same as illustrated in the introductory paragraph — paragraph 30 above).

We conducted our audit in accordance with ……. (remaining words are the same as illustrated in the scope paragraph—paragraph 30 above).

As stated in Note X of Schedule ……. to the financial statements, no depreciation has been provided for the period in the financial statements. This is contrary to Accounting Standard (AS) 6 on "Depreciation Accounting", issued by the Institute of Chartered Accountants of India and the accounting policy being followed by the entity according to which depreciation is provided on straight line basis. Had this accounting policy been followed, the provision for depreciation for the period would have been Rs..... This short provisioning for depreciation has

resulted into the profit for the year, fixed assets and reserves and surplus being overstated by Rs…….

Or

As stated in Note X of Schedule …….. to the financial statements, hire purchase sales have been treated as outright sales by the entity and contrary to accepted accounting practice, the entire profit thereon has been taken into account. The profit relating to installment not due as at the date of the Balance Sheet and included in profit for the year amounted to Rs…….. This has resulted in the profit for the year, inventories and reserve and surplus being overstated by Rs ……

In our opinion and to the best of our information and according to the explanations given to us, subject to the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements give a true and ... (remaining words are the same as illustrated in the opinion paragraph-paragraph 30 above)."

Disagreement on Accounting Policies—Inadequate Disclosure-Qualified Opinion

"We have audited …….. (remaining words are the same as illustrated in the introductory paragraph — paragraph 30 above).

We conducted our audit in accordance with ……..... (remaining words are the same as illustrated in the scope paragraph—paragraph 30 above).

On 15th January 2XXX, the …….. (Name of the entity) issued debentures in the amount of Rs.XXX for the purpose of financing plant expansion. The debentures agreement restricts the payment of future cash dividends to earnings after 31st March 2XXX. In our opinion, disclosure of this information is required by .....

In our opinion and to the best of our information and according to the explanations given to us, subject to the omission of the information included in the preceding

paragraph, the financial statements give a true and ……. (remaining words are the same as illustrated in the opinion paragraph, paragraph 30 above)."

Disagreement on Accounting Policies - Inadequate Disclosure - Adverse Opinion

"We have audited the attached Balance Sheet of ……. (Name of the entity), as at 31st March 2XXX, and also the Profit and Loss Account for the year ended on that date annexed thereto[8]. These financial statements are the responsibility of the entity's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with ……. (remaining words are the same as illustrated in the scope paragraph—paragraph 30 above).

(Paragraph(s) discussing the disagreement).

In our opinion and to the best of our information and according to the explanations given to us, because of the effects of the matters discussed in the preceding paragraph(s), the financial statements do not give a true and fair view in conformity with the accounting principles generally accepted in India[9]:

(a) in the case of the Balance Sheet, of the state of affairs of the company as at 31st March 2XXX; and

(b) in the case of the Profit and Loss Account, of the profit/loss for the year ended on that date.

## Effective Date

48. This Standard on Auditing becomes operative for all audits relating to accounting periods beginning on or after 1st April 2003. Earlier application of the SA is encouraged.

[8] Refer to footnote 3.
[9] ibid.

## Compatibility with the International Standard on Auditing (ISA) 700

The auditing standards established in this Standard on Auditing are generally consistent in all material respects with those set out in the International Standard on Auditing (ISA) 700, "The Auditor's Report on Financial Statements", except the following:

(a) Due to the practices prevailing in India, the SA requires the auditor to mention the "Place of Signature" instead of the "Auditor's Address" in the auditors report. The place of signature is the name of specific location, which is ordinarily the city where the audit report is signed [see paragraph 27]. According to ISA 700, the expression "Auditor's Address" means the name of a specific location, which is ordinarily the city where the auditor maintains the office that has the responsibility for the audit.

(b) The SA requires the auditor to mention the membership number assigned by the Institute of Chartered Accountants of India [see paragraph 28]. ISA 700, however, does not contain any corresponding requirement.

(c) The SA requires that whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s), individually and in aggregate, on the financial statements should be mentioned in the auditor's report [see paragraph 41]. ISA 700 does not require the auditor to quantify the possible effect(s) in aggregate on the financial statements.

Appendix

Illustrative Auditor's Report on the Financial Statements in the Case of a Company Incorporated Under the Companies Act, 1956 to which AS 3 is applicable[10]

[see paragraph 30]

## Auditor's Report

The Members of ……(name of the Company)[11]

We have audited the attached Balance Sheet of …… (name of the company), as at 31st March 2XXX, and also the Profit and Loss Account and the cash flow statement for the year ended on that date annexed thereto. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As required by the Manufacturing and Other Companies (Auditor's Report) Order, 1988[12] issued by the Central Government of India in terms of sub-section

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[10] In case AS 3 is not applicable to a company and such company also does not voluntarily prepare the cash flow statement, the references to cash flow statement should be deleted from the entire report.

[11] Reference may also be made to the Statement on Qualifications in Auditor's Report and the Guidance Note on Section 227(3)(e) and (f) of the Companies Act, 1956 issued by the Council of the Institute of Chartered Accountants of India.

(The readers may note that the Council, at 269th meeting, held from July 18 to 20, 2007, decided to withdraw the "Statement on Qualification in Auditor's Report" except paragraphs 2.1 to 2.30 dealing with reporting under section 227 (1A) of the Companies Act, 1956 and to rename the Statement as "Statement on Reporting under section 227(1A) of the Companies Act, 1956".)

[12] The Manufacturing and Other Companies (Auditor's Report) Order, 1988 has since been replaced by the Companies (Auditor's Report) Order, 2003 vide Department of Company Affairs' Notification dated June 12, 2003.

(4A) of section 227 of the Companies Act, 1956, we enclose in the Annexure[13] a statement on the matters specified in paragraphs 4 and 5 of the said Order.

Further to our comments in the Annexure referred to above, we report that:

(i) We have obtained all the information and explanations, which to the best of our knowledge and belief were necessary for the purposes of our audit;

(ii) In our opinion, proper books of account as required by law have been kept by the company so far as 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. The Branch Auditor's Report(s) have been forwarded to us and have been appropriately dealt with); [14]

(iii) The Balance Sheet, Profit and Loss Account and cash flow statement dealt with by this report are in agreement with the books of account (and with the audited returns from the branches);[15]

(iv) In our opinion, the Balance Sheet, Profit and Loss Account and cash flow statement dealt with by this report comply with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956;

(v) On the basis of written representations received from the directors, as on 31$^{st}$ March 2XXX and taken on record by the Board of Directors, we report that none of the directors is disqualified as on 31st March 2XXX from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956;

(vi) In our opinion and to the best of our information and according to the explanations given to us, the said accounts give the information required by the Companies Act, 1956, in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India[16]:

(a) in the case of the Balance Sheet, of the state of affairs of the company as at 31st March 2XXX;

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[13] Alternatively, instead of giving the comments on Companies (Auditor's Report) Order, 2003 in an Annexure, the comments may be contained in the body of the main report. Members' attention in this regard is invited to the Statement on the Companies (Auditor's Report) Order, 2003, issued by the Institute of Chartered Accountants of India. It may also be noted that requirements of the Companies (Auditor's Report) Order, 2003 have not been reproduced in this illustration.

[14] Wherever applicable.

[15] ibid.

[16] ibid.

(b) in the case of the Profit and Loss Account, of the profit / loss[17] for the year ended on that date; and

(c) in the case of the cash flow statement, of the cash flows for the year ended on that date.

For ABC and Co.
Chartered Accountants

Signature
(Name of the Member Signing the Audit Report)
(Designation[18])
Membership Number

Place of Signature

Date

[17] Whichever is applicable.

[18] Partner or Proprietor, as the case may be.

# SA 710 (AAS 25)

## COMPARATIVES

***(Effective for all audits relating to accounting periods beginning on or after April 1, 2003)***

## Contents


**Paragraph(s)**

**Introduction.....1-5**
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Standard on Auditing (SA) 710*, "Comparatives" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in September, 2002.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard on Auditing (SA) is to establish standards on the auditor's responsibilities regarding comparatives. It does not deal with situations when summarised financial statements or data are presented with the audited financial statements.

2. The auditor should determine whether the comparatives comply, in all material respects, with the financial reporting framework relevant to the financial statements being audited.

3. The existence of differences in financial reporting frameworks results in comparative financial information being presented differently in each framework. Comparatives in financial statements, for example, may present amounts (such as financial position, results of operations, cash flows) and appropriate disclosures of an entity for more than one period, depending on the framework. The frameworks and methods of presentation that are referred to in this SA are as follows:

(a) Corresponding Figures where amounts and other disclosures for the preceding period are included as part of the current period financial statements, and are intended to be read in relation to the amounts and other disclosures relating to the current period (referred to as "current period figures" for the purpose of this SA). These corresponding figures are not presented as complete financial statements capable of standing alone, but are an integral part of the current period financial statements intended to be read only in relationship to the current period figures; and

(b) Comparative Financial Statements where amounts and other disclosures for the preceding period are included for comparison with the financial statements of the current period, but do not form part of the current period financial statements.

4. Comparatives are presented in compliance with the relevant financial reporting framework. The essential audit reporting differences are that:

(a) for corresponding figures, the auditor's report only refers to the financial statements of the current period; whereas

(b) for comparative financial statements, the auditor's report refers to each period that financial statements are presented.

5. This SA establishes standard on the auditor's responsibilities for comparatives and for reporting on them under the 'corresponding figures' framework. This SA does not establish standards on the auditor's responsibilities when the 'comparative financial statements' framework is used for presentation of comparative financial information. It is recognised that such framework for presentation of comparative financial information is not widely prevalent in India. Appendix I to this SA discusses these different reporting frameworks.

## Auditor's Responsibilities

6. The auditor should obtain sufficient appropriate audit evidence that the corresponding figures meet the requirements of the relevant financial reporting framework. The extent of audit procedures performed on the corresponding figures is significantly less than that for the audit of the current period figures and is ordinarily limited to ensuring that the corresponding figures have been correctly reported and are appropriately classified. This involves the auditor assessing whether:

(a) accounting policies used for the corresponding figures are consistent with those of the current period or whether appropriate adjustments and/or disclosures have been made; and

(b) corresponding figures agree with the amounts and other disclosures presented in the prior period or whether appropriate adjustments and/or disclosures have been made.

7. When the financial statements of the prior period have been audited by another auditor, the incoming auditor should assess whether the corresponding figures meet the conditions specified in paragraph 6 above. The auditor should also comply with the requirements of Standard on Auditing (SA) 510, "Initial Engagements-Opening Balances".

8. When the financial statements of the prior period have not been audited, the incoming auditor nonetheless should assess whether the corresponding figures meet the conditions specified in paragraph 6 above. The auditor should also comply with the requirements of Standard on Auditing (SA) 510, "Initial Engagements-Opening Balances".

9. If the auditor becomes aware of a possible material misstatement in the corresponding figures when performing the current period audit, the auditor

should perform such additional procedures as are appropriate in the circumstances.

## Reporting

10. When the comparatives are presented as corresponding figures, the auditor's report should not specifically identify comparatives because the auditor's opinion is on the current period financial statements as a whole, including the corresponding figures. However, the auditor's report would make specific reference to the corresponding figures in the circumstances described in paragraphs 11, 12, 14(b), 15 and 16.

11. When the auditor's report on the prior period, as previously issued, included a qualified opinion, disclaimer of opinion, or adverse opinion and the matter which gave rise to the modification in the audit report[2] is:

(a) unresolved, and results in a modification of the auditor's report regarding the current period figures, the auditor's report should also be modified regarding the corresponding figures; or

(b) unresolved, but does not result in a modification of the auditor's report regarding the current period figures, the auditor's report should be modified regarding the corresponding figures.

Illustrative audit reports for situations discussed above are given in Appendix II to this SA.

12. When the auditor's report on the prior period, as previously issued, included a qualified opinion, disclaimer of opinion, or adverse opinion and the matter which gave rise to the modification is resolved and properly dealt with in the financial statements, the current report does not ordinarily refer to the previous modification. However, if the matter is material to the current period, the auditor may include an emphasis of matter paragraph dealing with the situation.

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[2] Standard on Auditing (SA) 700, "The Auditor's Report on Financial Statements", deals with the concept of "modified audit report". An auditor's report is considered to be modified when it includes:
Matters that do not affect the auditor 's opinion
(a) emphasis of matter
Matters that do affect the auditor 's opinion
(a) qualified opinion,
(b) disclaimer of opinion, or
(c) adverse opinion.

13. In performing the audit of the current period financial statements, the auditor, in certain unusual circumstances, may become aware of a material misstatement that affects the prior period financial statements on which an unmodified report has been previously issued.

14. In such circumstances, the auditor should examine that:

(a) appropriate disclosures have been made; or

(b) if appropriate disclosures have not been made, the auditor should issue a modified report on the current period financials modified with respect to the corresponding figures included therein.

15. If, in the circumstances described in paragraph 13, appropriate disclosures have been made in the current period financial statements, the auditor may include an emphasis of matter paragraph describing the circumstances and referencing to the appropriate disclosures. Appropriate disclosures could be in the form of proforma comparative information being presented in the notes to the financial statements. Proforma comparative information would help the reader of the financial statements to clearly perceive the effect of misstatement on the corresponding figures.

## Incoming Auditor-Additional Requirements

### Prior Period Financial Statements Not Audited

16. When the prior period financial statements are not audited, the incoming auditor should state in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to perform appropriate procedures regarding opening balances of the current period. Disclosure in the financial statements that the corresponding figures are unaudited is encouraged.

## Effective Date

17. This Standard on Auditing becomes operative for all audits relating to accounting periods beginning on or after April 1, 2003.

## Compatibility with International Standard on Auditing (ISA) 710

### Comparative Financial Statements Framework

This Standard on Auditing does not establish standards on the auditor's responsibilities when the 'comparative financial statements' framework is used for presentation of comparative financial information. This is a material departure from the standards set out in ISA 710 "Comparatives". It is recognised that such framework for presentation of comparative financial information is not widely prevalent in India.

### Incoming Auditor—Additional Requirements

ISA 710 requires that in situations where the incoming auditor identifies that the corresponding figures are materially misstated, the auditor should request management to revise the corresponding figures or if management refuses to do so, the auditor appropriately modifies the audit report. This requirement of ISA does not find a place in SA 710 in view of the current legal position prevailing in the Country under which the auditor is not expected to request the management to revise the corresponding figures.

ISA 710 recognises that in some reporting frameworks the incoming auditor is permitted to refer to the predecessor auditor's report on the corresponding figures in the incoming auditor's report for the current period. According to the ISA, when the auditor decides to refer to another auditor, the incoming auditor's report should indicate:

(a) that the financial statements of the prior period were audited by another auditor;

(b) the type of report issued by the predecessor auditor and, if the report was modified, the reasons therefor; and

(c) the date of that report.

In India, the incoming auditor is not permitted to refer to the predecessor auditor's report on the corresponding figures in his audit report. Therefore, this requirement of ISA has not been made part of SA 710.

The other auditing standards established in this SA are generally consistent in all material respects with those set out in ISA 710 "Comparatives".

Appendix I

## Discussion of Financial Reporting Frameworks for Comparatives

1. Comparatives covering one or more preceding periods provide the users of financial statements with information necessary to identify trends and changes affecting an entity over a period of time.

2. Under financial reporting frameworks (both implicit and explicit), comparability and consistency are desirable qualities for financial information. Defined in broadest terms, comparability is the quality of having certain characteristics in common and comparison is normally a quantitative assessment of the common characteristics. Consistency is a quality of the relationship between two accounting numbers. Consistency (for example, consistency in the use of accounting principles from one period to another, the consistency of the length of the reporting period, etc.) is a prerequisite for true comparability.

3. There are two broad financial reporting frameworks for comparatives: the corresponding figures and the comparative financial statements.

4. Under the corresponding figures framework, the corresponding figures for the prior period(s) are an integral part of the current period financial statements and have to be read in conjunction with the amounts and other disclosures relating to the current period. The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

5. Under the comparative financial statements framework, the comparative financial statements for the prior period(s) are considered separate financial statements. Accordingly, the level of information included in those comparative financial statements (including all statement amounts, disclosures, footnotes and other explanatory statements to the extent that they continue to be of significance) approximates that of the financial statements of the current period.

Appendix II

## Illustrative Auditor's Report

Illustration 1. Illustrative Audit Report for the circumstances described in paragraph 11(a). (Prepared under the reporting framework of Section 227 of the Companies Act, 1956)

Auditor's Report to the Members of ……(name of the Company)

1. We have audited the attached Balance Sheet of……(name of the Company), as at 31st March, 20X1 and also the Profit and Loss Account for the year ended on that date annexed thereto[3]. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.
2. We conducted our audit in accordance with auditing standards generally accepted in India. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.
3. As required by the Manufacturing and Other Companies (Auditor's Report) Order, 1988[4] issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Companies Act, 1956, we enclose in the Annexure[5] a statement on the matters specified in paragraphs 4 and 5 of the said Order.
4. Further to our comments in the Annexure referred to above, we report that:
   (i) We have obtained all the information and explanations, which to the best of our knowledge and belief were necessary for the

[3] Refer footnote 1 of SA 700, "The Auditor's Report on Financial Statements".

[4] The Manufacturing and Other Companies (Auditor's Report) Order, 1988 has been replaced by the Companies (Auditor's Report) Order, 2003 by Department of Company Affairs' Notification dated June 12, 2003.

[5] Alternatively, instead of giving the comments on the Companies (Auditor's Report) Order, 2003 in an Annexure, the comments may be contained in the body of the main report. Members' attention in this regard is invited to the Statement on the Companies (Auditor's Report) Order, 2003 issued by the Institute of Chartered Accountants of India.

purposes of our audit;

(ii) In our opinion, proper books of account as required by law have been kept by the company so far as 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. The Branch Auditor's Report(s) have been forwarded to us and have been appropriately dealt with);

(iii) The Balance Sheet and Profit and Loss Account dealt with by this report are in agreement with the books of account (and with the audited returns from the branches);

(iv) On the basis of written representations received from the directors, as on 31st March, 20X1, and taken on record by the Board of Directors, we report that none of the directors is disqualified as on 31st March 20X1 from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956;

(v) As discussed in Note YY of Schedule ZZ to the financial statements, no depreciation has been provided in the financial statements which practice, in our opinion, is not in accordance with Accounting Standard 6 on Depreciation issued by the Institute of Chartered Accountants of India. This is the result of a decision taken by management at the start of the preceding financial year and caused us to qualify our audit opinion on the financial statements relating to that year. Based on the straight-line method of depreciation and annual rates of 5% for the building and 20% for the equipment, the loss for the period ended 31st March 20X1 should be increased by Rs.XXXX and the loss for the previous period ended 31st March 20X0 should be increased by Rs.XXXX. The fixed assets as at 31st March 20X1 should be reduced by accumulated depreciation of Rs.XXXX and the fixed assets for the previous period ended 31st March 20X0 should be reduced by accumulated depreciation of Rs.XXXX. The accumulated loss should be increased by Rs.XXXX for the period ended 31st March 20X1 and by Rs.XXXX for the previous period ended 31st March 20X0.

(vi) Except for non-provision of depreciation referred to in the preceding paragraph, in our opinion, the Balance Sheet and Profit and Loss Account comply with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956.

5. In our opinion, and to the best of our information and according to the explanations given to us, except for the effect on the financial statements of non-provision of depreciation referred to in paragraph 4(vi) foregoing, the

said financial statements, read together with the other notes thereon give the information required by the Companies Act, 1956 in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the Balance Sheet, of the state of affairs of the Company, as at 31st March 20X1, and

(b) in the case of the Profit and Loss Account, of the loss for the year ended on that date.

For ABC and Co.
Chartered Accountants

Signature
(Name of the Member Signing the Audit Report)
(Designation[6])

Address:

Date:

Illustration 2 : Illustrative report for the circumstances described in paragraph 11(b). (prepared under the reporting framework of Section 227 of the Companies Act, 1956)

Auditor's Report to the Members of ……(name of the Company)

1. We have audited the attached Balance Sheet of……(name of the Company), as at 31st March, 20X1 and also the Profit and Loss Account for the year ended on that date annexed thereto. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

2. We conducted our audit in accordance with auditing standards generally accepted in India. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

[6] Partner or Proprietor, as the case may be.

3. As required by the Manufacturing and Other Companies (Auditor's Report) Order, 1988[7] issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Companies Act, 1956, we enclose in the Annexure[8] a statement on the matters specified in paragraphs 4 and 5 of the said Order.

4. Further to our comments in the Annexure referred to above, we report that:

   (i) We have obtained all the information and explanations, which to the best of our knowledge and belief were necessary for the purposes of our audit;

   (ii) In our opinion, proper books of account as required by law have been kept by the company so far as 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. The Branch Auditor's Report(s) have been forwarded to us and have been appropriately dealt with);

   (iii) The Balance Sheet and Profit and Loss Account dealt with by this report are in agreement with the books of account (and with the audited returns from the branches);

   (iv) It was not possible for us to obtain external confirmations about accounts receivable balances amounting to Rs. XXXXXX as at 31st March 20X0. Owing to the nature of company's records, we were unable to satisfy ourselves about the valuation and existence of accounts receivable and provisioning thereon. Since provisioning on accounts receivable enter into the determination of the results of operations and the balances are included in determination of state of affairs, we were unable to determine the effect of valuation and provisioning on the financial statements for the period ended 31st March 20X0. Our audit report on the financial statements for the period ended 31st March 20X0 was modified accordingly.

   (v) In our opinion, the Balance Sheet and Profit and Loss Account dealt with by this report comply with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956;

   (vi) On the basis of written representations received from the directors,

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[7] The Manufacturing and Other Companies (Auditor's Report) Order, 1988 has been replaced by the Companies (Auditor's Report) Order, 2003 by Department of Company Affairs' Notification dated June 12, 2003.

[8] Alternatively, instead of giving the comments on the Companies (Auditor's Report) Order, 2003 in an Annexure, the comments may be contained in the body of the main report. Members' attention in this regard is invited to the Statement on the Companies (Auditor's Report) Order, 2003, issued by the Institute of Chartered Accountants of India.

as on 31st March 20X1, and taken on record by the Board of Directors, we report that none of the directors is disqualified as on 31st March 20X1 from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956;

5. In our opinion, and to the best of our information and according to the explanations given to us, except for the effect on the corresponding figures for period ended 31st March 20X0 of the adjustments, if any, to the results of operations for the ended 31st March 20X0 and to the state of affairs as on that date, which we might have determined to be necessary had we been able to obtain external confirmations about accounts receivable balances amounting to Rs. XXXXXX as at 31st March 20X0, the said financial statements, read together with the other notes thereon give the information required by the Companies Act, 1956 in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India:

   (a) in the case of the Balance Sheet, of the state of affairs of the Company, as at 31 March, 20X1, and

   (b) in the case of the Profit and Loss Account, of the loss for the year ended on that date.

For ABC and Co.
Chartered Accountants

Signature
(Name of the Member Signing the Audit Report)
(Designation[9])

Address:

Date:

[9] Partner or Proprietor, as the case may be.

# SRE 2400 (AAS 33)

## ENGAGEMENTS TO REVIEW FINANCIAL STATEMENTS

***(Effective for all review engagements relating to accounting periods beginning on or after April 1, 2005)***

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Standard on Review Engagements (SRE) 2400*, "Engagements to Review Financial Statements" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in March, 2005. With the issuance of this Standard on Review Engagement, the Guidance Note on Engagements to Review Financial Statements issued by the Institute of Chartered Accountants of India in May 2000 stands withdrawn.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard on Review Engagement (SRE) is to establish standards and provide guidance on the auditor's[2] professional responsibilities when an engagement to review financial statements is undertaken and on the form and content of the report that the auditor issues in connection with such a review.

2. This SRE is directed towards the review of financial statements. However, it is to be applied to the extent practicable to engagements to review financial or other related information, for example, interim financial statements prepared by an entity pursuant to Accounting Standard (AS) 25, Interim Financial Reporting. This SRE is to be read in conjunction with the "Framework of Statements on Standard Auditing Practices and Guidance Notes on Related Services" issued by the Institute of Chartered Accountants of India.

## Objective of a Review Engagement

3. The objective of a review of financial statements is to enable an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with the financial reporting framework used for the preparation and presentation of the financial statements[3] (negative assurance).

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[2] As explained in the Framework of Statements on Standard Auditing Practices and Guidance Notes on Related Services (issued in 2001), the SAPs (now AASs) and Guidance Notes use the term "auditor" when describing both auditing and related services which may be performed. Such reference is not intended to imply that a person performing related services need be the auditor of the entity's financial statements.

(The readers may note that the Framework issued in 2001 has been withdrawn pursuant to the issuance of the "Framework for Assurance Engagements", which is applicable from April 1, 2008. The text of the Revised Framework is reproduced elsewhere in this Handbook.)

[3] Paragraph 3 of "Framework of Statements on Standard Auditing Practices and Guidance Notes on Related Services", issued by the Institute of Chartered Accountants of India, discusses the financial reporting framework. The paragraph reads as under:

> "Financial Reporting Framework
>
> Financial statements are ordinarily prepared and presented annually and are directed towards the common information needs of a wide range of users. Many of those users rely on financial statements as their major source of information because they do not have the power to obtain additional information to meet their specific information needs. Thus, financial statements need to be prepared in accordance with one, or a combination of:
>
> (a) relevant statutory requirements, e.g., the Companies Act, 1956, for companies;

## General Principles of a Review Engagement

4. The auditor should comply with the Code of Ethics issued by the Institute of Chartered Accountants of India. Ethical principles governing the auditor's professional responsibilities are:

(a) Independence;

(b) Integrity;

(c) Objectivity;

(d) Professional competence and due care;

(e) Confidentiality;

(f) Professional conduct; and

(g) Technical standards.

5. The auditor should conduct a review in accordance with this SRE.

6. The auditor should plan and perform the review with an attitude of professional skepticism recognising that circumstances may exist which cause the financial statements to be materially misstated.

7. For the purpose of expressing negative assurance in the review report, the auditor should obtain sufficient appropriate evidence primarily through inquiry and analytical procedures to be able to draw conclusions.

## Scope of a Review

8. The term "scope of a review" refers to the review procedures deemed necessary in the circumstances to achieve the objective of the review. The procedures required to conduct a review of financial statements should be determined by the auditor having regard to the requirements of this SRE, relevant legislation, regulation and, where appropriate, the terms of the review engagement and reporting requirements. The scope of a review is substantially narrower as compared to an audit in accordance with the generally accepted auditing standards for the expression of an opinion on the financial statements. Accordingly, while a review involves the application

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(b) accounting standards issued by the Institute of Chartered Accountants of India; and

(c) other recognised accounting principles and practices, e.g., those recommended in the Guidance Notes issued by the Institute of Chartered Accountants of India."

of audit skills and techniques, it does not usually involve a study and evaluation of internal accounting controls, tests of accounting records and of responses to inquiries by obtaining corroborating evidential matter through inspection, observation or confirmation and certain other procedures ordinarily performed during an audit.

## Moderate Assurance

9. A review engagement provides a moderate level of assurance that the information subject to review is free of material misstatement; this is expressed in the form of negative assurance. Although the auditor attempts to become aware of all significant matters, the limited procedures of a review make the achievement of this objective less likely than in an audit engagement, thus the level of assurance provided is correspondingly less than that given in an audit.

## Terms of Engagement

10. The auditor and the client should agree on the terms of the engagement. The agreed terms would be recorded in an engagement letter or other suitable form such as a contract.

11. An engagement letter will be of assistance in planning the review work. It is in the interests of both the auditor and the client that the auditor sends an engagement letter documenting the key terms of the appointment. An engagement letter confirms the auditor's acceptance of the appointment and helps avoid misunderstanding regarding such matters as the objectives and scope of the engagement and the extent of the auditor's responsibilities.

12. Matters that would be included in the engagement letter include:

- The objective of the service being performed.
- Management's responsibility for the financial statements.
- The scope of the review, including reference to this SRE.
- Unrestricted access to whatever records, documentation and other information requested in connection with the review.
- The fact that the engagement cannot be relied upon to disclose errors, violation of laws or other irregularities, for example, fraud or defalcations that may exist.

- A statement that an audit is not being performed and that an audit opinion will not be expressed. To emphasise this point and to avoid confusion, the auditor may also consider pointing out that a review engagement will not satisfy any statutory or third party requirements for an audit.

An example of an engagement letter for a review of financial statements appears in Appendix 1 to this SRE.

## Planning

13. The auditor should plan the work so that an effective review engagement will be performed.

14. In planning a review of financial statements, the auditor should obtain or update the knowledge of the business including consideration of the entity's organisation, accounting systems, operating characteristics and the nature of its assets, liabilities, revenues and expenses.

15. The auditor needs to possess an understanding of such matters and other matters relevant to the financial statements, for example, knowledge of the entity's production and distribution methods, product lines, operating locations and related parties. The auditor requires this understanding to be able to make relevant inquiries and to design appropriate procedures, as well as to assess the responses and other information obtained.

## Work Performed by Others

16. When using work performed by another auditor or an expert, the auditor should be satisfied that such work is adequate for the purposes of the review.

## Documentation

17. The auditor should document matters which are important in providing evidence to support the review report, and evidence that the review was carried out in accordance with this SRE.

## Procedures and Evidence

18. The auditor should apply judgment in determining the specific nature, timing and extent of review procedures. The auditor will be guided by such matters as:

- Any knowledge acquired by carrying out audits or reviews of the financial statements for prior periods.
- The auditor's knowledge of the business including knowledge of the accounting principles and practices of the industry in which the entity operates.
- The entity's accounting systems.
- The extent to which a particular item is affected by management judgment.
- The materiality of transactions and account balances.

19. The auditor should apply the same materiality considerations as would be applied if an audit opinion on the financial statements were being given. Although there is a greater risk that misstatements will not be detected in a review than in an audit, the judgment as to what is material is made by reference to the information on which the auditor is reporting and the needs of those relying on that information, not to the level of assurance provided.

20. Procedures for the review of financial statements will ordinarily include:

- Obtaining an understanding of the entity's business and the industry in which it operates.
- Inquiries concerning the entity's accounting principles, policies and practices.
- Inquiries concerning the entity's procedures for recording, classifying and summarising transactions, accumulating information for disclosure in the financial statements and preparing financial statements.
- Inquiries concerning all material assertions in the financial statements.

- Analytical procedures designed to identify relationships and individual items that appear unusual. Such procedures would include:
  - Comparison of the financial statements with statements for prior periods.
  - Comparison of the financial statements with anticipated results and financial position.
  - Study of the relationships of the elements of the financial statements that would be expected to conform to a predictable pattern based on the entity's experience or industry norm.

In applying these procedures, the auditor would consider the types of matters that required accounting adjustments in prior periods.

- Inquiries concerning actions taken at meetings of shareholders, the board of directors, committees of the board of directors and other meetings that may affect the financial statements.
- Reading the financial statements to consider, on the basis of information coming to the auditor's attention, whether the financial statements appear to conform to the basis of accounting indicated.
- Obtaining reports from other auditors, if any and if considered necessary, who have been engaged to audit or review the financial statements of components of the entity.
- Inquiries of persons having responsibility for financial and accounting matters concerning, for example:
  - Whether all transactions have been recorded.
  - Whether the financial statements have been prepared in accordance with the basis of accounting policies indicated.
  - Changes in the entity's business activities and accounting principles, policies and practices.
  - Matters as to which questions have arisen in the course of applying the foregoing procedures.
- Obtaining written representations from management when considered appropriate.

Appendix 2 to this SRE provides an illustrative list of procedures which are often used in an engagement to review financial statements. The list is not exhaustive, nor is it intended that all the procedures suggested apply to every review engagement.

21. The auditor should inquire about events subsequent to the balance sheet date that may require adjustment of, or disclosure in the financial statements. The auditor does not have any responsibility to perform procedures to identify events occurring after the date of the review report.

22. If the auditor has reason to believe that the information subject to review may be materially misstated, the auditor should carry out additional or more extensive procedures as are necessary to be able to express negative assurance or to confirm that a modified report is required.

## Conclusions and Reporting

23. The review report should contain a clear written expression of negative assurance. The auditor should review and assess the conclusions drawn from the evidence obtained as the basis for the expression of negative assurance.

24. Based on the work performed, the auditor should assess whether any information obtained during the review indicates that the financial statements do not give a true and fair view (or 'are not presented fairly, in all material respects') in accordance with the financial reporting framework used for the preparation and presentation of financial statements and relevant statutory requirements, if any.

25. The report on a review of financial statements describes the scope of the engagement to enable the reader to understand the nature of the work performed and make it clear that an audit was not performed and, therefore, that an audit opinion is not expressed.

26. The report on a review of financial statements should contain the following basic elements, ordinarily in the following layout:

(a) Title[4];

[4] It may be appropriate to use the term "independent" in the title to distinguish the auditor's report from reports that might be issued by others, such as officers of the entity, or from the reports of

(b) Addressee;

(c) Opening or introductory paragraph including:

(i) Identification of the financial statements on which the review has been performed; and

(ii) A statement of the responsibility of the entity's management and the responsibility of the auditor;

(d) Scope paragraph, describing the nature of a review, including:

(i) A reference to this SRE applicable to review engagements, or to relevant laws or regulations;

(ii) A statement that a review is limited primarily to inquiries and analytical procedures; and

(iii) A statement that an audit has not been performed, that the procedures undertaken provide less assurance than an audit and that an audit opinion is not expressed;

(e) Statement of negative assurance;

(f) Date of the report;

(g) Place; and

(h) Auditor's signature and membership number assigned by the Institute of Chartered Accountants of India.

Appendices 3 and 4 to this SRE contain illustrations of review reports.

27. The review report should:

(a) State that nothing has come to the auditor's attention based on the review that causes the auditor to believe the financial statements do not give a true and fair view (or 'are not presented fairly, in all material respects') in accordance with the framework used for the preparation and presentation of financial statements (negative assurance); or

(b) If matters have come to the auditor's attention, describe those matters that impair a true and fair view (or a fair presentation, in all

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other auditors who are not required to abide by the ethical requirements laid down by the Institute of Chartered Accountants of India.

material respects) in accordance with the framework used for the preparation and presentation of financial statements including, unless impracticable, a quantification of the possible effect(s) on the financial statements, and either:

(i) Express a qualification of the negative assurance provided; or

(ii) When the effect of the matter is so material and pervasive to the financial statements that the auditor concludes that a qualification is not adequate to disclose the misleading or incomplete nature of the financial statements, give an adverse statement that the financial statements do not give a true and fair view (or 'are not presented fairly, in all material respects') in accordance with the framework used for the preparation and presentation of financial statements; or

(c) If there has been a material scope limitation, describe the limitation and either:

(i) Express a qualification of the negative assurance provided regarding the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed; or

(ii) When the possible effect of the limitation is so significant and pervasive that the auditor concludes that no level of assurance can be provided, not provide any assurance.

28. The auditor should date the review report as of the date the review is completed, which is the date on which the auditor signs the review report. The date of report informs the reader that the auditor has considered the effect on the financial statements and on the report of the events and transactions of which the auditor became aware and that occurred up to that date. Therefore, the review should include performing procedures relating to events occurring up to the date of the report.

29. Since the auditor's responsibility is to report on the financial statements as prepared and presented by the management, the auditor should not date the report earlier than the date on which the financial statements are signed or approved by the management.

30. The auditor should not agree to a change of engagement where there is no reasonable justification for doing so. If the auditor is unable to agree to a change of the engagement and is not permitted to continue the original engagement, the auditor should withdraw and consider whether there is any obligation, either contractual or otherwise, to report the circumstances necessitating the withdrawal to other parties, such as the board of directors or shareholders.

## Effective Date

31. This Standard on Review Engagement (SRE) becomes operative for all review engagements relating to accounting periods beginning on or after 1 April, 2005.

## Compatibility with International Standard on Review Engagement (ISRE) 2400

The auditing standards established in this Standard on Review Engagement are generally consistent in all material respects with those set out in International Standard on Review Engagements (ISREs) 2400 on Engagements to Review Financial Statements except the following:

(a) The SRE does not require the engagement letter to include form of report to be issued pursuant to the engagement since the format of report, in some cases, is prescribed by the laws or regulations pursuant to which the financial statements are required to be reviewed.

(b) Due to the practices prevailing in India, the SRE requires the auditor to mention the "Place" instead of the "Auditor's Address" [see paragraph 26] in the report on a review of financial statements. The place of signature is the name of specific location, which is ordinarily the city where the review report is signed. According to ISA 700 (which defines the term), the expression "Auditor's Address" means the name of a specific location, which is ordinarily the city where the auditor maintains the office that has the responsibility for the audit.

(c) The SRE requires the auditor to mention the membership number assigned by the Institute of Chartered Accountants of India [see paragraph 26]. ISRE 2400, however, does not contain any corresponding requirement.

(d) Paragraph 29 of the SRE requires that the auditor should not agree to a change of engagement where there is no reasonable justification for doing so. If the auditor is unable to agree to a change of the engagement and is not permitted to continue the original engagement, the auditor should withdraw and consider whether there is any obligation, either contractual or otherwise, to report the circumstances necessitating the withdrawal to other parties, such as the board of directors or shareholders. There is no corresponding requirement in ISRE 2400.

Appendix 1

## Example of an Engagement Letter for a Review of Financial Statements

The following letter is for use as a guide in conjunction with the consideration outlined in paragraph 10 of this SRE and will need to be varied according to individual requirements and circumstances.

To the Board of Directors (or the appropriate representative of senior management):

This is with reference to your letter dated_____, appointing us to review the financial statements for the period ended_____.

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

We will review the balance sheet of ABC Company as of March 31, 20XX, and the related statement of profit and loss and cash flows for the year then ended, in accordance with the Standard on Review Engagements (SRE) 2400, "Engagements to Review Financial Statements" issued by the Institute of Chartered Accountants of India. We will not perform an audit of such financial statements and, accordingly, we will not express an audit opinion on them. Accordingly, we are expected to provide a negative assurance on the financial statements reviewed by us.

Responsibility for the financial statements, including adequate disclosure, is that of the management of the company. This includes the maintenance of adequate accounting records and internal controls and the selection and application of accounting policies. As part of our review process, we will request written representations from management concerning assertions made in connection with the review.

This letter will be effective for future years unless it is terminated, amended or superseded (applicable only in a continuing engagement).

Our engagement cannot be relied upon to disclose whether fraud or errors, or violation of laws and regulations exist. However, we will inform you of any material matters that come to our attention.

We also wish to invite your attention to the fact that our audit process is subject to 'peer review' under the Chartered Accountants Act, 1949. The reviewer may examine our working papers during the course of the peer review.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our review of the financial statements.

XYZ & Co.
Chartered Accountants
……
(Signature)
(Name of the Member)
(Designation[5])

Acknowledged on behalf of
ABC Company by
……
(Signature)
Name and Designation
Date

[5] Partner or proprietor, as the case may be.

# Appendix 2

# Illustrative Detailed Procedures that may be performed in an Engagement to Review Financial Statements

1. The inquiry and analytical review procedures carried out in a review of financial statements are determined by the auditor's judgment. When the auditor performs the inquiry and analytical review procedures, the auditor should use his professional judgement and experience in evaluating the results of such procedures and their effect on the review report and other procedures to be performed in connection with the review engagement. The procedures listed below are for illustrative purposes only. It is not intended that all the procedures suggested apply to every review engagement. This Appendix is not intended to serve as a program or checklist in the conduct of a review.

General

2. Discuss terms and scope of the engagement with the client and the engagement team.

3. Prepare an engagement letter setting forth the terms and scope of the engagement.

4. Obtain an understanding of the entity's business activities and the system for recording financial information and preparing financial statements.

5. Inquire whether all financial information is recorded:

   (a) completely;

   (b) promptly; and

   (c) after the necessary authorisation.

6. Obtain the trial balance and verify whether it agrees with the general ledger and the financial statements.

7. Consider the results of previous audits and review engagements, including accounting adjustments made.

8. Inquire whether there have been any significant changes in the entity from the previous year (e.g., changes in ownership or changes in capital structure).

9. Inquire about the accounting policies and consider whether:

   (a) they comply with accounting standards;

   (b) they have been applied appropriately; and

(c) they have been applied consistently and, if not, consider whether disclosure has been made of any changes in the accounting policies.

10. Read the minutes of meetings of shareholders, the board of directors and other appropriate committees in order to identify matters that could be important to the review.

11. Inquire if actions taken at shareholder, board of directors or comparable meetings that affect the financial statements have been appropriately reflected therein.

12. Inquire about the existence of transactions with related parties, how such transactions have been accounted for and whether related parties have been properly disclosed.

13. Inquire about contingencies and commitments.

14. Inquire about plans to dispose off major assets or business segments.

15. Obtain the financial statements and discuss them with management.

16. Consider the adequacy of disclosures in the financial statements and their suitability as to classification and presentation.

17. Compare the results shown in the current period financial statements with those shown in financial statements for comparable prior periods and, if available, with budgets and forecasts.

18. Obtain explanations from management for any unusual fluctuations or inconsistencies in the financial statements.

19. Consider the effect of any unadjusted errors—individually and in aggregate. Bring the errors to the attention of management and determine how the unadjusted errors will influence the report on the review.

20. Consider obtaining a representation letter from management.

Analytical Procedures and Inquiry

21. Obtain interim financial information and make the following comparisons for individual items appearing in the financial statements:

- Current period to budgets and forecasts
- Current period to immediately preceding period
- Current period to same period in preceding year
- Current year-to-date to preceding year-to-date
- Current period to last audited period, wherever appropriate

22. Inquire about significant changes since the last audited balance sheet in various items such as:

- Capital and reserves
- Loans
- Current liabilities and provisions
- Fixed assets
- Investments
- Inventories
- Current assets
- Loans and advances
- Deferred revenue expenditure, etc.

23. Obtain or calculate selected ratios on a comparative basis. These ratios could be:

- Current
- Quick
- Debtors turnover
- Inventory turnover
- Depreciation to fixed assets
- Debt to equity
- Gross profit
- Net profit
- Input output

24. Inquire about the relationship between related items in the statement of profit and loss as well as the quantitative data relating to production, purchases, sales, etc. and assess the reasonableness thereof, in the context of similar relationships for prior periods and other information available to the auditor.

25. In respect of comparison made in 21 through 24 above, obtain reasons for significant variances and discuss with management.

Cash and Bank

26. Obtain the bank reconciliation statement. Inquire about any old or unusual reconciling items with client personnel.

27. Inquire about transfers between cash accounts for the period before and after the review date.

28. Inquire whether there are any restrictions on cash accounts.

Receivables

29. Inquire about the accounting policies for initial recording of trade receivables and determine whether any allowances or discounts are given on such transactions.

30. Obtain a schedule of receivables and verify whether the total agrees with the trial balance.

31. Obtain and consider explanations of significant variations in account balances from previous periods or from those anticipated.

32. Obtain an aged analysis of the trade receivables. Inquire about the reason for unusually large accounts, credit balances on accounts or any other unusual balances and inquire about the collectibility of receivables.

33. Discuss with management the classification of receivables, including net credit balances and amounts due from directors and other related parties in the financial statements.

34. Inquire about the method for identifying "slow payment" accounts and setting allowances for doubtful accounts and consider it for reasonableness.

35. Inquire whether receivables have been pledged, factored or discounted.

36. Inquire about procedures applied to ensure that a proper cut-off of sales transactions and sales returns has been achieved.

37. Inquire whether receivables attributable to goods sent on consignment account have not been included in sales and such goods have been included in inventories.

38. Inquire whether any large credits relating to revenue recorded have been issued after the balance sheet date and whether provision has been made for such amounts.

Inventories

39. Obtain the inventory list and verify that the total agrees with the balance in the trial balance or other relevant records.

40. Inquire the procedures followed for recording inventory and determine the necessity of physical count of inventory. For example, a physical count may not be carried out, in case

- A perpetual inventory system is used and periodic comparisons are made with actual quantities on hand.

- An integrated cost system is used and it has produced reliable information in the past.

41. In case of physical count, inquire about the method for counting inventory and agree the inventory list with the physical count.

42. Discuss adjustments made resulting from the last physical inventory count.

43. Inquire about procedures applied to control cut-off and any inventory movements at the end of the period.

44. Inquire about the basis used in valuing each category of the inventory and, in particular, regarding the elimination of inter-branch profits. Inquire whether inventory is valued at the lower of cost and net realisable value.

45. Consider the consistency with which inventory valuation methods have been applied.

46. Compare amounts of major inventory categories with those of prior periods and with those anticipated for the current period. Inquire about major fluctuations and differences.

47. Inquire about the method used for identifying slow moving and obsolete inventory and whether such inventory has been accounted for at net realisable value.

48. Inquire whether any inventory has been consigned to the entity and, if so, whether adjustments have been made to exclude such goods from inventory.

49. Inquire whether any inventory is pledged, stored at other locations or on consignment to others and consider whether such transactions have been accounted for appropriately.

Investments

50. Obtain a schedule of the investments at the balance sheet date and verify whether it agrees with the trial balance.

51. Inquire about the accounting policy applied to investments.

52. Inquire about the classification of long-term and current investments.

53. Consider whether there has been proper accounting for gains and losses and investment income.

54. Inquire from management about the carrying values of investments. Consider whether there is any permanent diminution in value thereof.

Fixed Assets and Depreciation

55. Obtain a schedule of the fixed assets indicating the cost and accumulated depreciation and verify whether it agrees with the trial balance.

56. Inquire about the accounting policy applied regarding the provision for depreciation and distinguishing between capital and maintenance items.

57. Discuss with management the additions and deletions to fixed assets accounts and accounting for gains and losses on sales or retirements. Inquire whether all such transactions have been accounted for.

58. Inquire about the consistency with which the depreciation method and rates have been applied and compare depreciation provisions with prior years.

59. Obtain schedule of repairs and maintenance and inquire about significant amounts.

60. Consider whether the fixed assets have suffered a material, impairment in value and adequate provision has been made in respect thereof.

61. Inquire whether there are any liens on the fixed assets.

62. Consider whether lease agreements have been properly dealt with in the financial statements in conformity with accounting pronouncements.

Prepaid Expenses

63. Obtain schedules identifying the nature of these accounts and discuss with management the recoverability thereof wherever appropriate.

64. Inquire about the basis for recording these accounts and the adjustment methods used.

65. Compare balances of related expense accounts with those of prior periods and discuss significant variations with management.

Intangibles and Other Assets

66. Obtain schedules of intangible and other assets accounts, determine the nature of these accounts and discuss with management the recoverability of intangible and other assets, wherever appropriate.

67. Inquire about the basis of recognition of such assets and the methods of amortisation used for such accounts.

68. Inquire about the consistency with which the amortisation methods have been applied and compare amortisation provisions with prior years.

Capital and Reserves

69. Obtain and consider a schedule of the transactions in the capital account and reserves accounts, including new issues, redemption, buy back, and dividends.

70. Inquire whether there are any restrictions on reserves and surpluses.

Loans Payable

71. Obtain from management a schedule of loans payable and verify whether the total agrees with the trial balance.

72. Inquire whether there are any loans where management has not complied with the provisions of the loan agreement and, if so, inquire as to management's actions and whether appropriate adjustments have been made in the financial statements.

73. Consider the reasonableness of interest expense in relation to loan balances.

74. Inquire whether loans payable are secured.

75. Inquire whether loans payable have been appropriately classified between long-term and short-term.

Trade Payables

76. Obtain a schedule of trade payables and verify whether the total agrees with the trial balance.

77. Inquire about the accounting policies for initial recording of trade payables and whether the entity is entitled to any allowances or discounts given on such transactions.

78. Obtain and consider explanations of significant variations in account balances from previous periods or from those anticipated.

79. Inquire whether balances are reconciled with the creditors' statements and compare with prior period balances.

80. Consider whether there could be material unrecorded liabilities.

Accrued and Contingent Liabilities

81. Obtain a schedule of the accrued liabilities and verify whether the total agrees with the trial balance. Inquire about the method of determining accrued liabilities.

82. Compare major balances of related expense accounts with similar accounts for prior periods.

83. Determine whether the recognition of major expenses has taken place in the appropriate periods.

84. Inquire about approvals for such accruals, terms of payment, compliance with terms.

85. Inquire as to the nature of amounts included in contingent liabilities and commitments. Inquire whether any actual or contingent liabilities exist which have not been appropriately dealt with in the financial statements. If so, discuss with management whether provisions need to be made in the accounts or whether disclosure should be made in the notes to the financial statements.

Litigation

86. Inquire from management whether the entity is the subject of any legal actions-threatened, pending or in process. Consider the effect thereof on the financial statements.

Income and Other Taxes

87. Inquire from management if there were any events, including disputes with taxation authorities (both direct and indirect taxes), which could have a significant effect on the taxes payable by the entity. If yes, determine whether any provision is required.

88. Consider the tax expense (both current and deferred) in relation to the entity's income for the period.

89. Inquire from management as to the adequacy of the recorded deferred and current tax liabilities including provisions in respect of prior periods.

Subsequent Events

90. Obtain from management the latest interim financial statements and compare them with the financial statements being reviewed or with those for comparable periods from the preceding year.

91. Inquire about events after the balance sheet date that would have a material effect on the financial statements under review and, in particular, inquire whether:

(a) Any substantial commitments or uncertainties have arisen subsequent to the balance sheet date;

(b) Any significant changes in the share capital, long-term debt or working capital have occurred up to the date of inquiry; and

(c) Any unusual adjustments have been made during the period between the balance sheet date and the date of inquiry.

92. Obtain and read the minutes of meetings of shareholders, directors and appropriate committees subsequent to the balance sheet date.

93. Consider the need for adjustments or disclosure in the financial statements.

Extraordinary Items

94. Inquire and determine whether there are any extraordinary and unusual items and if so, whether these have been appropriately disclosed.

Operations

95. Compare results with those of prior periods and those expected for the current period. Discuss significant variations with management.

96. Discuss whether the recognition of major sales and expenses have taken place in the appropriate periods.

97. Consider and discuss with management the relationship between related items in the statement of profit and loss and assess the reasonableness thereof in the context of similar relationships for prior periods and other information available to the auditor.

Other Procedures

98. Inquire about:

- Changes in key management personnel.
- Major interruptions of operations due to strike, casualty, such as fire, etc.
- Significant contracts and agreements entered into/committed during the period.
- Wage settlements, if any.
- Changes in legislation that are likely to have material affect on the entity.

## Appendix 3

## Form of Unqualified Review Report

REVIEW REPORT TO...

We have reviewed the accompanying balance sheet of ABC Company at March 31, 20XX, and the related statement of profit and loss and cash flows for the year then ended. These financial statements have been approved by the board of directors of the company and are the responsibility of the company's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with the Standard on Review Engagement (SRE) 2400, "Engagements to Review Financial Statements" issued by the Institute of Chartered Accountants of India. This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and analytical procedures applied to financial data and thus provides less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

Based on our review, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view (or 'are not presented fairly, in all material respects') in accordance with Accounting Standards issued by the Institute of Chartered Accountants of India.

For ABC and Co.,
Chartered Accountants

Auditor's Signature
(Name of Member signing the Audit Report)
(Designation)[6]
(Membership Number)

Place

Date

[6] Partner or proprietor, as the case may be.

# Appendix 4

## Examples of Review Reports other than Unqualified

### Qualification for a Departure from an Accounting Standard

REVIEW REPORT TO...

We have reviewed the accompanying balance sheet of ABC Company at March 31, 20XX, and the related statement of profit and loss and cash flows for the year then ended. These financial statements have been approved by the board of directors of the company and are the responsibility of the company's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with the Standard on Review Engagements (SRE) 2400, "Engagements to Review Financial Statements" issued by the Institute of Chartered Accountants of India. This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and analytical procedures applied to financial data and thus provides less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

Management has informed us that inventory has been stated at its cost, which is in excess of its net realisable value. Management's computation, which we have reviewed, shows that inventory, if valued at the lower of cost and net realisable value as required by Accounting Standard (AS) 2, "Valuation of Inventories" issued by the Institute of Chartered Accountants of India, would have been decreased by Rs. X, and net profit and reserves would have been decreased by Rs. X.

Based on our review, except for the effects of the overstatement of inventory described in the previous paragraph, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view (or 'are not presented fairly, in all material respects') in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India.

For ABC and Co.,
Chartered Accountants
Auditor's Signature
(Name of Member signing the Audit Report)
(Designation)[7]
(Membership Number)

Place
Date

[7] Partner or proprietor, as the case may be.

Adverse Report for a Departure from an Accounting Standard

REVIEW REPORT TO...

We have reviewed the accompanying balance sheet of ABC Company at March 31, 20XX, and the related statement of profit and loss and cash flows for the year then ended. These financial statements have been approved by the board of directors of the company and are the responsibility of the company's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with the Standard on Review Engagements (SRE) 2400, "Engagements to Review Financial Statements" issued by the Institute of Chartered Accountants of India. This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and analytical procedures applied to financial data and thus provide less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

As noted in note X, the Company has adopted the method of taking entire profits on construction contracts to the statement of profit and loss on entering into the contract. This has resulted in anticipating the profit in cases where the contracts have not even been commenced or where only a very minor part of the expenditure relating to the construction contracts has been incurred. This method of accounting is contrary to the requirements of Accounting Standard (AS) 7, "Accounting for Construction Contracts", issued by the Institute of Chartered Accountants of India.

Based on our review, because of the pervasive effect on the financial statements of the matter discussed in the preceding paragraph, the accompanying financial statements do not give a true and fair view (or 'are not presented fairly, in all material respects') in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India.

For ABC and Co.,
Chartered Accountants
Auditor's Signature
(Name of Member signing the Audit Report)
(Designation)[8]
Place (Membership Number)
Date

[8] Partner or proprietor, as the case may be.

# SAE 3400 (AAS 35)

## THE EXAMINATION OF PROSPECTIVE FINANCIAL INFORMATION

***(Effective in relation to reports on projections/forecasts issued on or after April 1, 2007)***

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Standard on Assurance Engagements (SAE) 3400[*], "The Examination of Prospective Financial Information" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

[*] Issued in February, 2007. The date this Standard on Assurance Engagement comes into effect, the Guidance Note on Accountant's Report on Profit Forecasts and/or Financial Forecasts, issued in September, 1982 shall stand withdrawn.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard on Assurance Engagement (SAE) is to establish standards and provide guidance on engagements to examine and report on prospective financial information including examination procedures for best-estimate and hypothetical assumptions. This SAE does not apply to the examination of prospective financial information expressed in general or narrative terms, such as that found in management's discussion and analysis in an entity's annual report, though many of the procedures outlined herein may be suitable for such an examination[2]. Further, the principles laid down in the other Standards on Auditing, issued by the Institute of Chartered Accountants of India, should be used by the auditor, to the extent practicable, in applying this SAE.

2. In an engagement to examine prospective financial information, the auditor[3] should obtain sufficient appropriate evidence as to whether:

(a) management's best-estimate assumptions on which the prospective financial information is based are not unreasonable and, in the case of hypothetical assumptions, such assumptions are consistent with the purpose of the information;

(b) the prospective financial information is properly prepared on the basis of the assumptions;

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[2] The guidance provided in this Standard is in line with the provisions of clause (3) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 [as amended by the Chartered Accountants (Amendment) Act, 2006]. This clause provides that a chartered accountant in practice shall be deemed to be guilty of professional misconduct "if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast." As per the opinion of the Council while finalising the Guidance Note on Accountant's Report on Profit Forecasts and/or Financial Forecasts at its 100th meeting held on 22nd through 24th July 1982, a chartered accountant can participate in the preparation of profit or financial forecasts and can review them, provided he indicates clearly in his report the sources of information, the basis of forecasts and also the major assumptions made in arriving at the forecasts and so long as he does not vouch for the accuracy of the forecasts. The Council has further opined that the same opinion would also apply to projections made on the basis of hypothetical assumptions about future events and management actions which are not necessarily expected to take place so long as the auditor does not vouch for the accuracy of the projection. (emphasis added)

[3] The term "auditor" is used throughout this SAE when describing services involving examination of prospective financial information. Such reference is not intended to imply that a member performing such services need necessarily be the statutory auditor of the entity's financial statements.

(c) the prospective financial information is properly presented and all material assumptions are adequately disclosed, including a clear indication as to whether they are best-estimate assumptions or hypothetical assumptions; and

(d) the prospective financial information is prepared on a consistent basis with historical financial statements, using appropriate accounting principles.

3. "Prospective financial information" means financial information based on assumptions about events that may occur in the future and possible actions by an entity. It is highly subjective in nature and its preparation requires the exercise of considerable judgment. Prospective financial information can be in the form of a forecast, a projection, or a combination of both, for example, a one year forecast plus a five year projection.

4. A "forecast" means prospective financial information prepared on the basis of assumptions as to future events which management expects to take place and the actions management expects to take as of the date the information is prepared (best-estimate assumptions).

5. A "projection" means prospective financial information prepared on the basis of:

(a) hypothetical assumptions about future events and management actions which are not necessarily expected to take place, such as when some entities are in a start-up phase or are considering a major change in the nature of operations; or

(b) a mixture of best-estimate and hypothetical assumptions.

Such information illustrates the possible consequences as of the date the information is prepared if the events and actions were to occur (a "what-if" scenario).

6. Prospective financial information can include financial statements or one or more elements of financial statements and may be prepared:

(a) as an internal management tool, for example, to assist in evaluating a possible capital investment; or

(b) for the distribution/submission to third parties in, for example:

- a prospectus to provide potential investors with information about future expectations.
- an annual report to provide information to shareholders, regulatory bodies and other interested parties.
- a document, for example, cash flow forecasts, for the information of lenders.

7. Management is responsible for the preparation and presentation of the prospective financial information, including the identification and disclosure of the sources of information, the basis of forecasts and the underlying assumptions. The auditor may be asked to examine and report on the prospective financial information to enhance its credibility, whether it is intended for use by third parties or for internal purposes.

## The Auditor's Assurance Regarding Prospective Financial Information

8. Prospective financial information relates to events and actions that have not yet occurred and might not occur. While evidence may be available to support the assumptions on which the prospective financial information is based, such evidence is itself generally future- oriented and, therefore, speculative in nature, as distinct from the evidence ordinarily available in the examination of historical financial information. 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.

9. Further, given the types of evidence available in assessing the assumptions on which the prospective financial information is based, it may be difficult for the auditor to obtain a level of satisfaction sufficient to provide a positive expression of opinion that the assumptions are free of material misstatement. Consequently, in this SAE, when reporting on the reasonableness of management's assumptions, the auditor provides only a moderate level of assurance.

## Acceptance of Engagement

10. Before accepting an engagement to examine prospective financial information, the auditor would consider, amongst other things:

- the intended use of the information;

- whether the information will be for general or limited distribution;
- the nature of the assumptions, that is, whether they are best-estimates or hypothetical assumptions;
- the elements to be included in the information; and
- the period covered by the information.

11. The auditor should not accept, or should withdraw from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use.

12. In accordance with SA 210, "Terms of Audit Engagement", it is necessary that the auditor and the client should agree on the terms of the engagement. It is in the interest of both client and auditor that the auditor sends an engagement letter to help in avoiding misunderstandings regarding the engagement. An engagement letter would address the matters in paragraph 10 and set out the management's responsibilities for the assumptions and for providing the auditor with all relevant information and source data used in developing the assumptions.

## Knowledge of the Business

13. The auditor should obtain a sufficient level of knowledge of the business to be able to evaluate whether all significant assumptions required for the preparation of the prospective financial information have been identified. The auditor would also need to become familiar with the entity's process for preparing prospective financial information, for example, by considering:

(a) The internal controls over the system used to prepare prospective financial information and the expertise and experience of those persons preparing the prospective financial information.

(b) The nature of the documentation prepared by the entity supporting management's assumptions.

(c) The extent to which statistical, mathematical and computer-assisted techniques are used.

(d) The methods used to develop and apply assumptions.

(e) The accuracy of prospective financial information prepared in prior periods, if any, and the reasons for any significant variances therein.

14. The auditor should consider the extent to which reliance on the entity's historical financial information is justified. The auditor requires knowledge of the entity's historical financial information to assess whether the prospective financial information has been prepared on a basis consistent with the historical financial information and to provide a historical yardstick for considering management's assumptions. The auditor will need to establish, for example, whether relevant historical information was audited or reviewed and whether acceptable accounting principles were used in its preparation.

15. If the audit or review report on prior period historical financial information was other than a clean report[4] or if the entity is in a start-up/expansion phase, the auditor would consider the relevant facts and the effect on the examination of the prospective financial information.

## Period Covered

16. The auditor should consider the period of time covered by the prospective financial information. Since assumptions become more speculative as the length of the period covered increases, as that period lengthens, the ability of management to make best-estimate assumptions decreases. The period would not extend beyond the time for which management has a reasonable basis for the assumptions. The following are some of the factors that are relevant to the auditor's consideration of the period of time covered by the prospective financial information:

(a) The operating cycle, for example, in the case of a major construction project undertaken by a construction company, the time required to complete the project may dictate the period covered.

(b) The degree of reliability of assumptions, for example, if the entity is introducing a new product, the prospective period covered could be short and broken into small segments, such as weeks or months. Alternatively, if for example, the entity's sole business is owning a property under long-term lease, a relatively long prospective period might be reasonable.

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[4] Alternatively known as the unmodified report in terms of the Standard on Auditing (SA) 700, "The Auditor's Report on Financial Statements".

(c) The needs of users, for example, prospective financial information may be prepared in connection with an application for a loan for the period of time required to generate sufficient funds for repayment. Alternatively, the information may be prepared for investors in connection with the issue of securities to illustrate the intended use of the proceeds in the subsequent period.

## Examination Procedures

17. When determining the nature, timing and extent of examination procedures, the auditor should consider matters such as:

(a) the knowledge obtained during any previous engagements;

(b) management's competence regarding the preparation of prospective financial information;

(c) the likelihood of material misstatement;

(d) the extent to which the prospective financial information is affected by the management's judgment;

(e) the sources of information considered by the management for the purpose, their adequacy, reliability of the underlying data, including data derived from third parties, such as industry statistics, to support the assumptions;

(f) the stability of entity's business; and

(g) the engagement team's experience with the business and the industry in which the entity operates and with reporting on prospective financial information.

18. The auditor would assess the source and reliability of the evidence supporting management's best-estimate assumptions. Sufficient appropriate evidence supporting such assumptions would be obtained from internal and external sources including consideration of the assumptions in the light of historical information and an evaluation of whether they are based on plans that are within the entity's capacity. Examples of external sources are government publications, industry publications, economic forecast, existing or proposed legislation, and reports of changing technology. Examples of internal sources are budgets, the economic substance and viability of the entity and/or transaction or project of the entity, reputation of management

responsible for assumptions underlying the prospective financial information, wage agreements, patents, royalty agreements and records, sales backlog records, debt agreements, and actions of the board of directors involving entity plans, etc.

19. The auditor would consider whether, when hypothetical assumptions are used, all significant implications of such assumptions have been taken into consideration. For example, if sales are assumed to grow beyond the entity's current plant capacity, the prospective financial information will need to include the necessary investment in the additional plant capacity or the costs of alternative means of meeting the anticipated sales, such as subcontracting production.

20. The auditor would need to be satisfied that the hypothetical assumptions are consistent with the purpose of the prospective financial information and that there is no reason to believe they are clearly unrealistic.

21. The auditor will need to be satisfied that the prospective financial information is properly prepared from management's assumptions by, for example, making checks such as recomputation and reviewing internal consistency, that is, the actions management intends to take are compatible with each other and there are no inconsistencies in the determination of the amounts that are based on common variables such as interest rates.

22. The auditor would focus on the extent to which those areas that are particularly sensitive to variation will have a material effect on the results shown in the prospective financial information. This will influence the extent to which the auditor will seek appropriate evidence. It will also influence the auditor's evaluation of the appropriateness and adequacy of disclosure.

23. When engaged to examine one or more elements of prospective financial information, such as an individual financial statement, it is important that the auditor considers the interrelationship of other components in the financial statements.

24. When any elapsed portion of the current period is included in the prospective financial information, the auditor would consider the extent to which procedures need to be applied to the historical information. Procedures will vary depending on the circumstances, for example, how much of the prospective period has elapsed.

25. The auditor should obtain written representations from management regarding the intended use of the prospective financial information, the completeness of significant management assumptions and management's acceptance of its responsibility for the prospective financial information. The management is also responsible for identification and disclosure of uncontrollable factors, outstanding litigations, commitments, or any other material factors that are likely to affect the prospective financial information.

## Presentation and Disclosure

26. When assessing the presentation and disclosure of the prospective financial information and the underlying assumptions, in addition to the specific requirements of any relevant statutes, regulations as well as the relevant professional pronouncements, the auditor will need to consider whether:

(a) the presentation of prospective financial information is informative and not misleading;

(b) the accounting policies are clearly disclosed in the notes to the prospective financial information;

(c) the assumptions are adequately disclosed in the notes to the prospective financial information. It needs to be clear whether assumptions represent management's best-estimates or are hypothetical and, when assumptions are made in areas that are material and are subject to a high degree of uncertainty, this uncertainty and the resulting sensitivity of results needs to be adequately disclosed;

(d) the date as of which the prospective financial information was prepared is disclosed. Management needs to confirm that the assumptions are appropriate as of this date, even though the underlying information may have been accumulated over a period of time;

(e) the basis of establishing points in a range is clearly indicated and the range is not selected in a biased or misleading manner when results shown in the prospective financial information are expressed in terms of a range; and

(f) there is any change in the accounting policy of the entity from that disclosed in the most recent historical financial statements and whether

reason for the change and the effect of such change on the prospective financial information has been adequately disclosed.

## Documentation

27. The auditor should document matters, which are important in providing evidence to support his report on examination of prospective financial information, and evidence that such examination was carried out in accordance with this SAE. The working papers will include the sources of information, basis of forecasts and the assumptions made in arriving the forecasts, hypothetical assumptions, evidence supporting the assumptions, management representations regarding the intended use and distribution of the information, completeness of material assumptions, management's acceptance of its responsibility for the information, audit plan, the nature, timing and extent of examination procedures performed, and, in case the auditor expresses a modified opinion or withdraws from the engagement, the reasons forming the basis of such decision.

## Report on Examination of Prospective Financial Information

28. The report by an auditor on an examination of prospective financial information should contain the following:

(a) Title;

(b) Addressee;

(c) Identification of the prospective financial information;

(d) Reference to the Standards on Auditing applicable to the examination of prospective financial information;

(e) Statement that management is responsible for the prospective financial information including the underlying assumptions;

(f) When applicable, a reference to the purpose and/or restricted distribution of the prospective financial information;

(g) Statement that the examination procedures included examination, on a test basis, of evidence supporting the assumptions, amounts and other disclosures in the forecast or projection;

(h) Statement of negative assurance as to whether the assumptions provide a reasonable basis for the prospective financial information;

(i) Opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework;

(j) Appropriate caveats concerning the achievability of the results indicated by the prospective financial information;

(k) Date of report (which should be the date procedures have been completed);

(l) Place of signature; and

(m) Signature.

29. Such a report would:

- State whether, based on the examination of the evidence supporting the assumptions, anything has come to the auditor's attention, which causes the auditor to believe that the assumptions do not provide a reasonable basis for the prospective financial information.
- Express an opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework.
- State that:
  - Actual results are likely to be different from the prospective financial information since anticipated events frequently do not occur as expected and the variation could be material. Likewise, when the prospective financial information is expressed as a range, it would be stated that there can be no assurance that actual results will fall within the range; and
  - In the case of a projection, the prospective financial information has been prepared for (intended use), using a set of assumptions that include hypothetical assumptions about future events and management's actions that are not necessarily expected to occur. Consequently, readers are cautioned that the prospective financial

information should not be used for purposes other than the abovementioned intended use.

30. The following is an example of an extract from an unmodified report on a projection:

We have examined the projection of _____ (project)_____ (name of the entity) for the period from _____ to _____ as given in[5] ____ to the Prospective Financial Information from page __to ___in accordance with Standard on Assurance Engagement 3400, "The Examination of Prospective Financial Information", issued by the Institute of Chartered Accountants of India. The preparation and presentation of the projection including the underlying assumptions, set out in note ____ to _____ to the prospective financial information, is the responsibility of the Management and has been approved by the Board of Directors[6] of the company. Our responsibility is to examine the evidence supporting the assumptions (excluding the hypothetical assumption) and other information in the prospective financial information. Our responsibility does not include verification of the accuracy of the projections. Therefore, we do not vouch for the accuracy of the same.

This projection has been prepared for (describe purpose). As the entity is in a start-up phase the projection has been prepared using a set of assumptions that include hypothetical assumptions about future events and management's actions that are not necessarily expected to occur. Consequently, readers are cautioned that this projection may not be appropriate for purposes other than that described above.

We have carried out our examination of the prospective financial information on a test basis. Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the projection, assuming that _____ (state or refer to the hypothetical assumptions).

Further, in our opinion the projection is properly prepared on the basis of the assumptions as set out in Note _____ to the Prospective

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[5] Provide suitable identification, such as by reference to page numbers or by identifying the individual schedule.

[6] Other corresponding approving authority in the case of entities other than companies.

Financial Information and on a consistent basis in accordance with the historical financial statements, using appropriate accounting principles. Even if the events anticipated under the hypothetical assumptions described above occur, actual results are still likely to be different from the projection since other anticipated events frequently do not occur as expected and the variation may be material.

A complete illustrative format of an unmodified report on a projection is given in Appendix 1.

31. The following is an example of an extract from an unmodified report on a forecast:

We have examined the forecast of _____ (project) of the _____ (name of the entity) for the period from _____ to _____ in accordance with the Standard on Assurance Engagements (SAE) 3400, "The Examination of Prospective Financial Information", issued by the Institute of Chartered Accountants of India. The preparation and presentation of the forecast including the underlying assumptions, set out in Note _____ to the Prospective Financial Information is the responsibility of the management and has been approved by the Board of Directors of the Company. The sources of information are set out in Annexure _____ to the prospective financial information. Our responsibility is to examine the evidence supporting the forecast. Our responsibility does not include verification of the accuracy of the forecasts. Therefore, we do not vouch for the accuracy of the same.

Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the forecast. Further, in our opinion the forecast is properly prepared on the basis of the assumptions as set out in Note ____ and on consistent basis with historical financial statements, using appropriate accounting principles.

Actual results are likely to be different from the forecast since anticipated events frequently do not occur as expected and the variation may be material.

A complete illustrative format of an unmodified report on a forecast is given in Appendix 2.

32. When the auditor believes that the presentation and disclosure of the prospective financial information is not adequate, the auditor should express a qualified or adverse opinion in the report on the prospective financial information, or withdraw from the engagement as appropriate. An example would be where financial information fails to disclose adequately the consequences of any assumptions, which are highly sensitive.

33. When the auditor believes that one or more significant assumptions do not provide a reasonable basis for the prospective financial information prepared on the basis of best-estimate assumptions or that one or more significant assumptions do not provide a reasonable basis for the prospective financial information given the hypothetical assumptions, the auditor should either express an adverse opinion setting out the reasons in the report on the prospective financial information, or withdraw from the engagement.

34. When the examination is affected by conditions that preclude application of one or more procedures considered necessary in the circumstances, the auditor should either withdraw from the engagement or disclaim the opinion and describe the scope limitation in the report on the prospective financial information.

## Effective Date

35. This SAE is effective in relation to reports on projections/forecasts, issued on or after April 1, 2007. However, earlier application of the Standard is encouraged.

## Compatibility with International Standard on Assurance Engagement (ISAE) 3400

Except for the matters noted below, the basic principles and essential procedures of this SAE and International Standard on Assurance Engagement (ISAE) 3400 "The Examination of Prospective Financial Information", are consistent in all material respects:

(a) SAE precludes the auditor from expressing positive assurance regarding the assumptions as it may tantamount to vouching for the accuracy of the forecast/projection/hypothetical assumptions. Whereas,

the ISAE 3400 permits the auditor to express positive assurance when in his judgment an appropriate level of satisfaction has been obtained.

(b) The sub points in paragraph 17 (corresponding to paragraph 17 of the ISAE 3400) have been rearranged. Sub point (e) has been elucidated for the sake of better understanding of the readers. The sub points (f) and (g) have been added in the SAE as additional factors to be considered by the auditor.

(c) In paragraph 20 of the SAE, the phrase "although evidence supporting hypothetical assumptions need not be obtained" has been deleted since it is felt that such a phrase is inconsistent with the necessity for the auditor to obtain evidence to support his conclusions.

(d) In paragraph 26 (corresponding to paragraph 26 of the ISAE 3400), the term "professional standards" has been changed to "professional pronouncements" since pronouncements would include standards as well as other relevant documents, such as Guidance Notes, announcement(s), issued by the ICAI.

(e) In line with requirement of SA 700, "The Auditor's Report on Financial Statements" this SAE requires the auditor to include a scope section in the examination report to explain the nature and extent of the auditor's work. ISAE 3400 does not contain an equivalent requirement.

(f) SAE specifically provides for the documentation required to be done by the auditor in regard to any engagement of examination of prospective financial information. However, ISAE 3400 does not contain such explicit provision.

Appendix 1

# Illustrative Format of an Unmodified Report on a Projection

## Report on Examination of Prospective Financial Information

To the …(addressee)……..

We have examined the projection of _____ (project)_____ (name of the entity) for the period from _____ to _____ as given in[7] ____ to the Prospective Financial Information from page __to ___in accordance with Standard on Assurance Engagement 3400, "The Examination of Prospective Financial Information", issued by the Institute of Chartered Accountants of India. The preparation and presentation of the projection including the underlying assumptions, set out in note ____ to _____ to the prospective financial information, is the responsibility of the Management and has been approved by the Board of Directors[8] of the company. Our responsibility is to examine the evidence supporting the assumptions (excluding the hypothetical assumption) and other information in the prospective financial information. Our responsibility does not include verification of projections. Therefore, we do not vouch for the accuracy of the same.

This projection has been prepared for _____ (intended use). The projection has been prepared using a set of assumptions that include hypothetical assumptions about future events and management's actions that are not necessarily expected to occur. Consequently, users are cautioned that this projection may not be appropriate for purposes other than that described above.

We have carried out our examination of the prospective financial information on a test basis. Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the projection, assuming that _____ (state or refer to the hypothetical assumptions).

Further, in our opinion the projection is properly prepared on the basis of the assumptions as set out in Note _____ to the Prospective Financial Information and on a consistent basis with the historical financial statements, using appropriate accounting principles. Even if the events anticipated under the hypothetical assumptions described above occur, actual results are still likely to

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[7] Provide suitable identification, such as by reference to page numbers or by identifying the individual schedule.

[8] Other corresponding approving authority in the case of entities other than companies.

be different from the projection since other anticipated events frequently do not occur as expected and the variation may be material.

For ABC & Co.,
Chartered Accountants

Signature
(Name of the member signing the report)
(Designation)[9]
Membership Number

Date :
Place of Signature :

[9] Partner or proprietor, as the case may be.

Appendix 2

## Illustrative Format of an Unmodified Report on a Forecast

### Report on Examination of Prospective Financial Information

To the ……(addressee)…….

We have examined the forecast of _____(project)_____of the _____ (name of the entity) for the period from ___ to ___ as given[10] in _____ to _____ of the prospective financial information in accordance with Standard on Assurance Engagement ___, The Examination of Prospective Financial Information, issued by the Institute of Chartered Accountants of India. The preparation and presentation of the forecast including the underlying assumptions, set out in Note _____ to the Prospective Financial Information, is the responsibility of the management and has been approved by the Board of Directors of the company[11]. The sources of information are set out in Annexure _____ to the prospective financial information. Our responsibility is to examine the evidence supporting the forecast. Our responsibility does not include verification of the forecasts. Therefore, we do not vouch for the accuracy of the same.

This forecast has been prepared for _____ (intended use). The forecast has been prepared using a set of assumptions as set out in Note ____ to the prospective financial information.

We have carried out our examination of the prospective financial information on a test basis.

Based on our examination of the evidence supporting the assumptions, nothing has come to our attention, which causes us to believe that assumptions do not provide a reasonable basis for the forecast. Further, in our opinion the forecast, read with the notes thereon, is properly prepared on the basis of the assumptions as set out in Note _____ and on a consistent basis with the historical financial statements, using appropriate accounting principles.

Actual results are likely to be different from the forecast since anticipated events might not occur as expected and the variation might be material.

For ABC & Co.,
Chartered Accountants
Signature
(Name of the member signing the report)
(Designation)[12]
Membership Number

Date :
Place of Signature:

[10] Provide suitable identification, such as by reference to page numbers or by identifying the individual schedule.

[11] Other corresponding approving authority in the case of entities other than companies.

[12] Partner or proprietor, as the case may be.

# SRS 4400 (AAS 32)

## ENGAGEMENTS TO PERFORM AGREED-UPON PROCEDURES REGARDING FINANCIAL INFORMATION

***(Effective for all agreed upon procedures engagements on or after April 1, 2004)***

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Standard on Related Services (SRS) 4400*, "Engagements to Perform Agreed-upon Procedures regarding Financial Information" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

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* Issued in April, 2004. With the issuance of this Standard on Related Services, the "Guidance Note on Engagements to Perform Agreed Upon Procedures regarding Financial Information", issued by the Institute of Chartered Accountants of India in July 2001, shall stand withdrawn.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard on Related Services (SRS) is to establish standards and provide guidance on the auditor's[2] professional responsibilities when an engagement to perform agreed-upon procedures regarding financial information is undertaken and on the form and content of the report that the auditor issues in connection with such an engagement.

2. In an engagement to perform agreed-upon procedures, the auditor is engaged by the client to issue a report of factual findings, based on specified procedures performed on specified subject matter of specified elements, accounts or items of a financial statement. 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.

3. This SRS is directed towards engagements regarding financial information. However, it may provide useful guidance for engagements to perform agreed-upon procedures regarding non-financial information, provided the auditor has adequate knowledge of the subject matter in question and reasonable criteria exist on which to base his findings. These Standards on Auditing is to be read in conjunction with the "Framework of Statements on Standard Auditing Practices and Guidance Notes on Related Services"[3]. The principles laid down in the other SAs, issued by the Institute of Chartered Accountants of India, may be used by the auditor, to the extent practicable, in applying this SRS.

## Objective of an Agreed-upon Procedures Engagement

4. The objective of an agreed-upon procedures engagement is for the auditor to carry out procedures of an audit nature to which the auditor

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[2] The term "auditor" is used throughout this SRS when describing services involving performance of agreed-upon procedures. Such reference is not intended to imply that a person performing related services need necessarily be the auditor of the entity's financial statements.

[3] The Framework issued in 2001 has been withdrawn pursuant to the issuance of the "Framework for Assurance Engagements", which is applicable from April 1, 2008. The text of the Revised Framework is reproduced elsewhere in this Handbook.

and the entity and any appropriate third parties have agreed and to report on factual findings.

5. As the auditor simply provides a report of the factual findings of agreed-upon procedures, no assurance is expressed by him in his report. Instead, users of the report assess for themselves the procedures and the findings reported by the auditor and draw their own conclusions from the work done by the auditor.

6. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results. However, it is possible in certain circumstances that the report of the engagement may not be restricted only to those parties that have agreed to the procedures to be performed, but made available to a wider range of entities or individuals, e.g., in case of government organisations.

## General Principles of an Agreed-upon Procedures Engagement

7. The auditor should comply with the Code of Ethics, issued by the Institute of Chartered Accountants of India. Ethical principles governing the auditor's professional responsibilities for this type of engagement are:

(a) Integrity;

(b) Objectivity;

(c) Professional competence and due care;

(d) Confidentiality;

(e) Professional conduct; and

(f) Technical standards

Independence is not a requirement for agreed-upon procedures engagement, however, the terms or objective of the engagement may require the auditor to comply with the independence requirements of the Code of Ethics issued by the Institute of Chartered Accountants of India. Where the auditor is not independent, a statement to that effect should be made in the report of factual findings.

8. The auditor should conduct an agreed-upon procedure engagement in accordance with this SRS and the terms of the engagement.

## Defining the Terms of the Engagement

9. The auditor should ensure with representatives of the entity and, ordinarily, other specified parties who will receive copies of the report of factual findings, that there is a clear understanding regarding the agreed procedures and the conditions of the engagement. Matters to be agreed include the following:

(a) Nature of the engagement including the fact that the procedures performed will not constitute an audit or a review and that accordingly no assurance will be expressed.

(b) Stated purpose for the engagement.

(c) Identification of the financial information to which the agreed-upon procedures will be applied.

(d) Nature, timing and extent of the specific procedures to be applied.

(e) Limitations on distribution of the report of factual findings. When such limitation would be in conflict with the legal requirements, if any, the auditor would not accept the engagement.

10. In certain circumstances, for example, when the procedures have been agreed to between the regulator, industry representatives and representatives of the accounting profession, the auditor may not be able to discuss the procedures with all the parties who will receive the report. In such cases, the auditor may consider, for example, discussing the procedures to be applied with appropriate representatives of the parties involved, reviewing relevant correspondence from such parties.

11. It is in the interests of both the client and the auditor that the auditor sends an engagement letter documenting the key terms of the appointment. An engagement letter confirms the auditor's acceptance of the appointment and helps avoid misunderstanding regarding such matters as the objectives and scope of the engagement, the extent of the auditor's responsibilities and the form of reports to be issued.

12. Matters that would be included in the engagement letter include:

- A listing of the procedures to be performed as agreed-upon between the parties.
- A statement that the distribution of the report of factual findings would be restricted to the specified parties who have agreed to the procedures to be performed.

An example of an engagement letter appears in Appendix I to this SRS.

## Planning

13. The auditor should plan the work so that an effective engagement will be performed.

## Documentation

14. The auditor should document matters which are important in providing evidence to support the report of factual findings, and evidence that the engagement was carried out in accordance with this SRS and the terms of the engagement.

## Procedures and Evidence

15. The auditor should carry out the procedures agreed-upon and use the evidence obtained as the basis for the report of factual findings.

16. The procedures applied in an engagement to perform agreed-upon procedures may include:

- Inquiry and analysis.
- Recomputation, comparison and other clerical accuracy checks.
- Observation.
- Inspection.
- Obtaining confirmations.

Appendix II to this SRS is an example report which contains an illustrative list of procedures which may be used as one part of a typical agreed-upon procedures engagement.

## Reporting

17. The report on an agreed-upon procedures engagement needs to describe the purpose and the agreed-upon procedures of the engagement in sufficient detail to enable the reader to understand the nature and the extent of the work performed. The report should also clearly mention that no audit or review has been performed.

18. The report of factual findings should contain:

(a) Title;

(b) Addressee (ordinarily, the appointing authority );

(c) Identification of specific financial or non-financial information to which the agreed-upon procedures have been applied;

(d) A statement that the procedures performed were those agreed-upon with the recipient;

(e) A statement that the engagement was performed in accordance with the Standard on Related Services applicable to agreed-upon procedures engagements;

(g) Identification of the purpose for which the agreed-upon procedures were performed;

(h) A listing of the specific procedures performed;

(i) A description of the auditor's factual findings including sufficient details of errors and exceptions found;

(j) A statement that the procedures performed do not constitute either an audit or a review and, as such, no assurance is expressed;

(k) A statement that had the auditor performed additional procedures, an audit or a review, other matters might have come to light that would have been reported;

(l) A statement that the report is restricted to those parties that have agreed to the procedures to be performed;

(m) A statement (when applicable) that the report relates only to the elements, accounts, items or financial and non-financial information specified and that it does not extend to the entity's financial statements taken as a whole;

(n) Date of the report;

(o) Place of signature ; and

(p) Auditor's signature

The report should be signed by the accountant in his personal name. Where the firm is appointed, the report should be signed in the personal name of the accountant and in the name of the firm. The partner/proprietor signing the report on agreed-upon procedures should also mention the membership number assigned by the Institute of Chartered Accountants of India

Appendix II to this SRS contains an example of a report of factual findings issued in connection with an engagement to perform agreed-upon procedures regarding financial information.

## Effective Date

19. This Standard on Related Services is applicable to all agreed upon procedures engagements beginning on or after April 1, 2004.

## Compatibility with the International Standard on Auditing (ISA)** 920

The standards established in this Standard on Related Services are generally consistent in all material respects with those set out in the International Standard on Auditing (ISA) 920, "Engagements to Perform Agreed-upon Procedures regarding Financial Information".

** Now the International Standard on Related Services (ISRS) 4400.

## Appendix I

## Example of an Engagement Letter for an Agreed-upon Procedures Engagement

The following letter is for use as a guide in conjunction with paragraph 12 of this Standard on Related Services and is not intended to be a standard letter. The engagement letter will need to be varied according to individual requirements and circumstances.

Date

To the Board of Directors (or other appropriate representatives of the client who engaged the auditor).

This is in reference to your letter dated _____, appointing us to perform agreed-upon procedures in respect of _____ (identify the items, e.g., sales, profit of a segment, accounts receivables, etc., of the entity).

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services that we will provide.

Our engagement will be conducted in accordance with the Standard on Related Services (SRS) 4400, "Engagements to Perform Agreed-upon Procedures regarding Financial Information", issued by the Institute of Chartered Accountants of India and we will indicate so in our report.

We have agreed to perform the following procedures and report to you the factual findings resulting from our work:

(Describe the nature, timing and extent of the procedures to be performed, including specific reference, where applicable, to the identity of documents and records to be read, individuals to be contacted and parties from whom confirmations will be obtained.)

The procedures that we will perform are solely to assist you in _____ (state purpose). Our report is not to be used for any other purpose and is solely for your information, and/ or for use by _____ (in case the terms of reference so require).

The procedures that we will perform will not constitute an audit or a review made in accordance with the generally accepted auditing standards in India and, consequently, no assurance will be expressed.

We look forward to your full cooperation and trust that you will make available to us whatever records, documentation and other information requested in connection with our engagement.

Our fees will be billed as work progresses.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the terms of the engagement including the specific procedures, which we have agreed will be performed.

For XYZ & Co
Chartered Accountants
……..
Signature
(Name of the Member)
Designation[4]
Date:
Address:

Acknowledged on behalf of
ABC Company by
( signed )
.....
Name and Title
Date
Address

[4] Partner or proprietor, as the case may be.

## Appendix II

Example of a Report of Factual Findings in Connection with Accounts Receivable

CONFIDENTIAL

Report Of Factual Findings In Connection With
Agreed-upon Procedures Assignment Related To Accounts Receivable

To (those who engaged the auditor)

We have performed the procedures agreed with you and enumerated below with respect to the accounts receivable of ABC Company as at _____(date), set forth in the accompanying schedules (not shown in this example). Our engagement was undertaken in accordance with the Standard on Related Services (SRS) 4400, "Engagements to Perform Agreed-upon Procedures regarding Financial Information", issued by the Institute of Chartered Accountants of India. The procedures were performed solely to assist you in evaluating the validity of the accounts receivable and are summarized as follows:

1. We obtained and checked the addition of the trial balance of accounts receivable as at _____ (date), prepared by ABC Company, and we compared the total to the balance in the related general ledger account.

2. We compared the attached list (not shown in this example) of major customers and the amounts outstanding at _____ (date) to the related names and amounts in the trial balance.

3. We obtained customers' statements or confirmations from customers to confirm balances outstanding at _____ (date).

4. We compared such statements or confirmations to the amounts referred to in 2 above. For amounts which did not agree, we obtained reconciliations from ABC Company. For reconciliations obtained, we identified and listed outstanding invoices, debit notes and outstanding cheques, each of which was greater than Rs. XXX. We located and examined such invoices and debit notes subsequently raised and cheques subsequently received and we ascertained that they have been rightly listed as outstanding on the reconciliations.

We report our findings below:

(a) With respect to item 1, we found the addition to be correct and the total amount to be in agreement.

(b) With respect to item 2, we found the amounts compared to be in agreement.

(c) With respect to item 3, we found there were suppliers' statements for all such customers.

(d) With respect to item 4, we found the amounts agreed, or with respect to amounts which did not agree, we found the Company had prepared reconciliations and that the debit notes, invoices and outstanding cheques over Rs. XXX were appropriately listed as reconciling items with the following exceptions:

(Detail the exceptions)

Because the above procedures do not constitute either an audit or a review made in accordance with the generally accepted auditing standards in India, we do not express any assurance on the accounts receivable as at _____(date).

Had we performed additional procedures or had we performed an audit or review of the financial statements in accordance with the generally accepted auditing standards in India, other matters might have come to our attention that would have been reported to you.

Our report is solely for the purpose set forth in the first paragraph of this report and for your information and is not to be used for any other purpose or to be distributed to any other parties. This report relates only to the accounts and items specified above and does not extend to any financial statements of ABC Company, taken as a whole.

Date: For XYZ & Co

Chartered Accountants

Place:

……

Signature

(Name of the Member and Membership number)

Designation[5]

[5] Partner or proprietor as the case may be.

# SRS 4410 (AAS 31)

## ENGAGEMENTS TO COMPILE FINANCIAL INFORMATION

***(Effective for all compilation engagements beginning on or after April 1, 2004)***

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Standard on Related Services (SRS) 4410*, "Engagements to Compile Financial Information" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

* Issued in April, 2004. With the issuance of this Standard on Related Services, the Guidance Note on Members' Duties regarding Engagements to Compile Financial Statements, issued by the Institute of Chartered Accountants of India, issued in February 2002, shall stand withdrawn.

[1] Published in the July 2007 issue of the Journal.

## Introduction

1. The purpose of this Standard on Related Services (SRS) is to establish standards on professional responsibilities of an accountant[2] when an engagement to compile financial statements or other financial information is undertaken and the form and content of the report to be issued in connection with such a compilation so that the association of the name of the accountant with such financial statements or financial information is not misconstrued by a user of those statements or information as having been audited by him.

2. This SRS is directed towards the compilation of financial information. However, it should be applied to the extent practicable, to engagements to compile non-financial information, provided the accountant has adequate knowledge of the subject matter in question. Engagements to provide limited assistance to a client in the preparation of financial statements (for example, selection of an appropriate accounting policy), do not constitute an engagement to compile financial statements. This SRS should be read in conjunction with the "Framework of Statements on Standard Auditing Practices and Guidance Notes on Related Services[3]".

## Objective of a Compilation Engagement

3. The objective of a compilation engagement is for an accountant to use accounting expertise, as opposed to auditing expertise, to collect, classify and summarise financial information. This ordinarily entails reducing detailed data to a manageable and understandable form without the requirement to test the assertions underlying that information. The procedures employed are not designed and do not enable the accountant to express any assurance on the financial information. However, users of the compiled financial information derive some benefit as a result of the accountant's involvement because the service has been performed with professional competence and due care.

4. A compilation engagement would ordinarily include the preparation of financial statements (which may or may not be a complete set of financial

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2 For the purpose of this Standard on Related Services and to distinguish between an audit and a compilation engagement, the term 'accountant' (rather than 'auditor') has been used throughout to refer to a member of the Institute in practice.

3 The Framework issued in 2001 has been withdrawn pursuant to the issuance of the "Framework for Assurance Engagements", which is applicable from April 1, 2008. The text of the Revised Framework is reproduced elsewhere in this Handbook.

statements) but may also include the collection, classification and summarisation of other financial information, for example, preparation of quarterly financial results, restatement of financial statements in accordance with a financial reporting framework other than in accordance with which the financial statements to be restated are already prepared and presented.

## General Principles of a Compilation Engagement

5. The accountant should comply with the "Code of Ethics" issued by the Institute of Chartered Accountants of India. The ethical principles governing the accountant's professional responsibilities for this type of engagement are:

(a) Integrity;

(b) Objectivity;

(c) Professional competence and due care;

(d) Confidentiality;

(e) Professional conduct; and

(f) Technical standards.

Independence is not a requirement for a compilation engagement. However, where the accountant is not independent, a statement to that effect should be made in the accountant's report.

6. In all circumstances when an accountant's name is associated with financial information compiled by him, the accountant should issue a report.

## Responsibility of Management

7. The management is responsible for taking reasonable steps to prevent and detect errors, fraud or other irregularities. This includes:

a) Ensuring that the financial information generated in the entity is correct, complete and reliable;

b) Maintaining adequate accounting and other records and internal controls and selecting and applying appropriate accounting policies;

c) Establishing controls designed to safeguard the assets of the entity and also to deter fraudulent or other dishonest conduct and to detect any fraud that occurs;

d) Establishing controls to provide reasonable assurance that the entity complies with laws and regulations applicable to its activities, or for detecting any non-compliance with laws or regulations that occurs.

8. A compilation engagement cannot be regarded as providing assurance on the adequacy of the client's internal control systems or on the actual incidence of fraud or non-compliance with laws and regulations. A compilation engagement carried out by the accountant does not relieve the management of these responsibilities.

9. The management is also responsible for preparation and presentation of financial statements or other financial information in accordance with the applicable laws and regulations, if any. The accountant should, accordingly, obtain an acknowledgement from the management of its responsibility for the appropriate preparation and presentation of the financial statements or other information and of its approval of such information to be compiled. The accountant should also obtain an acknowledgement from management of its responsibility for the accuracy and completeness of the underlying accounting data and the complete disclosure of all material and relevant information to the accountant.

## Defining the Terms of the Engagement

10. An engagement letter will be of assistance in planning the compilation work. The scope of a compilation engagement would, normally, be defined by the instructions of the client, though in certain cases, for example, in case of compilation of financial statements of a company, the form and content of such financial statements might be laid down under a statute. The accountant should, therefore, ensure that there is a clear understanding between the client and the accountant regarding the terms of the engagement by means of an engagement letter or such other suitable form of contract. Thus, it is in the interest of both the accountant and the entity that the accountant sends an engagement letter documenting the key terms of the appointment. An engagement letter confirms the accountant's acceptance of the engagement and helps avoid

misunderstanding regarding matters such as the objective and scope of the engagement and the extent of the auditor's responsibilities.

11. The engagement letter would include matters such as the following:

(a) Nature of the engagement including the fact that neither an audit nor a review will be carried out and that accordingly no assurance will be expressed.

(b) Fact that the engagement cannot be relied upon to disclose fraud or defalcations that may exist but that the accountant will bring to the attention of the management any such matter which might come to his attention during the course of his engagement.

(c) Nature of the information to be supplied by the client.

(d) Fact that management is responsible for:

- ♦ the accuracy and completeness of the information supplied to the accountant, including maintenance of adequate accounting records and internal controls and selection and application of appropriate accounting policies.
- ♦ preparation and presentation of the financial statements of the entity, in accordance with the applicable laws and regulations, if any.
- ♦ safeguarding the assets of the entity and also establishing appropriate controls designed to prevent and detect fraud and other irregularities.
- ♦ ensuring that the activities of the entity are carried in accordance with applicable laws and regulations and that it institutes appropriate controls to prevent and detect any non-compliance.
- ♦ ensuring complete disclosure of all material and relevant information to the accountant.

(e) Intended use and distribution of the information, once compiled.

(f) Basis of accounting on which financial information is to be compiled and the fact that the basis, and any known departures therefrom, if any will be disclosed.

(g) The fact that the management is responsible to the users for the information to be compiled by the accountant.

(h) Unrestricted access to whatever records, documents and other information is requested in connection with the compilation engagement.

(i) Basis on which fees would be computed and any billing arrangements.

(j) Request for the client to confirm the terms of engagement by acknowledging the receipt of the engagement letter.

An example of an engagement letter for a compilation engagement appears in Appendix I.

## Planning

12. The accountant should plan the work so that an effective engagement will be performed.

## Documentation

13. The accountant should document matters, which are important in providing evidence that the engagement was carried out in accordance with this Standard on Related Services and the terms of the engagement.

## Procedures

14. The accountant should obtain a general knowledge of the business and operations of the entity and should be familiar with the accounting principles and practices of the industry in which the entity operates and with the form and content of the financial statements/ other financial information that is appropriate in the circumstances.

15. To compile financial information, the accountant requires a general understanding of the nature of the entity's business transactions, the form of its accounting records and the accounting basis on which the financial information is to be presented. The accountant ordinarily obtains knowledge of these matters through experience with the entity or inquiry of the entity's personnel.

16. Other than as noted in this Standard on Related Services, the accountant is not, ordinarily, required to:

(a) make any inquiries of management to assess the reliability and completeness of the information provided;

(b) assess internal controls;

(c) verify any matters; or

(d) verify any explanations.

In a compilation engagement, an accountant would normally have to rely on the management for most of the information needed to compile the financial statements or other financial information, including accounting estimates as well as the fact that the information given to the accountant is complete and reliable. The accountant should request management representation letter covering significant information or explanations given orally on which he considers representations are required.

17. If the accountant becomes aware that the information supplied by management is incorrect, incomplete, or otherwise unsatisfactory, the accountant should consider performing the procedures listed in Paragraph 16 and request management to provide additional information. If management refuses to provide additional information, the accountant should withdraw from the engagement, informing the entity of the reasons for the withdrawal.

18. The accountant should read the compiled information and consider whether it appears to be appropriate in form and free from obvious material misstatements. In this sense, material misstatements include:

(a) mistakes in the application of the identified financial reporting framework.

(b) non-disclosure of the financial reporting framework and any known departures therefrom.

(c) non-disclosure of any other significant matters of which the accountant has become aware.

The identified financial reporting framework and any known departures therefrom should be disclosed within the financial information, though their effects need not be quantified.

## Special Considerations

### Clients Having an Identified Financial Reporting Framework

19. As far as practicable, in case of compilation of financial statements prepared within an identified financial reporting framework[4], the accountant should ensure that the financial statements or other financial information compiled comply with the requirements of the identified financial reporting framework. In case of any material departures from the requirements of the identified financial reporting framework, the fact should be stated in the Notes to the Accounts or other compiled financial information as well as in the accountant's report on the compilation.

### Clients Having No Identified Financial Reporting Framework

20. In case of clients for whom compliance with an identified financial reporting framework is not required or the Accounting Standards issued by the Institute of Chartered Accountants of India are not mandatory, the client may specify that the accounts should be compiled on, for example, based on the requirements of the Income Tax Act, 1961. However, since, accounts are normally assumed to be compliant with the generally accepted accounting practices, including the Accounting Standards issued by the Institute of Chartered Accountants of India, the different basis of compilation should be set out in the Notes to the Accounts or other compiled financial information as well as the report issued by the accountant on compilation.

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[4] Paragraph 3 of the Framework for Statements on Standard Auditing Practices and Guidance Notes on Related Services states as follows:

"Financial statements are ordinarily prepared and presented annually and are directed toward the common information needs of a wide range of users. Many of those users rely on the financial statements as their major source of information because they do not have the power to obtain additional information to meet their specific information needs. Thus, financial statements need to be prepared in accordance with one, or a combination of :

(a) relevant statutory requirements, e.g., the Companies Act, 1956, for companies;

(b) accounting standards issued by the Institute of Chartered Accountants of India; and

(c) other recognised accounting principles and practices, e.g., those recommended in the Guidance Notes issued by the Institute of Chartered Accountants of India."

(The readers may note that the Framework issued in 2001 has been withdrawn pursuant to the issuance of the "Framework for Assurance Engagements", which is applicable from April 1, 2008. The text of the Revised Framework is reproduced elsewhere in this Handbook.)

Non-Compliance with the Accounting Standards

21. In the case of a company, the financial statements compiled must comply with the relevant provisions of the Companies Act, 1956, including the Accounting Standards and, accordingly, give a true and fair view. However, without carrying out the procedures necessary for an audit, the accountant cannot form any opinion on whether the accounts give a true and fair view, even though he has compiled these financial statements. The compilation is based on the information supplied to the accountant by the client and does not include any verification thereof. However, if the accountant becomes aware of material non-compliance with any applicable Accounting Standard(s), the same should be brought to the attention of the management and, if the same is not rectified by the management, it should be included in the Notes to the Accounts and the compilation report of the accountant.

Accounting Estimates Made by Clients

22. Often in compilation engagements, it is necessary for certain items in the accounts, for example, work in progress, to be based on estimates by the client. Such estimated items should be so described where material. If, based on the information provided to the accountant, it appears that certain estimates are unreasonable, the accountant should draw these to the attention of the management for reconsideration.

23. If the accountant becomes aware of material misstatements, the accountant should persuade the management to carry out necessary amendments in the financial statements or other compiled financial information. If such amendments are not made and the financial statements are still considered to be misleading, the accountant should withdraw from the engagement.

24. The financial statements or other financial information compiled should be approved by the client before the compilation report is signed by the accountant. The client should be asked to sign a statement on the face of the accounts retained by the accountant. The accountant should ensure that the users of the financial statements or other financial information so compiled are aware of the extent of his/her involvement with the accounts so that the users do not derive unwarranted assurance. Accordingly, the word 'audit' should not be used in describing the nature of services involving compilation of

financial statements or other financial information, nor the fee for these services be described as "auditors' fee", or remuneration in the accounts, correspondence or any other document. The accountant should also take note that the financial statements or other financial information so compiled should not be prepared on the letter-heads or other stationery of the accountant, carrying his (or firm's) name and address since it is liable to be misinterpreted.

## Reporting on a Compilation Engagement

25. It is essential that the accountant clearly brings out the nature of association with the financial statements and the nature of the work performed by him. The report on compilation engagements should, ordinarily, be in the following lay out:

(a) Title: The title of the report should be "Accountant's Report on Compilation of Unaudited Financial Statements" (and not "Auditor's Report");

(b) Addressee: The report should ordinarily be addressed to the appointing authority;

(c) Identification of the financial information also noting that it is based on the information provided by the management;

(d) When relevant, a statement that the accountant is not independent of the entity;

(e) A statement that the management is responsible for:

- ♦ completeness and accuracy of the underlying data and complete disclosure of all material and relevant information to the accountant;
- ♦ maintaining adequate accounting and other records and internal controls and selecting and applying appropriate accounting policies;
- ♦ preparation and presentation of financial statements or other financial information in accordance with the applicable laws and regulations, if any;
- ♦ establishing controls to safeguard the assets of the entity and preventing and detecting frauds or other irregularities;

- ♦ establishing controls for ensuring that the activities of the entity are carried out in accordance with the applicable laws and regulations and preventing and detecting any non-compliance;

(f) A statement that the engagement was performed in accordance with this Standard on Related Services ;

(g) A statement that neither an audit nor a review has been carried out and that accordingly no assurance is expressed on the financial information;

(h) A paragraph, when considered necessary, drawing attention to the disclosure of material departures from the identified financial reporting framework;

(i) Date of the report;

(j) Place of signature; and

(k) Accountant's signature: The report on compilation of financial information should be signed by the auditor in his personal name. Where a firm is appointed for the engagement, the report should be signed in the personal name of the accountant and in the name of the firm. The partner/proprietor signing the report on compilation of financial information should also mention the membership number assigned by the Institute of Chartered Accountants of India

Appendix II to this Standard contains examples of compilation reports.

26. The financial statements or other financial information compiled by the accountant should contain a reference such as "Unaudited," "Compiled without Audit or Review" and also "Refer to Compilation Report" on each page of the financial information or on the front of the complete set of financial statements.

## Effective Date

27. This Standard on Related Services is applicable to all compilation engagements beginning on or after April 1, 2004.

## Compatibility with International Standard on Auditing (ISA)** 930

The standards for compilation engagements established in this Standard on Related Services are generally consistent in all material respects with those set out in the International Standard on Auditing (ISA) 930, "Engagements to Compile Financial Information", except for the additional section titled, "Special Considerations", as given in paragraphs 19 to 22 of this Standard on Related Services .

The said section has been added to provide guidance to members in respect of certain typical issues which might be faced by the members in carrying out compilation engagements. For example, duties and responsibilities of the accountant in case of clients having an identified financial reporting framework, such as the Companies Act, 1956 and any material departures therefrom; clients having no identified financial reporting framework, say, where the financial statements are based on the requirements of the Income Tax Act, 1961. The section also provides guidance in respect of situations where the accountant becomes aware of a material non-compliance with the applicable Accounting Standards; as also duties of the accountant relating to accounting estimates made by the client.

Moreover, the Standard on Related Services , in paragraph 24, unlike the International Standard on Auditing (ISA) 930, also requires that the financial statements should be approved by the client before compilation report is signed by the accountant. The SRS also requires the accountant to ensure that the users of the compiled financial statements are aware of the extent of his/ her involvement with the accounts so that the users do not derive any unwarranted assurance. The SRS, unlike the ISA, also prohibits the accountant from preparing the financial statements on his letter head or other stationery bearing his (or firm's) name or address.

In addition, the SRS, unlike the ISA, does not require the accountant to send a form of expected report to the client alongwith the engagement letter. Also, the SRS requires the accountant to mention the place of signature in his report as compared to the ISA which requires the accountants to give his address.

** Now the International Standard on Related Services (ISRS) 4410.

Appendix I

## Example of an Engagement Letter for a Compilation Engagement

The following letter is for use as a guide in conjunction with the considerations outlined in paragraph 11 of this Standard on Related Services . This example is for the compilation of financial statements of a company and will need to be varied according to individual requirements and circumstances.

(Date)

To the Board of Directors (or other appropriate representatives of senior management):

You have, vide your letter dated _____ requested that we compile the balance sheet of _____(name of the company) as at _____(date) and the related profit and loss account and the (cash flow statement)[5] for the year ended on that date. We are pleased to confirm our acceptance and understanding of the engagement by means of this letter. As no audit or review engagement procedures would be carried out, no opinion on the financial statements will be expressed. Further, our engagement cannot be relied upon to disclose whether frauds or defalcations, or illegal acts exist. However, we will inform you of any such matters which might come to our attention in the course of the engagement.

As management, you are responsible for:

(a) the accuracy and completeness of the information supplied to us, including maintenance of adequate accounting records and internal controls and selection and application of appropriate accounting policies.

(b) preparation and presentation of the financial statements of the entity, in accordance with the applicable laws and regulations, if any.

(c) safeguarding the assets of the entity and also establishing appropriate controls designed to prevent and detect fraud and other irregularities.

(d) ensuring that the activities of the entity are carried in accordance with applicable laws and regulations and that it institutes appropriate controls to prevent and detect any non-compliance.

You will confirm that events and transactions are recorded in accordance with the applicable Accounting Standard(s), issued by the Institute of Chartered Accountants of India and other recognised accounting principles and practices and inform us of any departures therefrom.

[5] Only in cases where relevant.

As part of our normal procedures, we may request you to provide written confirmations of any information or explanations given to us orally during the course of our work.

We understand that the intended use and distribution of the information we have compiled is _____ (specify).

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records, documentation and other information requested in connection with our engagement.

Our fees will be billed as the work progresses.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our compilation of your financial statements.

XYZ & Co.
Chartered Accountants
……
Signature
(Name of the Member)
Designation[6]

Address:
Date:

For ABC & Co.
Acknowledged on behalf of _____(name of the company)
---
Signature
Name and Designation

Date
Address

[6] Partner or proprietor, as the case may be.

Appendix II

Examples of a Report of an Engagement to Compile Financial Statements

Illustration 1: Report on Compilation of Financial Statements

ACCOUNTANT'S REPORT ON COMPILATION OF UNAUDITED FINANCIAL STATEMENTS

To…….

On the basis of the accounting records and other information and explanations provided to us by the management, we have compiled, the unaudited balance sheet of ……..(name of the entity) as at March 31, XXXX and the related profit and loss account and the cash flow statement[7] for the period then ended.

The management of the _____ (name of the entity) is responsible for:

(a) Completeness and accuracy of the underlying data and complete disclosure of all material and relevant information to the accountant.

(b) Maintaining adequate accounting and other records and internal controls and selecting and applying appropriate accounting policies;

(c) Preparation and presentation of financial statements in accordance with the applicable laws and regulations, if any.

(d) Establishing controls to safeguard the assets of the entity and preventing and detecting frauds or other irregularities.

(e) Establishing controls for ensuring that the activities of the entity are carried out in accordance with the applicable laws and regulations and preventing and detecting any non compliance.

The compilation engagement was carried out by us in accordance with the Standard on Related Services (SRS) 4410 , "Engagements to Compile Financial Information", issued by the Institute of Chartered Accountants of India.

The balance sheet and the profit and loss account are in agreement with the books of account. We have not audited or reviewed these financial statements and accordingly express no opinion thereon.

For ABC & Co.

[7] Where applicable.

Chartered Accountants
……..
Signature
(Name of the accountant and membership number)
Designation[8]

Date:
Place:

Illustration 2: Compiled Financial Statements Where Such Financial Statements do not Comply with the Generally Accepted Accounting Practices in India.

ACCOUNTANT'S REPORT ON
COMPILATION OF UNAUDITED FINANCIAL STATEMENTS

To…….

On the basis of the accounting records and other information and explanations provided to us by the management, we have compiled the unaudited balance sheet of _____ (name of the entity) as of March 31, XXXX and the related profit and loss account and the cash flow statement[9] for the period then ended.

The management of the _____ (name of the entity) is responsible for:

(a) Completeness and accuracy of the underlying data and complete disclosure of all material and relevant information to the accountant.

(b) Maintaining adequate accounting and other records and internal controls and selecting and applying appropriate accounting policies;

(c) Preparation and presentation of financial statements in accordance with the applicable laws and regulations, if any.

(d) Establishing controls to safeguard the assets of the entity and preventing and detecting frauds or other irregularities.

(e) Establishing controls for ensuring that the activities of the entity are carried out in accordance with the applicable laws and regulations and preventing and detecting any non-compliance.

The compilation engagement was carried out by us in accordance with the Standard on Related Services (SRS) 4410 , "Engagements to Compile Financial Information", issued by the Institute of Chartered Accountants of India.

[8] Partner or Proprietor.

[9] Where applicable.

Since the financial statements have been compiled for the Income Tax Department and have been drawn up on cash basis of accounting to reflect the necessary adjustments for computation of the income by the Department, these financial statements, accordingly, do not comply with the generally accepted accounting principles in India.

The balance sheet and the profit and loss account are in agreement with the books of account. We have not audited or reviewed these financial statements and accordingly express no opinion thereon.

Date:
Place:

For ABC & Co.
Chartered Accountants
……..
Signature
(Name of the accountant and membership number)
Designation[10]

[10] Partner or proprietor.

# GENERAL CLARIFICATION (GC)–AASB/2/2004 ON SA 210

## Standard on Auditing (SA) 210, "Terms of Audit Engagement"

{The following is the General Clarification (GC)–AASB/2/2004 issued by the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India on Standard on Auditing (SA) 210, "Terms of Audit Engagement."}

1. The Standard on Auditing (SA) 210, "Terms of Audit Engagement" was issued with a view to establish standards on:

(a) agreeing the terms of the engagement with the client; and

(b) the auditor's response to a request by a client to change the terms of an engagement to one that provides a lower level of assurance.

2. A question that arises is whether it is necessary that the engagement letter issued by the auditor should be acknowledged by addressee and returned to the auditor to indicate that the client's understanding of the terms of the engagement is in accordance with the engagement letter issued by the auditor and to establish that the auditor has complied with the requirements of the Standard in so far as they are related to sending the audit engagement letter.

3. Paragraphs 2 through 4 of SA 210 provide as follows:

> "2. The auditor and the client should agree on the terms of the engagement. The agreed terms would need to be recorded in an audit engagement letter or other suitable form of contract.
>
> 3. This SA is intended to assist the auditor in the preparation of engagement letters relating to audits of financial statements. The Standard is also applicable to related services. When other services such as tax, accounting, or management consultancy and other services are to be provided, separate letters may be appropriate.
>
> 4. Though the objective and scope of an audit and the auditor's obligations are, normally, laid down in the applicable statute or regulations and the pronouncements of the Institute of Chartered Accountants of India, the audit engagement letters would be informative for the clients."

4. From the above it is clear that the basic purpose of issuing an engagement letter is that the auditor and the client should agree on the terms of the engagement. The auditor and the client are normally considered to be agreeing on the terms of the engagement if the objective and scope of an audit and the auditor's obligations are laid down in the statute or regulations governing the engagement. Examples of such engagements include audit under section 227 of the Companies Act, 1956, audit of public sector banks, etc. In such cases, it is not necessary that the engagement letter sent by the auditor in accordance with paragraph 5 of SA 210 is acknowledged by the addressee and returned to the auditor to establish that the client's understanding of the terms of the engagement is in accordance with the engagement letter issued by the auditor. It shall be sufficient compliance with the requirements related to sending the audit engagement letter, if an engagement letter is appropriately delivered to the client and the auditor retains the evidence for such delivery. In such cases, the audit engagement letters would be informative for the clients.

5. If, however, the client seeks any further explanations or clarification in regard to any terms, conditions or other contents of the engagement letter issued, it might indicate that there exists a difference in understanding of the terms of audit engagement either on the part of the client or on the part of the auditor. The auditor, in such cases, should take necessary steps to resolve the issues, for example by appropriately replying to the issues raised by the client. It is also desirable that the auditor documents the evidence indicating that the issues are settled and the client and auditor agree on the terms of the engagement.

6. There may be certain engagements where the objective and scope of the engagement and the auditor's obligations are not laid down in the applicable statute or regulations. In such situations, the auditor should request the client that a copy of the engagement letter be acknowledged by the addressee and returned to the auditor to establish:

(a) that the client's understanding of the arrangements for the engagement is in accordance with the engagement letter issued by the auditor; and

(b) that the auditor has complied with the requirements of the standard in so far as they are related to sending the audit en

# GENERAL CLARIFICATION (GC)–AASB/1/2002 ON SA 620

## Standard on Auditing (SA) 620, Using the Work of an Expert

{The following is the General Clarification (GC)-AASB/1/2002 issued by the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India on Standard on Auditing (SA) 620, "Using the Work of an Expert."}

1. Paragraph 12 of SA 620 provide as under:

   "12. The appropriateness and reasonableness of assumptions and methods used and their application are the responsibility of the expert. The auditor does not have the same expertise and, therefore, cannot always challenge the expert's assumptions and methods. However, the auditor should obtain an understanding of those assumptions and methods to determine that they are reasonable based on the auditor's knowledge of the client's business and on the results of his audit procedures."

2. The auditor while verifying the accrued liability for retirement benefits or for Group Gratuity Schemes has to use the work of an another expert, i.e., actuary or the insurer itself. In such a case, the issue to be considered is whether it is sufficient for the auditor to rely on the certificate given by insurer or actuary without establishing the reasonableness of the assumptions made by the actuary or the insurer based on the auditor's knowledge of the client's business. It is clarified that the auditor should, while using the certificate issued by the actuary or the insurer, obtain an understanding of the methods used by the actuary or the insurer in determining the liability and should also judge the appropriateness and reasonableness of assumptions, for example, with regard to the following:

   (i) Rate of Return
   (ii) Number of Employees
   (iii) Retirement Age
   (iv) Salaries
   (v) Promotion Policies
   (vi) Age of Employees