



TRAINING MANUAL ON ENGAGEMENT AND QUALITY CONTROL STANDARDS



Auditing and Assurance Standards Board

The Institute of Chartered Accountants of India

(Set up by an Act of Parliament)

New Delhi

Training Manual on Engagement and Quality Control Standards



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Edition : August, 2009

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Department : Auditing and Assurance Standards Board

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Website : www.icai.org

ISBN : 978-81-8441-274-1

Published by : The Publication Department on behalf of the Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi - 110 002.

Printed by : Sahitya Bhawan Publications, Hospital Road, Agra 282 003.
July/2009/1000 Copies

FOREWORD

Standards on Auditing codify the best practices to be adhered to by the members while discharging their attest function such as an independent audit of financial statements. No wonder then that the Council of the Institute has pronounced the Standards as being mandatory in nature. It is therefore quintessential for the members to read, understand and implement these Standards in their engagement.

I am sure you have seen the fast pace with which the AASB is working on bringing out more and more Standards on Auditing in line with those issued by the International Auditing and Assurance Standards Board under the Clarity Project. In the last two years, the Board has brought out 22 revised/ new internationally benchmarked Standards and many more are in the pipeline as we move swiftly towards our auditing standards' convergence deadline.

Given the above scenario, the Institute is organising a number of continuing professional education programmes to create awareness among members on these Standards and to help train the members in proper implementation of these Standards. I am happy to have in my hands this Training Manual on these Standards, developed by the Auditing and Assurance Standards Board. The simplicity and lucidity with which each of the Standards has been explained by way of power point slides, the technical posers, documentation requirements in various auditing standards, all go on to make the Manual a really useful publication, especially for use at the continuing professional education programmes.

I am sure that the members will make fullest use of the guidance given in the Manual.

Date: 21st August, 2009
Place: New Delhi

CA. Uttam P Agarwal
President, ICAI

PREFACE

Continuing updation of the professional education and skills is essential for auditors if they are to provide value added services to the clients and other stakeholders. It is important that they keep updated with the fast paced changes in the technical literature that is issued by the Institute for their guidance. Since the last year, the members must have seen a number of revised auditing standards being issued by the Institute. These revised auditing standards represent the changes in the field of auditing, including the improvements to the existing auditing practices and procedures, response to the changing economic scenario as also the changing demands of the stakeholders from the auditors.

To help the members remain abreast with these revised auditing standards being issued by the Institute, the Auditing and Assurance Standards Board has once again this year brought out this Training Manual on Auditing Standards. The Manual has been developed with the prime objective of serving as a background material for training programmes on auditing standards. The Manual contains crisp power point slides along with instructors' notes of the auditing standards effective for audits of financial statements for periods beginning on or after April 1, 2009, including the revised Standards on Auditing issued by the ICAI under the AASB's Clarity Project. However, for ease of reference, we have included the text of the revised/ new Standards on Auditing which are effective for audits of financial statements for the period beginning on or after April 1, 2010. The Manual also contains some case studies in the form of technical posers. These are aimed at encouraging discussion among the trainees. Thus, the Manual can be used fruitfully at any CPE programme on auditing standards.

At this juncture, I wish to thank all the members of the Auditing and Assurance Standards Board without whose enthusiasm and encouragement such a publication would not have been envisioned in the first place. I also wish to place on record the efforts of CA. Puja Wadhwa, Secretary, Auditing and Assurance Standards Board and her team viz., CA. Savita Singhal, Executive Officer and Ms P Anitha, Steno Typist in finalising this Manual.

While it needs no stressing that the Manual is not a substitute for the official text of the Standards published by the Institute and that the members must read the text of the Standards to properly understand the requirements of the Standard, I am sure that as its earlier version issued in 2008, this Training Manual, in its own right, too would prove to be immensely useful for the trainers as well as the trainees.

Date: 21st August, 2009
Place: New Delhi

CA. Harinderjit Singh
Chairman,
Auditing and Assurance Standards Board

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Note to the Readers

This Training Manual has been developed by the staff of the Secretariat of the Auditing and Assurance Standards Board solely for the purpose of enhancing the understanding of the Engagement and Quality control Standards and for circulation among the participants at the CPE training programmes organized by the Institute of Chartered Accountants of India. The contents of this Training Manual have not been vetted by either the Auditing and Assurance Standards Board or the Council of the Institute. Accordingly, the contents of this Training Manual are not authoritative. Readers are requested to refer the authoritative text of the Standards and/or Guidance Notes, etc., issued by the Institute and referred to in this publication. The Institute does not accept any responsibility for any action taken by the readers on the basis of the contents of this Training Manual.



To help us make this training manual more useful to you, we request you to send us your comments and suggestions on the training manual to:

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Part I

Introduction

This part of the Training Manual is aimed at providing a brief insight to the readers into the history of the auditing profession, nature of an audit and the role played by the auditing standards. Part I also briefly explains the various types of services offered by the professional accountants and the types of assurances attached to those services. It also deals with what the Institute has done and is doing in the area of auditing standards, the standard setting process as also the Institute's enforcement mechanism for auditing standards.



Need for Audit

A Historical Perspective

1.1 The modern, techno-savvy, materialistic and fiercely competitive socio-economic environment, over the last three decades, has led to the emergence of a number of professions in the society. But the birth of the auditing profession is probably as old as trade and commerce itself. In fact, the word “auditor” has its origin in the Latin word “*audire*”¹ which means “to hear”. The word “auditor” in Latin means “the hearer”. The term “auditor” was probably coined during the times when the auditing profession was in its infancy, when, for example, during the cross checking of merchandise, a person used to call out the quantity for each type of merchandise from his records and the other person used to listen to that and check the actual physical quantities. Initially, therefore, the profession was not founded on a well structured body of knowledge as it is today. For a long time to come, the auditing profession, remained a one to one cross check on the correctness (*and not really the fairness*) of the financial statements and other financial information. With the increase in the volume and geographical spread of trade and commerce throughout the world, coupled with the socio-economic development of the society, auditing as a profession also evolved and found an irreplaceable stronghold in the society.

1.2 The major thrust to this evolution of audit was given by the industrial revolution that took Europe by storm in the 18th and 19th centuries. With the growing production and geographical spread of the businesses, the need for funds also grew. It became increasingly difficult for the owners to bring in all the requisite funds from their own resources. As a result, they began tapping funds available with the outsiders. These outsiders understandably looked for security of their investments in terms of financial health of the business as well as competence of the owners in running the business. The need for assurance on the financial health of the business directly gave rise to a need for an audit. Further, the need for competence in running the business led to induction of professionally qualified experts. This, therefore, paved way for the businesses being run on the agency relationships, essentially known as the companies or corporations, where the fund providers/ owners were different from those running the show. In other words, there was a divorce between ownership and management. Audit came in as a strong tool in the hands of the owners to effectiveness and efficiency with which the management had employed the funds.

1.3 Whereas the first of its kind, all embracing and consolidated legislation for working of corporation came in the form of the Joint Stock Companies Act, 1856 in the United Kingdom, the auditing profession got the recognition, perhaps long overdue, for its indispensable contribution in economic growth when in 1854 was established the Institute of Chartered Accountants in Scotland, the Institute of Chartered Accountants in England and Wales in 1880 and the Institute of Chartered Accountants in Ireland in 1880. All these Institutes were established under the respective Royal Charters.

¹ Latin definitions have been taken from the website of the University of Notre Dame, France.



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The Need

1.4 Whereas from the above it is clear that the divorce between managements and owners led to audit emerging as an inevitable, with further growth and innovation in technology and infrastructure, the geographical as well as the product spread of the businesses also multiplied manifolds – both within and outside the national frontiers. The spread also brought with it accessibility to greater number of potential investors located on far corners of the earth. This obvious remoteness of the users of the financial information from the source of generation of such information made it inevitable that auditing that financial information so as to bridge that gap. Thus, auditing is to a large extent a tool that is used to lend credibility to the financial information and hence, cements the ever vulnerable trust between the management and the investors that exists due to actual and prospective conflict of interest facing the managements in discharging their stewardship function.

1.5 The growing complexity of the business transactions undertaken as well as the innovative financial products available in the capital markets necessitated the development of accounting policies that could adequately and appropriately address the recognition, measurement and disclosure issues involved therein. The accounting policies so developed were at times unavoidably complex in understanding, especially for the lay users of financial statements. At this juncture also, auditing came to their rescue since the audit reports contain an opinion on the truth and fairness of the financial statements and would bring out any inappropriate accounting and its impact on the entity's profits or assets and liabilities. Thus, auditing is, therefore, essential to protect the users of the financial information, including the regulators and the Government, from the economic consequences of using unreliable information. Auditing, therefore, is more often than not, also viewed as a first step to enforcement of the accounting standards by the business enterprises.



Auditing Profession in India

2.1 The history of auditing profession in India dates far back than the history of accounting profession in any other part of the world. The accountancy profession in India traces back to a period even prior to that of the Babylonian Empire². As in the case of any other part of the world, the present form of the Indian accountancy profession owes its genesis to “19th century where the development of commerce, trade and industry engendered the need for competent persons with knowledge and ability to practice accountancy and the development of corporate structure of business organisation in the country resulting in a division between ownership of funds and their management”³.

2.2 The evolution and growth of the accountancy and auditing profession in India has, therefore, been analogous with the development of the mercantile laws in the country. The legislation passed in 1857 contained a provision for annual audit of the company's accounts. The Indian Companies Act 1866 not only required the directors of the company to keep true accounts of the stock in trade and sums of money received and expended as well as credits and liabilities of the company, but also contained detailed provisions in respect of audit of accounts of companies. The 1866 Act, interestingly, contained a number of provisions affecting important aspects of audit like ensuring independence of the auditors, remuneration, eligibility for re-election, filling of casual vacancy, right of access to books and accounts of the company, report to the members, etc. The other important legislations were the Joint Companies Acts of 1850, 1857 and 1860 and the Indian Companies Act, 1882.

2.3 Other important legislations in the life of the accountancy and auditing profession in India have been the Companies Act, 1913 and the Companies Act, 1956. However, the legislation that changed the face of the accountancy and auditing profession in India was the Chartered Accountants Act, 1949. The years that marked the independence of our country from the British rule also brought with them autonomy for the profession. The Chartered Accountants Act, 1949 paved way for the establishment of the Institute of Chartered Accountants of India, an institution to regulate the profession of chartered accountancy in India. Besides, the Schedules to the Act itself contained a number of stringent provisions aimed at ensuring ethical behaviour by chartered accountants.

Auditing and the Institute of Chartered Accountants of India

2.4 From its very inception, the Institute has recognized that a profession cannot survive if it cannot meet the expectation of the society. Therefore, as early as in 1955, the Institute had established the Research Committee, to carry out research in the fields of critical importance to the profession, such as auditing, and develop technical literature. Some of the important audit related publications brought out by the Research Committee are as follows:

1955 : Audit of Accounts of General Insurers

² The History of Accountancy Profession in India, Vol. I, page 27.

³ *ibid*



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1957	:	Answers to the Queries relating to the Companies Act, 1956
1962	:	Audit of Accounts of Liquidators
1963	:	Statement on Auditing Practices [@]
1968	:	Independence of Auditors
1970	:	Statement on Qualifications in Auditor's Report ^{@@}
1975/1988	:	Statement on Manufacturing and Other Companies (Auditor's Report) Order, 1975/ 1988 ^{@@@}
1975	:	Statement on Payments to Auditors for Other Services ^{@@@@}

2.5 With the growing internationalization of trade and commerce, not only did the complexities in the transactions undertaken by the business enterprises increased the cross frontier use of the financial information certified by auditors from various parts of the globe having different knowledge and professional skills also increased. Having the need to promote adoption of uniform best professional practices by the auditors world over and above all to serve the public interest as its underlying objective, in 1974, was formed the International Federation of Accountants (IFAC). The Institute of Chartered Accountants of India is one of the IFAC's founding members. The IFAC has constituted a number of Committees/ Boards under its aegis to develop standards and/ or guidance on an array of related areas such as education and training of professional accountants, auditing, ethics, small and medium practitioners, etc. The International Auditing and Assurance Standards Board (IAASB) (known as the International Auditing Practices Committee (IAPC) till 2002) of the IFAC is entrusted with the task of formulating the International Engagement⁴ and Quality Control Standards.

2.6 Though as mention earlier, the Institute had brought a number of important publications on audit, such as the Statement on Auditing Practices, a pressing need was felt to develop a set of globally benchmarked auditing standards in India as well. Accordingly, in September, 1982 was formed the Auditing Practices Committee (APC). The main function of the APC, as mentioned, in the Preface to the Statements on Standard Auditing Practices, was to formulate auditing standards in India (known as the Statements on Standard Auditing Practices). For this purpose the Committee was required to consider the laws, customs and usages in the country. Further, the Institute being a member of the IFAC, it is also a membership obligation of the Institute to promote the International Standards issued by the IAASB. Accordingly, the APC was also required to take into account the international standards issued by the IAPC. The APC was also required to follow the standard setting procedure laid down in the abovementioned Preface. The Auditing Practices Committee was renamed as the Auditing and Assurance Standards Board in 2002 by the Council of the Institute and the Statements on Standard Auditing Practices were also renamed as the Auditing and Assurance Standards. Till 2007, the Auditing and Assurance Standards Board had issued, under the authority of the Council of the Institute of Chartered Accountants of India (ICAI), thirty five Auditing and Assurance Standards.

[@] Withdrawn in March, 2005.

^{@@} Paragraphs 1.1 to 1.5, 2.31 to 2.32 and 3.1 to 4.10 has been withdrawn in July, 2007 and the statement is renamed as "Statement on Reporting under Section 227 (IA) of the Companies Act, 1956".

^{@@@} Withdrawn in 2003 pursuant to issuance of CARO, 2003.

^{@@@@} Withdrawn in April, 2007.

⁴ International Engagement Standards include the International Standards on Auditing, International Standards on Related Services, International Standards on Review Engagements and International Standards on Assurance Engagements.



Auditing Profession in India

In mid 2007, the Board initiated its Clarity Project with the objective of revising its auditing standards in line with the revised International Standards being issued by the IAASB under its Clarity Project. Pursuant to the Clarity Project, the Auditing and Assurance Standards were renumbered and re-categorised on the pattern followed by IAASB. Further, the format of writing the Standards issued under the Clarity Project has undergone a changes. The Standards are now been divided into two separate sections, i.e., first, Requirement section, containing the introduction, scope, objectives and the principles of the Standard; and second the Application and Other Explanatory section including Appendices. These aspects have been discussed in further details in Chapter 3 of Part I.

2.7 In addition to the standards, the Auditing and Assurance Standards Board also formulates Guidance Notes. Guidance Notes are designed to address issues faced by the auditors in on field implementation of the auditing standards. Guidance Notes may also address other generic auditing issues that may be faced by the auditors. Some of the Guidance Notes issued by the Auditing and Assurance Standards Board are industry specific, bringing out in details the peculiarities of these industries. A list of the auditing Guidance Notes issued till date is enclosed as Appendix B at the end of Part I.



Auditing and Assurance Standards^{*}

What are Auditing Standards?

3.1 In the simplest terms, auditing standards represent a codification of the best practices in the field of auditing. Auditing standards are therefore, the performance benchmarks for the auditors. Auditing standards contain guidance for the professionals on how they should carry out their professional engagements, enshrined as the basic principles and essential procedures to apply those basic principles that relates to judgment or behaviour. Auditing standards are framed to ensure probity, integrity and quality in the professionals' work, essential for ensuring the confidence of the society in the financial information being reported by the business enterprises. The objective of auditing standards is to a large extent serving the public interest.

Need for Auditing Standards

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

- Ensuring application of accepted financial reporting standards thereby lending credibility and wider acceptability to the financial statements
- Providing benchmarks against which the performance of the members can be measured and evaluated at global level also
- Ensuring compliance with the applicable legislative and regulatory framework
- Ensuring right approach of the professionals in complex/ emerging areas of audit
- Ensuring consistency and quality in the work performed by the professionals

The auditing standards therefore are an important instrument for bridging the expectation gap between the society and the auditors. Moreover, the basic objective behind auditing standards, as discussed in paragraph 3.2 above, make it imperative that the auditing standards apply whenever an independent audit of any entity, whether profit oriented or not, and irrespective of its size, legal form.

Features of an Effective Auditing Standard

3.3 Auditing Standard, to be really effective, is founded on the principles and ground realities, is easy to understand, has universal acceptance, and is reasonably flexible to permit

^{*} As explained in later paragraphs, AASs have been reclassified and recategorised as Engagement Standards with the Revised Preface becoming applicable w.e.f. April 1, 2008.



Auditing and Assurance Standards

application in all types of situations and importantly, amenable to enforcement. In addition, an Auditing Standard is not to be perceived by the society as being overly protective of the auditor but as being in the best interests of the users of the auditors' services. Hence, the Auditing Standards-setting process is objective and transparent, giving fair representation to the concerned stakeholders.

Auditing Standard-setting in India

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

The Revised Preface

3.5 The desire to be the best among equals in the world necessitates that one is ready to undergo the painstaking processes of learning, unlearning and re-learning all through. For the auditing profession in India too, which is looking forward to be reckoned among the best in the world and be accepted globally, this necessity comes as a necessary unavoidable. The Auditing and Assurance Standards Board (AASB), as a top priority, has taken on the ambitious project of convergence with the International Standards issued by the International Auditing and Assurance Standards Board. As a first step towards convergence, it had, after going through its rigorous due process, in July 2007 published the *Revised Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Services*, corresponding to its namesake issued by the IAASB in 2006. The Revised Preface, applicable from April 1, 2008, has changed the face of the auditing literature, introducing some more fundamental concepts to the existing ones. The following paragraphs give a gist of the significant provisions of the Revised Preface.

Engagement Standards

3.6 Hitherto all the auditing standards issued by the AASB were known as the Auditing and Assurance Standards. The Revised Preface categorises and christens the Standards based on the nature of service being provided by a member. It, therefore, introduces an umbrella concept of Engagement Standards. The term "Engagement Standards" comprises the following Standards:

- (a) *Standards on Auditing (SAs)*, to be applied in the audit of historical financial information.
- (b) *Standards on Review Engagements (SREs)*, to be applied in the review of historical financial information.
- (c) *Standards on Assurance Engagements (SAEs)*, to be applied in assurance engagements, dealing with subject matters other than historical financial information.



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

The Revised Preface therefore, does away with the nomenclature “Auditing and Assurance Standards” .

It also contains provisions for Standards, to be known as the Standards on Quality Control (SQC), which would be fundamental to all the services covered by the Engagement Standards.

Standards on Auditing

3.7 The Standards on Auditing (SAs) referred to in paragraph 3.6 above are formulated in the context of an audit of financial statements by an independent auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information.

New Format of Presenting the Standards on Auditing

3.8 In line with the format adopted by the IAASB under its Clarity Project, the Revised Preface provides that instead of a running text, the Standards on Auditing would now contain two distinct sections, one, the Requirements section and, two, the Application Guidance section.

Requirements Section

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

Application Material

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

3.11 The Revised Preface also contains the principles as to when a Standard on Auditing would be inapplicable as also the reporting responsibilities of the members in case of non compliance with any of the Standards.

Authority Attached

3.12 The Revised Preface also contains the authority attached to various documents issued by the Council or the AASB under the authority of the Council of the Institute, viz., Standards, Statements, Guidance Notes, General Clarifications, Studies, etc.



Renumbering of Standards

3.13 The provisions of the Revised Preface, coupled with the difficulties otherwise being faced by the Board in writing Standards on the conventions followed by the IAASB, necessitated the need to adopt a new numbering pattern for the auditing standards. Whereas hitherto the auditing standards were being allotted sequential numbers as and when they were issued, under the Revised Preface, these standards have categorised on the basis of the specific aspect of audit that they deal with and accordingly allotted the number from that category. These categories are as follows:

Category	Number Series
Standards on Quality Control	01 – 99
Introductory Matters	100 - 199
General Principles and Responsibilities	200 – 299
Risk Assessment and Responses to Assessed Risks	300 – 499
Audit Evidence	500 – 599
Using Work of Others	600 - 699
Audit Conclusions and Reporting	700 - 799
Specialised Areas	800 - 899
Standards on Review Engagements	2000 – 2699
Standards on Assurance Engagements	3000 - 3399
Subject Specific Standards	3400 – 3699
Standards on Related Services	4000 - 4699

A complete list of the re-classified and re-categorised Auditing and Assurance Standards is given in **Annexure 1**. Also given in **Annexure 2** is the diagrammatic representation of the structure of Standards issued by AASB.



Annexure 1

New Re-Number and Re-Categorisation of AASs

New Standard Number		Old AAS number
STANDARDS ON QUALITY CONTROL (SQC)s		
1-99	Standards on Quality Control (SQC)s	
1	Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements	
FRAMEWORK		
	Framework for Assurance Engagements	
AUDITS AND REVIEWS OF HISTORICAL FINANCIAL INFORMATION		
	Standards on Auditing (SAs)	
100-199	Introductory Matters	
200-299	General Principles and Responsibilities	
200	Objective and General Principles Governing an Audit of Financial Statements	1 & 2
210	Terms of Audit Engagements	26
220	Quality Control for Audits of Historical Financial Information	17
230	Documentation	3
240	The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements	4
250	Consideration of Laws and Regulations in an Audit of Financial Statements	21
260	Communication of Audit Matters with Those Charged with Governance	27
300-499	Risk Assessment and Response to Assessed Risks	
300	Planning an Audit of Financial Statements	8
310	Knowledge of the Business	20
315	Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment	



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320	Audit Materiality	13
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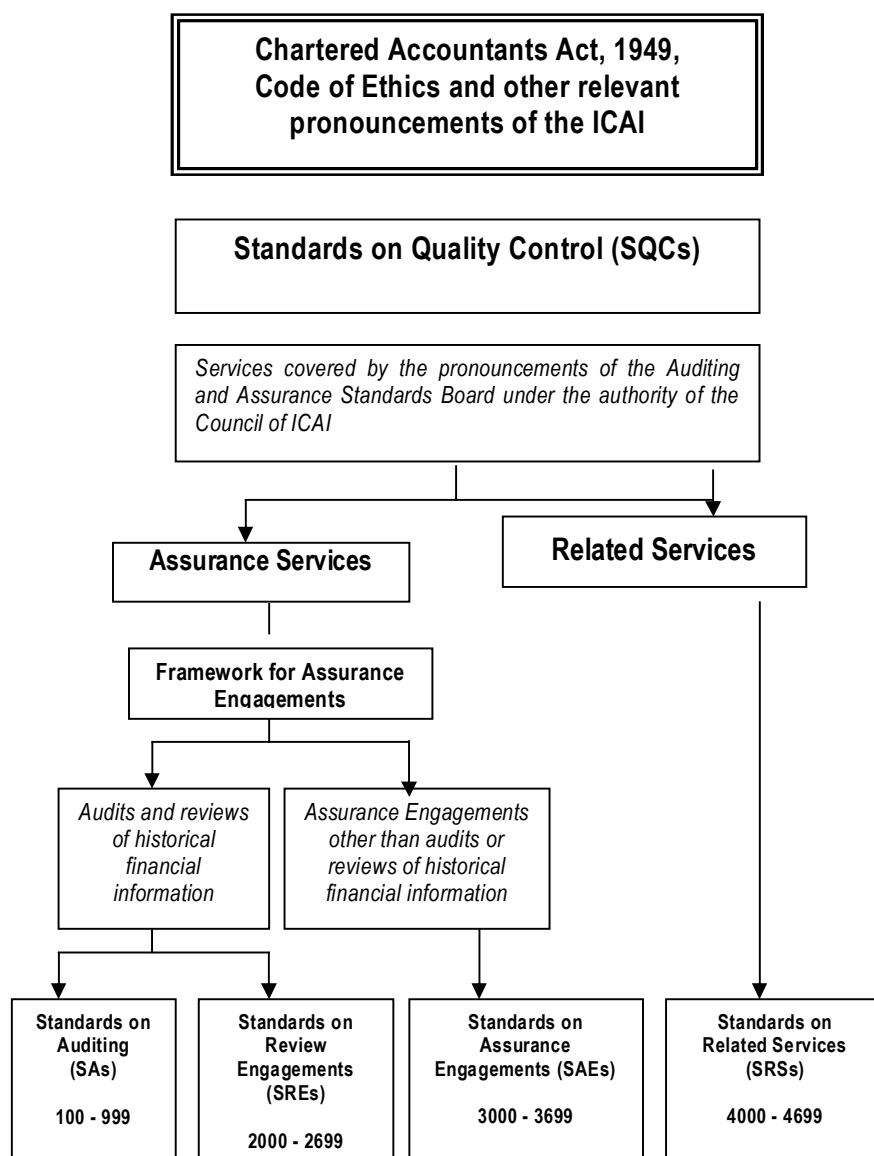


Training Manual on Engagement and Quality Control Standards

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Structure of Standards Issued By Auditing and Assurance Standards Board Under the Authority of the Council of ICAI





4

The Framework

Framework for Assurance Engagement

4.1 Since the Revised Preface categorises Standards on the basis of the level of assurance that they provide, it was essential to bring out some literature that could explain comprehensively the concepts of assurance. The Revised Framework for Assurance Engagements⁵, issued by the Auditing and Assurance Standards Board (AASB) in July 2007 is one such document which contains the fundamental concepts of an assurance engagement. Under the Revised Preface, assurance engagements are covered by Standards on Auditing/ Standards on Review Engagements/ Standards on Assurance Engagements. Understanding of the concepts in an assurance engagement would help the members and others in which Standard(s) would apply in which case. The following paragraphs contain a gist of main principles and concepts enshrined in the Framework.

Definition and Objective of an Assurance Engagement

4.2 The Framework defines an assurance engagement as an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users, other than the ones responsible for subject matter of the engagement, about the outcome of the subject matter against a set criteria.

Types of Assurance Engagements

4.3 The Framework envisages two types of assurance engagements that can be performed by a practitioner—reasonable assurance engagements and limited assurance engagements. The Framework also explains the difference between the two in terms of the engagement risk. The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement. The practitioner's conclusions are expressed in a positive form. Independent audit of financial statements under section 224 of the Companies Act, 1956 is an example of a reasonable assurance engagement.

4.4 The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement but where that risk is greater than that for reasonable assurance engagement, the practitioner's conclusions are expressed in the negative form. A review performed under the requirements of clause 41 of the Listing Agreement is an example of a limited assurance engagement.

Non Assurance Engagements

4.5 The Framework also lays down the criteria for such engagements to which the Framework would not apply.

⁵ The original Framework of Statements on Standard Auditing Practices and Guidance Notes was issued in July, 2001 by the Institute.



The Framework

Engagement Acceptance

4.6 The practitioner, in terms of the Framework, is required to ensure himself as to the existence of certain aspects before accepting an assurance engagement. These include relevant ethical requirements, appropriateness of subject matter, suitability of criteria, access to sufficient appropriate audit evidence, rational purpose of the engagement, etc.

Elements of an Assurance Engagement

4.7 The Framework identifies a three party relationship, appropriate subject matter, suitable criteria, sufficient appropriate evidence and written assurance report as the five elements of an assurance engagement. All these five elements as also the significant aspects involved therein have been discussed in details in the Framework.

Auditing Standards–the Enforcement Mechanism

4.8 The importance of compliance with the auditing standards is enshrined in the Chartered Accountants Act, 1949 itself. Clause 9 of Part I of the Second Schedule to the Chartered Accountants Act, 1949 holds a member guilty of professional misconduct if he fails to invite attention to material departure from the generally accepted procedures of audit applicable to the circumstances. The Institute being the regulator of chartered accountancy profession in India has also developed enforcement mechanisms for compliance with the Auditing and Assurance Standards. While some parts of these mechanisms are aimed at encouraging members to follow auditing standards others are punitive. These are discussed below.

The Code of Ethics

4.9 The Code of Ethics of the Institute enshrines a number of ethical principles governing the behaviour of a member of the Institute. All the members of the Institute are expected to comply with the requirements of the Code. The Code sets out the objectives of the accountancy profession as “*to work to the highest standards of professionalism, to attain the highest level of performance and generally to meet the public interest*”. The Code goes on further to set out the fundamental principles necessary to achieve these objectives. One of these principles is compliance with the technical standards.

Peer Review

4.10 The Institute as a proactive measure, *suo motu*, set up a Peer Review Board in 2002 with the object to help members comply with the Technical Standards laid down by the Institute and put in place proper systems for maintaining the quality of attestation services work they perform. The examination and review of a practice unit would be carried out by a “reviewer”, i.e., a member, selected from a panel of reviewers maintained by the Peer Review Board. The Peer Review process also provides guidance to members to improve their performance and adherence to various statutory and regulatory requirements.

Financial Reporting Review Board

4.11 The work of an auditor is also subject to a scrutiny by the Financial Reporting Review Board (FRRB) of the Institute. The FRRB reviews the general purpose financial statements of certain enterprises with a view to determine, to the extent possible:

- (a) Compliance with the generally accepted accounting principles in the preparation and presentation of financial statements;



Training Manual on Engagement and Quality Control Standards

- (b) Compliance with the disclosure requirements prescribed by regulatory bodies, statutes and rules and regulations relevant to the enterprise; and
- (c) Compliance with the reporting obligations of the enterprise as well as the auditor.

4.12 The FRRB may review the general purpose financial statements either *suo moto* or on a reference made to it by any regulatory body like, Reserve Bank of India, Securities and Exchange Board of India, Insurance Regulatory and Development Authority, Department of Company Affairs, etc. The FRRB also reviews general purpose financial statements of enterprises relating to which serious accounting irregularities in the general purpose financial statements have been highlighted by the media reports. Findings of the FRRB relating to non-compliance with the factors stated above would form the basis for initiating action against the auditor under the Chartered Accountants Act, 1949. In so far as the management of the enterprise is concerned, pending the grant of relevant powers to the FRRB by the Government of India, the FRRB would inform irregularity to the regulatory body relevant to the enterprise and would also communicate the same to the management.

Disciplinary Mechanism

4.13 A member of ICAI is subject to its disciplinary mechanism. The Chartered Accountants Act, 1949 (hereinafter the Act unless specified otherwise) gives authority to the Central Council of ICAI to enquire into cases of professional or other misconduct on the part of members of ICAI and to take disciplinary action.

4.14 The Act as amended by the Amendment Act of 2006 provides for the constitution of the Board of Discipline consisting of a presiding officer who has knowledge of disciplinary matters and of the profession and of two members, one of whom shall be a member of the Central Council and the other a person to be nominated by the Central Government out of persons of experience having eminence in the field of law, economics, business, finance or accountancy. The Board looks into complaints which fall under the First Schedule to the Act.

4.15 There is also a Disciplinary Committee which consists of the President or Vice-President of ICAI as the presiding officer and of two members who are members of the Central Council of ICAI and two members to be nominated by the Central Government from amongst persons of eminence having experience in the field of law, economics, business, finance or accounting. The Disciplinary Committee looks into complaints against members falling under both the First Schedule as well as the Second Schedule to the Chartered Accountants Act, 1949.

4.16 To a large extent, the First Schedule covers professional and other misconduct related to non-observance of the internal regulations of the Institute. It has four parts namely:

- ◆ Part I applicable to professional misconduct by members in practice.
- ◆ Part II applicable to professional misconduct by members in service.
- ◆ Part III applicable to professional misconduct by members generally (whether in practice or not).
- ◆ Part IV applicable to other misconduct by members generally.



The Framework

4.17 The Second Schedule generally covers professional misconduct in areas where public interest is involved. It has three parts, namely:

- ◆ Part I applicable to professional misconduct by members in practice. This includes inter-alia, disclosure of confidential information, failure to disclose material facts or misstatements in financial statements, failure to exercise due diligence or grossly negligent conduct, failure to obtain sufficient information to warrant the expression of an opinion and failure to invite attention to material departures from the generally accepted audit procedures.
- ◆ Part II applies to professional misconduct by members generally (whether in practice or not).
- ◆ Part III applies to other misconduct by members generally.

4.18 The Chartered Accountants Act, 1949 provides for the appointment by the Central Government of an Appellate Authority consisting of a person who is or has been a judge of a High Court as the Chairperson and two past members of the Central Council and two persons to be nominated by the Central Government from amongst persons having knowledge and practical experience in the field of law, economics, business, finance or accountancy.

4.19 Appeals to the Appellate Authority against an order of the Board of Discipline or the Disciplinary Committee can be made by an aggrieved member and/or the Director (Discipline).

Quality Review Board

4.20 Section 28A of the Chartered Accountants Act, 1949, as amended by the Chartered Accountants (Amendment) Act, 2006, envisages establishment of a Quality Review Board (QRB) by the Central Government to perform the following functions:

- (i) to make recommendations to the Council with regard to the quality of services provided by the members of the Institute;
- (ii) to review the quality of services provided by the members of the Institute including audit services; and
- (iii) to guide the members of the Institute to improve the quality of services and adherence to various statutory and regulatory requirements.

4.21 The Central Government, vide its notification issued in June 2007 has constituted the Quality Review Board. The Board has a total of ten members, excluding the Chairman, whereof five members are nominated by the Central Government and five by the Council of the Institute. The Chairman to the Board is also nominated by the Central Government.



5

The Quality Control Standard

5.1 The auditing profession worldwide commands respect and demand for its services primarily on account of the faith of the public, at large on its work. Given that fact and also that audit firms do not have any investment of public funds in them, its earnings or increase in its clientele cannot and should not be the only or the primary measure of its success. The success, or rather credibility, of an audit firm should rightly be measured in terms of the quality of its services it is able to provide. With that in mind, the Institute, through its standards and more importantly, the Code of Ethics as well as a number of self recommendatory measures, has reiterated the necessity for its members to provide high quality services. In fact, even the governing laws, such as the Chartered Accountants Act, 1949 and the Companies Act, 1956 contain provisions relating to exercise of professional care and skills as well as those relating to a ceiling on number of audits that can be accepted by a chartered accountant. All these are ultimately directed towards maintaining the quality of work done by the chartered accountants.

5.2 The Institute, nearly two decades ago, issued a Guidance Note on Quality Control for Audit Work. Realising the critical nature of the aspect covered by the Guidance Note, the latter was converted into Standard on Auditing (SA) 220 (Hitherto known as Auditing and Assurance Standard (AAS) 17), Quality Control for Audit Work in July 1999. The Institute, in 2007, issued 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*. This Standard is an all pervasive Standard in respect of quality control at the level of the audit firm. Besides, the Standard is essential since in the absence of this Standard, the Institute would never be able to claim complete convergence with the International Standards. The Standard is recommendatory from April 1, 2008 and mandatory from April 1, 2009.

5.3 As the name suggests, the SQC 1 contains extensive requirements in relation to establishment and maintenance of a system of quality control in the audit firms as well as even for sole practitioners. The important elements of a system of quality control discussed by the Standard include:

- ◆ Leadership Responsibilities for Quality Within the Firm
- ◆ Ethical Requirements
- ◆ Acceptance and Continuation of Client Relationships and Specific Engagements
- ◆ Human Resources
- ◆ Engagement Performance
- ◆ Documentation of the Engagement Quality Control Review.

The Auditing and Assurance Standards Board has also brought out an implementation guidance for the SQC 1.



Part II

Presentation



An Overview of Engagement and Quality Control Standards

- ❖ **Authority and Preface**
- ❖ **Standards on Quality Control (SQCs)**
- ❖ **Framework for Assurance Engagements**
- ❖ **Engagement Standards**
 - Standards on Auditing – 100 - 999
 - 100 – 199 : Introductory Matters
 - 200 – 299 : General Principles & Responsibilities
 - 300 – 499 : Risk Assessment & Response to Assessed Risks
 - 500 – 599 : Audit Evidence
 - 600 – 699 : Using Work of Others
 - 700 – 799 : Audit Conclusions & Reporting
 - 800 – 899 : Specialized Areas
 - 2000 – 2699 : Standards on Review Engagements (SREs)
 - 3000 – 3699 : Standards on Assurance Engagements (SAEs)
 - 4400 – 4699 : Standards on Related Services (SRSs)

Standards on Review Engagements – 2000 - 2699

- 2400: Engagements to Review Financial Statements

Standards on Assurance Engagements – 3000 – 3699

- 3000 – 3399 : Applicable to all assurance engagements
- 3400 – 3699 : Subject Specific Standards
 - *3400: The Examination of Prospective Financial Information*

Standards on Related Services – 4400 – 4699

- 4400 : Engagements to Perform Agree upon Procedures regarding Financial Information
- 4410 : Engagements to Compile Financial Information



Authority and Preface



Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services

Effective from April 1, 2008

Preface

❖ Issued in July, 2007.

Introduction

- ❖ **Revised Preface facilitates understanding of the pronouncements issued by AASB under the authority of the Council.**
- ❖ **ICAI's commitment to the goal of providing high quality accountancy services, acceptable world wide:**
 - Develops and promulgates technical standards and other professional literature.

Preface



Relationship with IAASB

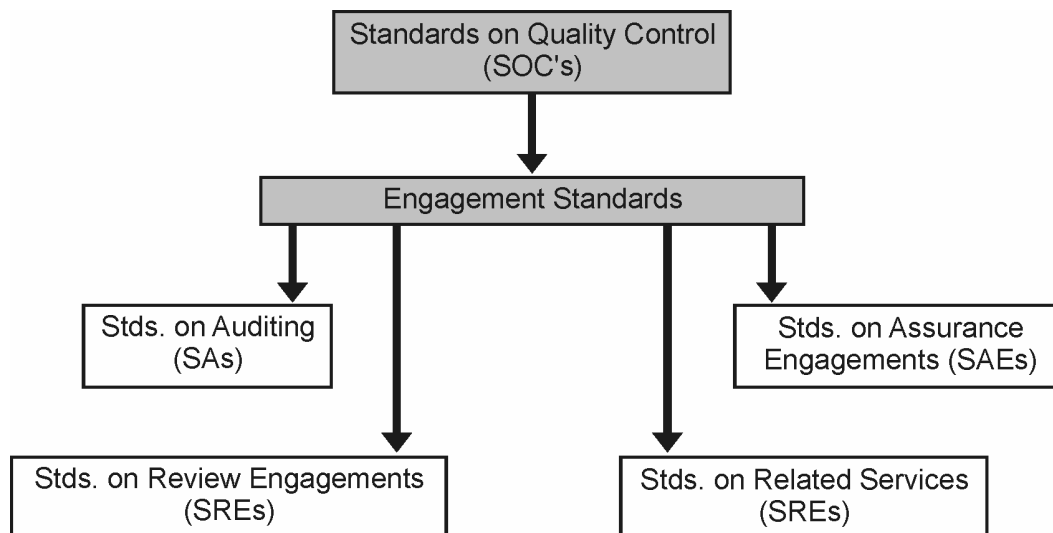
- ❖ ICAI is a founder member of IFAC.
- ❖ Membership obligation–convergence with International Standards issued by IAASB of IFAC.

Preface



What's new about Standards Issued by AASB

"AASs" concept done away with. "Engagement Standards" concept introduced.



Preface

❖ The term "Engagement Standards" comprises the following Standards:

- **Standards on Auditing (SAs)**, to be applied in the audit of historical financial information.
- **Standards on Review Engagements (SREs)**, to be applied in the review of historical financial information.
- **Standards on Assurance Engagements (SAEs)**, to be applied in assurance engagements, dealing with subject matters other than historical financial information.
- **Standards on Related Services (SRSs)**, to be applied to engagements involving application of agreed upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.



Standards on Auditing (SAs)

- ❖ **Mandatory.**
- ❖ **Applied in audit of Financial Statements by an independent auditor.**
- ❖ **Expression of opinion.**
- ❖ **Overall objective of the auditor is to obtain reasonable assurance about whether FS as a whole are free from material misstatement.**
- ❖ **Unable to fulfill overall objective, SAs requires the auditor to :**
 - **Modify his audit opinion.**
 - **Withdraw from the engagement.**
- ❖ **Materially in compliance with financial reporting framework.**

Preface

Format of SAs

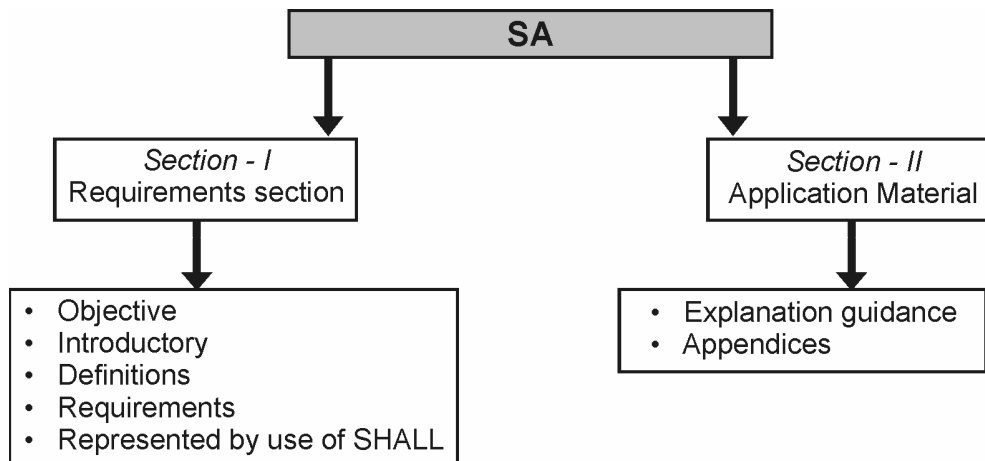
Until now: Running text

	<i>Standard Portion</i>	<i>Application guidance</i>
AAS 1 to 13	Plain lettering	Plain lettering
AAS 14 to 35	Bold lettering	Plain lettering
Standard represented by use of word SHOULD .		

Preface



New Format of SAs – IAASB Clarity Convention



Preface

- ❖ **Introduction:** The 'Introduction' section deals the purpose and scope of the Standard, subject matter of the Standard and effective date of the Standard.
- ❖ **Objectives:** The 'Objectives' section provides the reference in which the Requirements are elaborated in the Standard. The aim of the auditor is to achieve the Objectives as specified in all Standards of Auditing (SAs).
- ❖ **Definitions:** The 'Definitions' section deals with the meaning attributed to certain expressions for the purpose of SAs. The aim is to assist the auditors to ensure consistent application of the Standards.
- ❖ **Requirements:** The fundamental principles of the Standard are contained in the Requirements section and presented by use of "shall". Hitherto, the word, "should" was used in the Standards, for this purpose. Further, this format also does away with the need to present the principles laid down by the Standard in bold text. The 'Requirements' section also contains cross reference to the relevant Application and Other Explanatory Material.
- ❖ **Application and Other Explanatory Material:** The 'Application and Other Explanatory Material' contained in an SA is an integral part of the SA as it provides further explanation of, and guidance for carrying out, the requirements of an SA, along with the background information on the matters addressed in the SA. It may include examples of procedures, some of which the auditor may judge to be appropriate in the circumstances. Such guidance is, however, not intended to impose a requirement. Appendices which form part of Application and Other Explanatory Material are an integral part of a Standard.



Other Significant Aspects

- ❖ **Compliance with SAs:**
 - Mandatory.
 - Departure only if alternate audit procedures achieve objective of SAs.
 - Document reasons for departure.
 - Document alternative procedures.
 - Report to draw attention.
- ❖ **SA not applicable if situation outlined in SA is absent :**
 - Document alternative procedures performed.

Preface

- ❖ The need for the auditor to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective.

Standards on Quality Control

- ❖ Apply to firms.
- ❖ In respect of all their services falling under the Engagement Standards issued by AASB of ICAI.

Preface

- ❖ **Standards on Quality Control (SQCs)**, issued by the AASB under the authority of the Council, are to be applied for all services covered by the Engagement Standards.



Other Standards

- ❖ Old format continues.
- ❖ Standard portion in **BOLD** & use of **SHOULD**.
- ❖ Explanatory guidance in plain.
- ❖ Running text.
- ❖ **Compliance :**
 - Mandatory.
 - Departure only if alternate audit procedures achieve the purpose of the procedure.
 - Document reasons for departure.
 - Document alternative procedures.
 - Report to draw attention.

Preface

Statements on Auditing/General Clarifications

- ❖ Mandatory.
- ❖ Issued under the authority of the Council.
- ❖ Use Professional judgment.
- ❖ **Compliance :**
 - Mandatory.
 - Departure only if alternate audit procedures achieve the purpose of the procedure.
 - Document reasons for departure.
 - Document alternative procedures.
 - Report to draw attention.

Preface



Training Manual on Engagement and Quality Control Standards

Guidance Notes

- ❖ Assists in implementing engagement and quality control standards.
- ❖ Provides guidance on generic/industry specific audit issues, not necessarily arising out of a Standard.
- ❖ Publish under the authority of the Board.
- ❖ Recommendatory to follow.
- ❖ Non-compliance :
 - Justify the appropriateness and completeness of alternative procedures adopted.

Preface

Technical Guides / Practice Manuals / Studies / Other Papers

- ❖ Publish under the authority of the Board.
- ❖ *Technical Guides*- Imparting knowledge on particular aspects.
- ❖ *Practice Manuals*- Provides additional guidance.
- ❖ *Studies/Other Papers*- Promote discussion/debate/ creating awareness on various topics.
- ❖ Do not establish principles or essential procedures to be followed in audit.

Preface



AASB and Its Due Process



Need for Codification of “Due Process”

- ❖ Strengthen transparency.
- ❖ Enhancing objectivity.
- ❖ Fixing accountability.
- ❖ Balancing authority *vis a vis* responsibility.
- ❖ One stop reference in case of doubt.

Preface

AASB

- ❖ Initially, a part of the Research Committee.
- ❖ Constituted as the AUDITING PRACTICES COMMITTEE (APC) on September 17, 1982.
- ❖ Non-standing Committee of ICAI.
- ❖ Converted to AASB in July, 2002 :
 - Greater Transparency.
 - Greater Efficiency.
 - Strengthening standard setting process.

Preface



Objectives and functions

- ❖ **Formulation of:**
 - Engagement Standards.
 - Quality Control Standards.
 - Statements on Auditing.
 - Guidance Notes.
 - Clarifications on Standards.
 - Technical Guides, Practice Manuals, Studies and Other Papers.
- ❖ Identify areas in which Engagement and Quality Control Standards needs to be developed.
- ❖ **Review :**
 - Existing and emerging auditing practices worldwide.
 - Existing Standards and Statements on Auditing.
 - Guidance Notes.

Preface

Significant New Propositions in “Due Process” – Standards/ Statements

- ❖ **IAASB Policy Paper of July 2006 – the basic guidepost.**
- ❖ **Composition :**
 - From ICAI's Council.
 - Co-opted from Profession.
 - One Special invitee from :
 - RBI, SEBI and IRDA.
 - (IIMs)/academic/research organization.
 - Prominent Industry association.
 - Public interest representation.
- ❖ **Supported by the Secretariat of the Board.**

Preface



Authority and Preface

❖ Term :

- Chairman – 3 years (co terminus with sitting Council's term).
- Members – 1 year (co terminus with sitting Council's term).

❖ Attendance :

- Consideration of Standards/ Statements/ Guidance Notes (at any stage) – 2/3rd members, in person or by telecom.
- Other times – 1/3rd of members.
- Absence from 3 consecutive meetings –AASB notifies Council.

Preface



Training Manual on Engagement and Quality Control Standards

Document circulation / Activity timelines

Document	Mode	Time
Draft from study groups	AASB website	At least 21 days before mtg.
Proposed ED – Council members	Email	10 days
Final Exposure Draft	ICAI & AASB website & Journal	At least 60 days earlier 45 days
	Posted to specified persons / organisations	At least 60 days earlier 45 days
Comments on Exposure Draft	AASB Website	Upto 10 days prior to mtg.
Mtg. for consideration of comments Open for public	AASB & ICAI website	At least 30 days before the date

Preface

- ❖ Identify Project Proposal and then priorities them.
- ❖ In the preparation of Standards, Statements and General Clarifications, AASB is assisted by Study Groups/Task Forces.
- ❖ The AASB appoints one of the professional accountants as a convenor of the Study Group/Task Force, which, in consultation with the Chairman, AASB, nominates other members of the Study Group/Task Force, ordinarily five to seven in number.
- ❖ A study group is usually based in the area where the convenor is located. In situations considered necessary, the Board may also consider having an outside expert on such Study Groups/Task Forces and such an expert need not necessarily be a professional accountant.
- ❖ Responsible for preparing the basic draft of the Standard/ Statement/ General Clarification.
- ❖ In addition, a separate group of experts may be formed to advice the Study Group /Task Force.
- ❖ Exposure Drafts should be sent to the following persons:
 - Council members, the Institute's past Presidents, Regional Councils and their branches.
 - MCA, C&AG, RBI, IRDA, CBDT, CBEC, SEBI, ICSI, ICWAI, IIMs, TRAI.
 - The Central Registrar of Co-operative Societies.
 - The Indian Banks Association.
 - Industry organizations such as Federation of Indian Chambers of Commerce and Industry, Associated Chambers of Commerce, Confederation of Indian Industry.
 - The Standing Conference on Public Enterprises.
 - Recognized stock exchanges in India.
 - Any other body considered relevant by the AASB keeping in view the nature and requirement of AAS/Statement.



Authority and Preface

❖ Public observers at meetings :

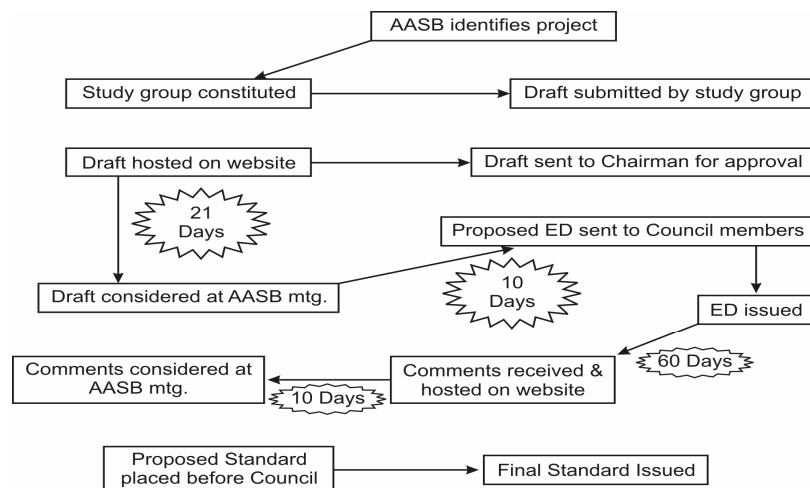
- Only while consideration of Statement/ Standard/ Guidance Note.
- Only as observer.
- At own expense.
- Limited seats.
- Notify AASB at least 15 days in advance.
- First come, first serve.

❖ Voting :

- Required only for approval of technical documents.
- Affirmative votes of 2/3rd of total AASB members.
- Physical attendance/ telecom link.
- One member, one vote.

Preface

Flowchart



Preface



Formulation of Guidance Notes

Essentially the same procedure as in Standards except:

- ❖ Normally, no Exposure Draft issued.
- ❖ Public not invited during deliberations.

Preface



Standards on Quality Control (SQC's)



Standard on Quality Control (SQC) 1

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

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

Objective

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

Note:

Quality control responsibility of firm personnel for specific engagements set out in other Standards, e.g., SA 220 (AAS 17).

SQC 1



Parameters

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

Collectively known as “the CODE”.

SQC 1

System of Quality Control

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

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

SQC 1

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



Standard on Quality Control (SQC) 1

Definitions

• Engagement documentation • Engagement partner • Engagement quality control review • Engagement quality control reviewer • Engagement team • Firm • Inspection • Listed entity	• Monitoring • Network firm • Partner • Personnel • Professional standards • Reasonable assurance • Staff • Suitably qualified external person

SQC 1

Definitions Explained – Engagement Documentation

Record of:

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

Assembled for each engagement in Engagement File.

SQC 1



Definition Explained – Engagement Partner

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

SQC 1

Definition Explained – Engagement QC Review

Process:

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

SQC 1



Definition Explained – Engagement QC Reviewer

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

SQC 1

Definition Explained – Engagement Team

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

SQC 1



Definition Explained – Firm

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

SQC 1

Definition Explained – Inspection

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

SQC 1



Definition Explained – Listed Entity

Stocks/ shares/ debt quoted on:

- *Recognised stock exchange.*
- *Marketed under regulation of recognised stock exchange/ equivalent body.*

SQC 1

Definition Explained – Monitoring

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

SQC 1



Definition Explained – Network Firm

- ❖ Entity under common control/ownership/management with firm.
- ❖ Any entity that can reasonably be assume to be part of the firm nationally/internationally.

SQC 1

Definition Explained – Partner

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

SQC 1



Definition Explained – Personnel

- ❖ Partners.
- ❖ Staff.

SQC 1

Definition Explained – Professional Standards

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

SQC 1



Definition Explained – Reasonable Assurance

- ❖ High but not absolute level of assurance.

SQC 1

Definition Explained – Staff

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

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Definition Explained – Suitably Qualified External Person

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

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Elements of SQC

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

SQC 1



Training Manual on Engagement and Quality Control Standards

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

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I. Leadership Responsibilities for QC

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

SQC 1



Standard on Quality Control (SQC) 1

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

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Person delegated the QC responsibility

- Experience === identify, understand QC issues and develop appropriate policies & procedures.
- Authority === enable implementation of policies.

II. Ethical Requirements

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

SQC 1



Training Manual on Engagement and Quality Control Standards

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

SQC 1

Independence

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

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Standard on Quality Control (SQC) 1

Policies / procedure should require:

Maintenance of independence of personnel	Breach of independence
- Engagement partners to provide firm with relevant information about client. - Prompt notification of threats to independence. - Accumulation & communication of relevant information to appropriate personnel.	- All subjected to independence to promptly notify breach of independence. - Prompt communication of identified breaches.

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



Training Manual on Engagement and Quality Control Standards

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

SQC 1

Written Confirmations

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

Factors to consider in setting criteria:

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

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

III. Client Acceptance & Continuance

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

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Standard on Quality Control (SQC) 1

Significant matters to consider (examples):

<i>Client integrity</i>	<i>Firm capabilities</i>	<i>Ethical issues</i>
• Identity / reputation of owners / key management / related parties. • Nature of operations. • Attitude of owners / governing body towards internal controls. • Aggressive towards maintaining firm's fee as low as possible. • Indication of inappropriate scope limitation. • Indication of inappropriate scope limitation. • Indications of money laundering. • Non continuance of previous auditors.	• Industry knowledge among personnel. • Experience of relevant regulatory/reporting requirements. • Ability to gain necessary skills. • Availability of experts. • Availability of individuals fulfilling the criteria. • Ability to complete engagement within reporting deadline.	• Professional/legal responsibilities applying in circumstances. • Possibility of withdrawal – from engagement and / or client relationship.

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Client acceptance/ retention – coverage

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

Client integrity – sources of information

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

Accepting engagement from a new/ existing client. Consider whether it gives rise to actual/ perceived conflict of interest?

Client continuance.

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

Ethical issues – additional matters

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



Withdrawal from Engagement

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

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Discussion with appropriate level of management

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

If withdrawal necessary

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

IV. Human Resources

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

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

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Sufficient personnel

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



Standard on Quality Control (SQC) 1

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

SQC 1

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

Assignment of Engagement Teams

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

SQC 1

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



Training Manual on Engagement and Quality Control Standards

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

SQC 1

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

V. Engagement Performance

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

SQC 1

Policies & Procedures

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

Briefing the team

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



Standard on Quality Control (SQC) 1

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

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Considering capabilities, competence of individuals on team

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

Addressing issues arising during the engagement

- Considering their significance & appropriately modifying the planned approach.

A. Supervision

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

SQC 1



B. Review

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

SQC 1

C. Consultation

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

SQC 1

Consultation

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



Standard on Quality Control (SQC) 1

❖ Consultation procedure to require:

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

❖ External consultation:

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

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Training Manual on Engagement and Quality Control Standards

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

SQC 1

Consultation documentation

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

Differences of opinion

Benefits:

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



D. Engagement QC Review

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

SQC 1

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

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

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

Nature, timing & extent of QC review

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

SQC 1



Training Manual on Engagement and Quality Control Standards

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

SQC 1

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

Eligibility criteria for QC reviewer

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

SQC 1

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



Standard on Quality Control (SQC) 1

Engagement documentation

❖ Policies/ procedures to require:

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

SQC 1

E. Engagement Documentation

Assembly of Files

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

SQC 1



Training Manual on Engagement and Quality Control Standards

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

SQC 1

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

❖ Examples of controls:

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

SQC 1

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

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



Standard on Quality Control (SQC) 1

Retention of engagement documentation

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

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

Ownership of documentation

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

SQC 1

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



VI. Monitoring

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

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

SQC 1



Standard on Quality Control (SQC) 1

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

SQC 1

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



Training Manual on Engagement and Quality Control Standards

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

SQC 1

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

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

SQC 1

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



Standard on Quality Control (SQC) 1

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

SQC 1

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

SQC 1



Training Manual on Engagement and Quality Control Standards

Complaints & allegations

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

SQC 1

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

VII. Documentation

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

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



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



What this Framework Defines

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

Framework

Why this Framework

Useful for:

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

Framework

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



Overview of the Framework

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

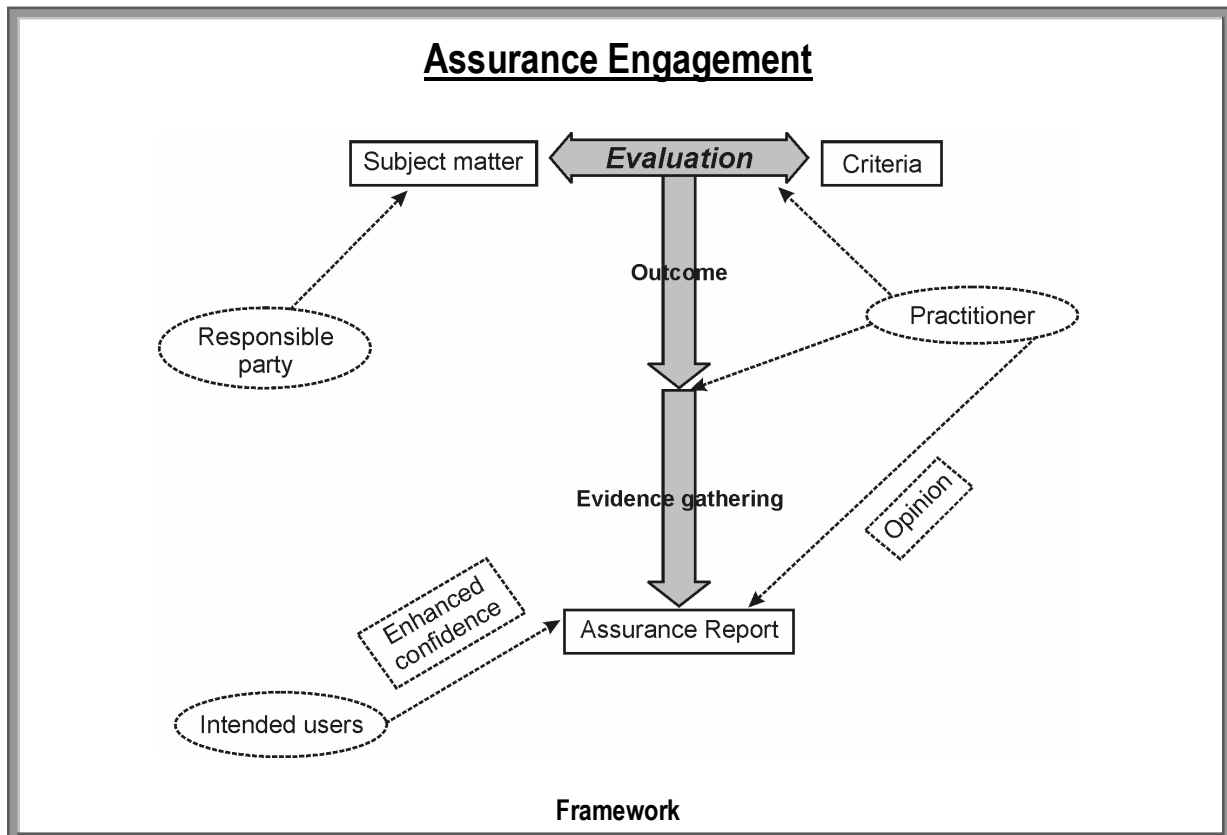
Framework

Governance Parameters

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

Framework

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



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



Engagement Circumstances

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

Framework

Scope

Framework Does Not Apply to

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

Framework



Assurance vs. Consulting

What is Consulting?

Analytical process

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

Framework

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

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

Framework



Training Manual on Engagement and Quality Control Standards

Exceptions

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

Framework

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

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

Framework

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



Engagement Acceptance

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

Framework

If Engagement Does Not Meet These Criteria?

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

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

Framework

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



Elements of Assurance Engagement

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

Framework

I. Three Party Relationship

The three parties:

- ❖ Practitioner.
- ❖ Responsible party.
- ❖ Intended user.

Framework

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



I.1 Practitioner

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

Framework

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

I.2 Responsible Party

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

Framework



I.3 Intended Users

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

Framework

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



II. Subject Matter

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

Framework

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

Appropriate Subject Matter?

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

Framework



III. Suitable Criteria

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

Framework

Suitable Criteria - Characteristics

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

Framework

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



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

Framework

IV. Evidence

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

Framework



IV.1 Professional Skepticism

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

Framework

IV.2 Sufficient Appropriate Evidence

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

Framework



Some Generalizations on Evidence

- ❖ Externally generated evidence from independent sources is more reliable.
- ❖ Internally generated evidence more reliable when related controls are effective.
- ❖ Directly obtained by practitioner more reliable than that by inference.
- ❖ Documentary evidence more reliable.
- ❖ Original documents more reliable than photocopies/ faxes.

Framework

- ❖ More assurance from consistent evidence from different sources/ different nature.
- ❖ Difficult to obtain evidence for subject matter covering a period of time than that relating to a point in time.
- ❖ Consider cost of obtaining *vis a vis* usefulness of evidence.
But cost/ difficulty does not exonerate from evidence gathering procedures.

Framework



IV.3.i Materiality

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

Framework

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

IV.3.ii Assurance Engagement Risk

Expression of inappropriate conclusion when outcome is materially misstated.

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

Framework



Components of Engagement Risk

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

Framework

Can Engagement Risk be Zero?

No.

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

Framework



Nature, Timing & Extent of Evidence Gathering Procedures

- ❖ Reasonable assurance engagements:
 - Understand subject matter information, engagement circumstances, internal controls.
 - Assess risk of material misstatement.
- ❖ Respond to assess risk :
 - Perform further procedures.
 - Evaluate sufficiency, appropriateness of evidence.

Framework

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

- ❖ Limited assurance engagement :
 - Deliberately limited vis a vis reasonable assurance engagement :
 - Analytical procedures.
 - Inquiries.

Framework



IV.3.iii Quantity & Quality of Evidence

Affected by:

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

Framework

Material Scope Limitation

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

IMPLYING :

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

Framework



V. Assurance Report

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

Framework

Other than Unqualified Reports

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

Some circumstances may call for withdrawal.

Framework



Inappropriate Use of Practitioner's Name

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

Framework



Engagement Standards



An Overview of Engagement Standards

❖ Engagement Standards

➤ **Standards on Auditing - 100 - 999**

- 100 – 199: Introductory Matters
- 200 - 299: General Principles & Responsibilities (9)
- 300 – 499: Risk Assessment & Response to Assessed Risks (5)
- 500 – 599: Audit Evidence (11)
- 600 – 699: Using Work of Others (3)
- 700 – 799: Audit Conclusions & Reporting (2)
- 800 – 899: Specialized Areas

➤ **2000 – 2699- Standards on Review Engagements (SREs) (1)**

➤ **3000 – 3699- Standards on Assurance Engagements (SAEs) (1)** **4400 – 4699- Standards on Related Services (SRSs) (2)**



Standards on Auditing (SAs)

200 - 299: General Principles and Responsibilities

- SA 200 – Basic Principles Governing an Audit.
- SA 200A – Objective and Scope of the Audit of Financial Statements.
- SA 210 - Terms of Audit Engagement.
- SA 220 – Quality Control for Audit Work.
- Revised SA 230 - Audit Documentation*.
- Revised SA 240 - The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**.
- Revised SA 250 – Consideration of Laws and Regulation in an Audit of Financial Statements***.
- Revised SA 260 - Communication with Those Charged with Governance****.
- SA 299 - Responsibility of Joint Auditors.

**Hitherto known as SA 230, "Documentation."*

***Hitherto known as SA 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements".*

****Hitherto known as SA 250, "Consideration of the Laws and Regulations in an Audit of Financial Statements".*

*****Hitherto known as SA 260, "Communications of Audit Matters to Those Charged with Governance".*



SA 200

Basic Principles Governing an Audit

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

- ❖ Issued in April 1985.

Introduction

- ❖ Objective:
 - describes basic principles governing auditor's professional responsibilities.
 - compliance with whenever an audit is carried out.
- ❖ Audit is an independent examination:
 - of financial information.
 - for any entity.
 - to express an opinion.

SA 200

- ❖ Audit is carried out with the objective of expression of an opinion, irrespective of the size or legal form of the entity.
- ❖ Compliance with basic principles requires the application of auditing procedures and reporting practices appropriate to the particular circumstances.



Basic Principles - I

- ❖ **Integrity, Objectivity and Independence:**
 - straightforward, honest, sincere approach.
 - must not allow prejudice or bias to override his objectivity.
- ❖ **Confidentiality:**
 - should not disclose information acquired in the course of work to a third party unless legal or professional duty to disclose.
- ❖ **Skills and Competence:**
 - qualification, training, experience.
 - continuing awareness of developments including pronouncements of ICAI.

SA 200

Independence

- ❖ **Importance of Independence-** If the opinion of the auditor is to command respect and the confidence of the public, it is essential that they must ensure their independence to assure the public as regards the faith and confidence that would be reposed on them.
- ❖ In order to ensure independence, the Companies Act, 1956 as well as the Chartered Accountants Act, 1949, Regulations made there under and Code of Ethics, lay down certain provisions:
 - The Companies Act, 1956 – Section 224, 225, 226, 227(4A) and 314.
 - The Chartered Accountants Act, 1949 – Clause (4), (8), (9) & (10) of Part I of the First Schedule.
 - Notifications issued by the Council of the Institute No.1-CA(37)/70 dated May 23, 1970; No.1-CA(39)/70 dated October 16, 1970; No.1 – CA(7)/60/2002 dated March 8, 2002, No.1-CA(7)/63/2002 dated August 2, 2002.

Confidentiality

- ❖ Reference may be made to Clause (1) of Part I of the Second Schedule to the Chartered Accountant Act, 1949.
- ❖ Reference may be made to clarification on the Auditors' Rights where Clients and Other Auditors Seek Access to their Audit Working Papers published in May, 2000 issue of the Journal.



Basic Principles - II

❖ Work Performed by Others:

- The auditor responsible for forming and expressing his opinion on the financial information.
- Can rely on the work performed by others, provided he:
 - exercises adequate skill and care in using work performed by others.
 - directs, supervise and review work delegated to assistants.
 - obtains reasonable assurance that work performed by others is adequate for his purpose.

SA 200

Basic Principles - III

❖ Documentation:

- Document all matters important in providing evidence - audit in accordance with the basic principles.

❖ Planning:

- Plan work to conduct an effective audit in an efficient and timely manner.
- Plans based on knowledge of the client's business.

SA 200

- ❖ Plans should be made to cover, among other things:
 - Acquiring knowledge of the client's accounting system, policies and internal control procedures.
 - Establishing the expected degree of reliance to be placed on internal control.
 - Determining and programming the nature, timing, and extent of the audit procedures to be performed; and coordinating the work to be performed.
- ❖ Plans should be further developed and revised as necessary during the course of the audit.



Basic Principles - IV

❖ **Audit Evidence:**

- Obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures.
 - to enable auditor to draw reasonable conclusions therefrom.

❖ **Accounting System & Internal Controls:**

- **management responsibility**-maintain adequate accounting system incorporating various internal controls.
- **auditor responsibility** - gain an understanding of the accounting system and related internal controls for evaluation purposes.

SA 200

- ❖ 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:
 - tests of details of transactions and balances;
 - analysis of significant ratios and trends including the resulting enquiry of unusual fluctuations and items.
- ❖ The auditor should reasonably assure himself that the accounting system is adequate and that all the accounting information which should be recorded has been recorded.
- ❖ 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.



Basic Principles - V

❖ Audit conclusions & reporting:

- to express an opinion.
- adequate disclosure of all material matters, accounting policies application, compliance with regulations and statute.

SA 200

- ❖ The auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of the 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:
 - the financial information has been prepared using acceptable accounting policies, which have been consistently applied;
 - The financial information complies with the relevant regulations and statutory requirements; and
 - There is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to the statutory requirements where applicable.
- ❖ 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.
- ❖ 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 thereof.



SA 200A

Objective and Scope of the Audit of Financial Statements

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

- ❖ Issued in April 1985.

Introduction

- ❖ Describes overall objective & scope of audit of general purpose financial statements by an independent auditor.
- ❖ **Objective of audit** – enable auditor to express an opinion on FS.

SA 200A

- ❖ 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.



Responsibilities

Management	Auditor
• Preparation of the Financial Statement • Maintenance of adequate accounting records and internal controls (IC). • Selection and application for accounting policies. • Safeguarding of assets of the enterprise. • Audit of financial statement does not relieve management of its responsibilities.	• Independent examination of records. • Expressing an opinion on PS.

SA 200A

Scope of Audit

- ❖ Determined by auditor having regard to:
 - terms of the engagement.
 - requirements of the relevant legislation.
 - pronouncements of ICAI.
- ❖ Terms of engagement cannot override the requirements of legislation or pronouncements of ICAI.

SA 200A



Conducting an Audit-I

- ❖ All aspects **relevant to FS** should be adequately covered.
- ❖ Focus on items **material** in relation to the affairs of the enterprise.
- ❖ Auditor not expected to perform duties beyond the scope of his competence.
- ❖ To form an opinion on the financial statements the auditor should be reasonably satisfied that:
 - information contained in accounting records and source data is reliable and sufficient for the preparation of FS.
 - proper disclosures, subject to the statutory requirements, are made in FS.

SA 200A

- ❖ Materiality cannot be defined in absolute terms and it includes all items, the knowledge of which might influence the decisions of the user of FS. Reference may also be made to Accounting Standard (AS) 1, on "Disclosure of Accounting Policies".
- ❖ The professional skill required of an auditor does not include that of an investigator or a forensic accountant.

Conducting an Audit-II

- ❖ **Reliability and sufficiency** of records is assessed by the auditor by:
 - studying and evaluating the accounting systems and internal control (IC).
 - testing IC to determine nature, extent and timing of other auditing procedures.
 - carrying other tests, enquiries, and other verification procedures.
- ❖ **Proper disclosures** in the FS are ensured by the auditor by:
 - comparing the FS with accounting records, source data and ensuring proper summarization.
 - assessing the selection and consistent application of accounting policies by the management.
 - appropriateness of management estimates.

SA 200A



Inherent Limitations

- ❖ Absolute certainty in auditing is not possible:
 - test nature of audit.
 - involves exercise of judgment.
 - persuasive not conclusive nature of audit evidence.
 - inherent limitations of internal control.
- ❖ Unavoidable risk that some material mis-statement may remain undiscovered.

SA 200A

- ❖ Reference may be made to paragraph 15 of AAS 6 explaining "Inherent Limitations of Internal Controls".

SA 210

Terms of Audit Engagement

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

- ❖ Issued in January 2003.



Introduction

- ❖ Establishes standards on:
 - Agreeing terms of engagement with client.
 - Auditor's response to a client to change terms of engagement to a lower level one.
- ❖ Auditor & client should agree on terms of engagement.

SA 210

- ❖ 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. (Code of Ethics issued by the Institute of Chartered Accountants of India defines the term "management consultancy and other services").
- ❖ 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 Letter (AEL)

- ❖ Auditor should send preferably before commencement of audit, to help avoid any misunderstandings.
- ❖ Procedure – Acknowledgement by client.
- ❖ Principal Contents (may vary for each client):
 - objective.
 - management's responsibilities.
 - scope of audit.
 - inherent limitation of audit.
 - unrestricted access to records.
 - audit process subject to Peer review.

SA 210

- ❖ Appendix to AAS 26 sets out the example of an AEL under the Companies Act, 1956.
- ❖ Management's responsibility:
 - preparation of FS on a going concern basis.
 - selection and consistent application of appropriate accounting policies.
 - making judgements and estimates.
 - Maintenance of adequate accounting records and internal controls.



AEL...

- Arrangements for planning of audit.
- Expectation of receiving from management written representations.
- Deliverables list – Letters/Reports to be issued to client.
- Fee computation basis and billing arrangements.
- Arrangements concerning involvement of other auditors / experts / predecessor auditor / internal auditor etc.
- Any restriction on the auditor's liability when such possibility exists.

SA 210

Audit of Components

- ❖ Factors affecting decision to send separate engagement letter to the component include:
 - appointing authority for the auditor of the component.
 - need for separate audit report.
 - legal requirements.
 - extent of any work performed by other auditors.
 - degree of independence of the management of the component.
 - degree of ownership by parent.

SA 210



Recurring Audits

- ❖ Consider need for revision of the terms of engagement and need to remind the client of the existing terms of engagement.
- ❖ New engagement letter when:
 - change in senior management/ BOD/ownership.
 - significant change in nature or size of client's business.
 - misunderstanding by client of objective and scope of audit.
 - legal requirements or pronouncements of ICAI, or changes in the existing ones.
 - any revised or special terms of engagement.

SA 210



Change in Terms

- ❖ If client requests change to a lower level of assurance engagement:
 - consider the appropriateness of doing so.
 - do not agree if no reasonable justification for change.
 - consider implications including legal/contractual.
 - if terms changed then auditor and client should agree on new terms.
- ❖ If change not agreeable and not permitted to continue original engagement, then withdraw and consider obligation to report to other parties, such as board of directors or shareholders.

SA 210

- ❖ Request for change in engagement may result from:
 - change in circumstances,
 - misunderstanding as to nature of audit,
 - restriction on the scope of the engagement, imposed by management or caused by circumstances.
- ❖ If the auditor concludes that there is reasonable justification to change the engagement and if the audit work performed complies with the AASs 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:
 - the original engagement, or
 - 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.



SA 220

Quality Control for Audit Work

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

Introduction

- ❖ Establishes standards on QC:
 - policies and procedures at audit firm level regarding audit work generally.
 - procedures regarding delegation of work to assistants on an individual audit.
 - QC policies and procedures – implemented at both level of audit firm and on individual audits.

SA 220



Definitions

- ❖ **Auditor** – person with the final responsibility for audit.
- ❖ **Audit firm** – firm/ sole practitioner providing audit services.
- ❖ **Personnel** - partners and professional staff engaged in the audit practice.
- ❖ **Assistants** - personnel involved in an individual audit other than the auditor.

SA 220

QC Firm Level

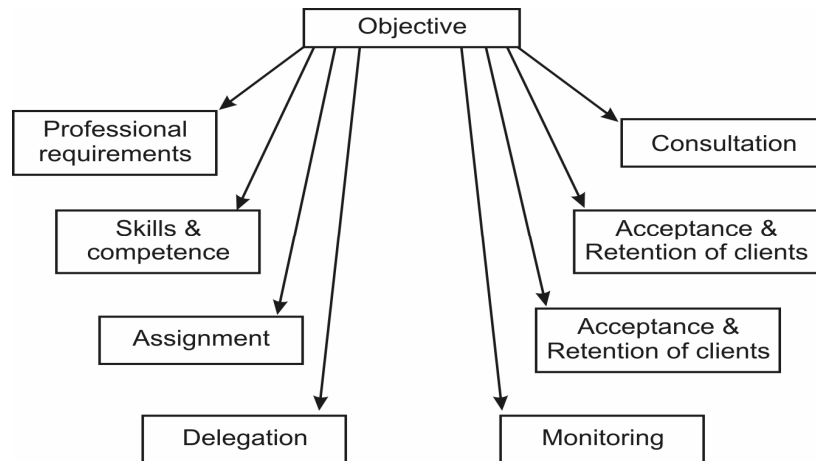
- ❖ Implement QC policies and procedures designed to ensure that all audits are conducted in accordance with SAs.
- ❖ Communicate QC policies & procedures to all personnel.

SA 220

- ❖ Communication of QC policies & procedures should be such that they are understood & implemented.



QC at Firm level – Objectives



SA 220

- ❖ **Professional Requirements:** Personnel in the firm are to adhere to the principles of Independence, Integrity, Objectivity, Confidentiality and Professional Behavior.
- ❖ **Skills and Competence:** The firm is to be staffed by personnel who have attained and maintain the Technical Standards and Professional Competence required to enable them to fulfill their responsibilities with Due Care.
- ❖ **Assignment:** Audit work is to be assigned to personnel who have the degree of technical training and proficiency required in the circumstances.
- ❖ **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.
- ❖ **Consultation:** Whenever necessary, consultation within or outside the firm is to occur with those who have appropriate expertise.
- ❖ **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.
- ❖ **Monitoring:** The continued adequacy and operational effectiveness of quality control policies and procedures is to be monitored.



Individual Audits

- ❖ QC policies and procedures of the audit firm applicable to the extent appropriate to the individual audit.
- ❖ Consideration of professional competence of assistants when deciding extent of direction, supervision and review appropriate for each assistant.
- ❖ Delegation of work to assistants in a manner that provides reasonable assurance that work will be performed with due care by persons having the degree of professional competence required in the circumstances.

SA 220

Direction

- ❖ Assistants need appropriate direction.
- ❖ Direction involves informing assistants of:
 - their responsibilities.
 - objectives of the procedures they are to perform.
 - nature of entity's business.
 - possible accounting or auditing problems that may affect the nature, timing and extent of audit procedures with which they are involved.

SA 220

- ❖ Audit programme, overall audit plan and time budgets are useful tools for communicating audit directions.



Supervision

- ❖ Involves:
 - Monitor the progress of the audit.
 - Address significant accounting and auditing issues.
 - Resolve differences of professional judgment between personnel.

SA 220

- ❖ Supervision is closely related to both direction and reviews and may involve elements of both.
- ❖ Persons carrying out supervisory responsibilities monitor progress to consider whether:
 - assistants are competent and understand audit directions.
 - work is being carried out in accordance with overall audit plan and audit programme.
- ❖ Address significant accounting and auditing issues raised during the audit, by assessing their significance and their impact on audit plan and audit programme.
- ❖ Resolve any differences of professional judgment between personnel and consider the level of consultation that is appropriate.



Training Manual on Engagement and Quality Control Standards

Review

- ❖ Review to be done by personnel of at least equal competence.
- ❖ Significant areas for review:
 - overall audit plan and audit programme.
 - assessments of inherent and control risks.
 - documentation of audit evidence.
 - FS and proposed adjustments in FS.

SA 220

- ❖ Review that:
 - work is performed in accordance with audit programme.
 - results are adequately documented.
 - significant audit matters are resolved or reflected in audit conclusions.
 - objectives of audit procedures have been achieved.
 - conclusions expressed are consistent with results of the work performed and support audit opinion.
- ❖ Review assessments of inherent and control risks, including results of test control and modifications, if any, to audit plan/programme.
- ❖ Review documentation of evidence obtained from substantive procedures and conclusions drawn therefrom, including results of consultations.
- ❖ Review FS, proposed adjustments in FS arising out of auditor's examination, and the auditor's proposed observations/report.
- ❖ The process of reviewing an audit, in the case of large complex audits, may involve other persons not otherwise involved in the audit.



Revised SA 230

Audit Documentation

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

- ❖ Replaces SA 230 (AAS 3), "Documentation", issued in July, 1995.

Overview of SA 230

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

SA 230(R)

- ❖ 'R' Stands for Revised.



Audit Documentation

Record of:

- audit procedures performed.
- relevant audit evidence obtained.
- conclusions reached.

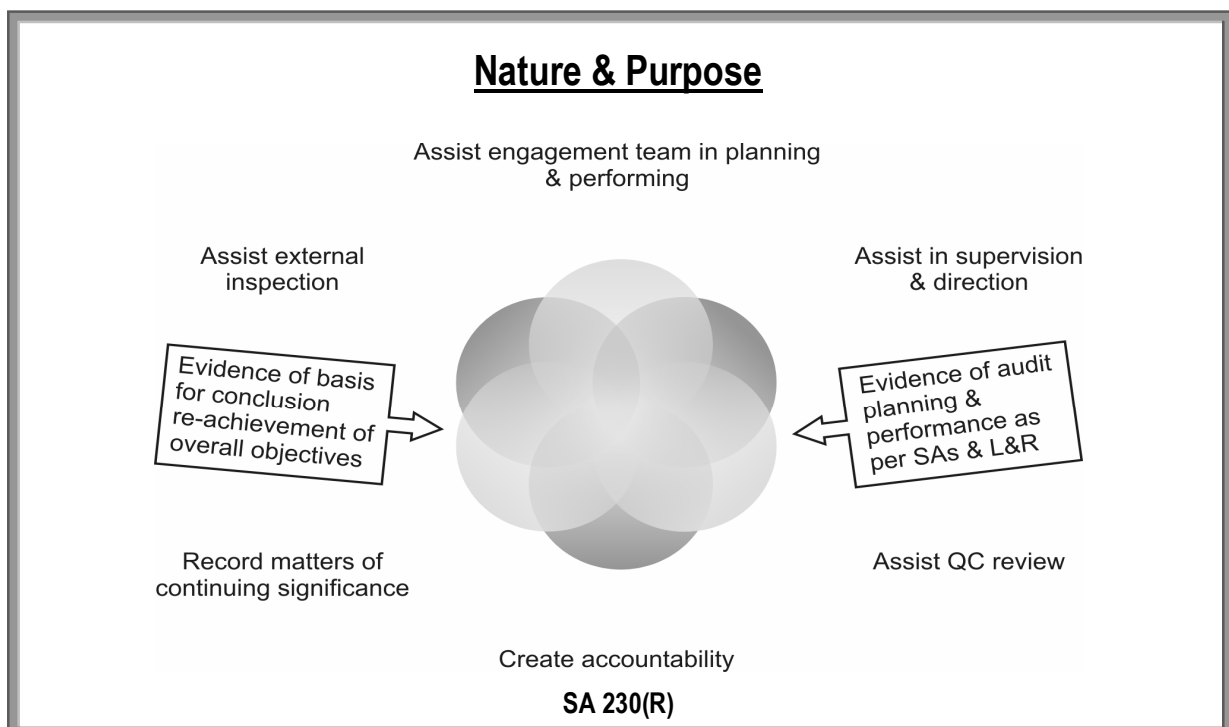
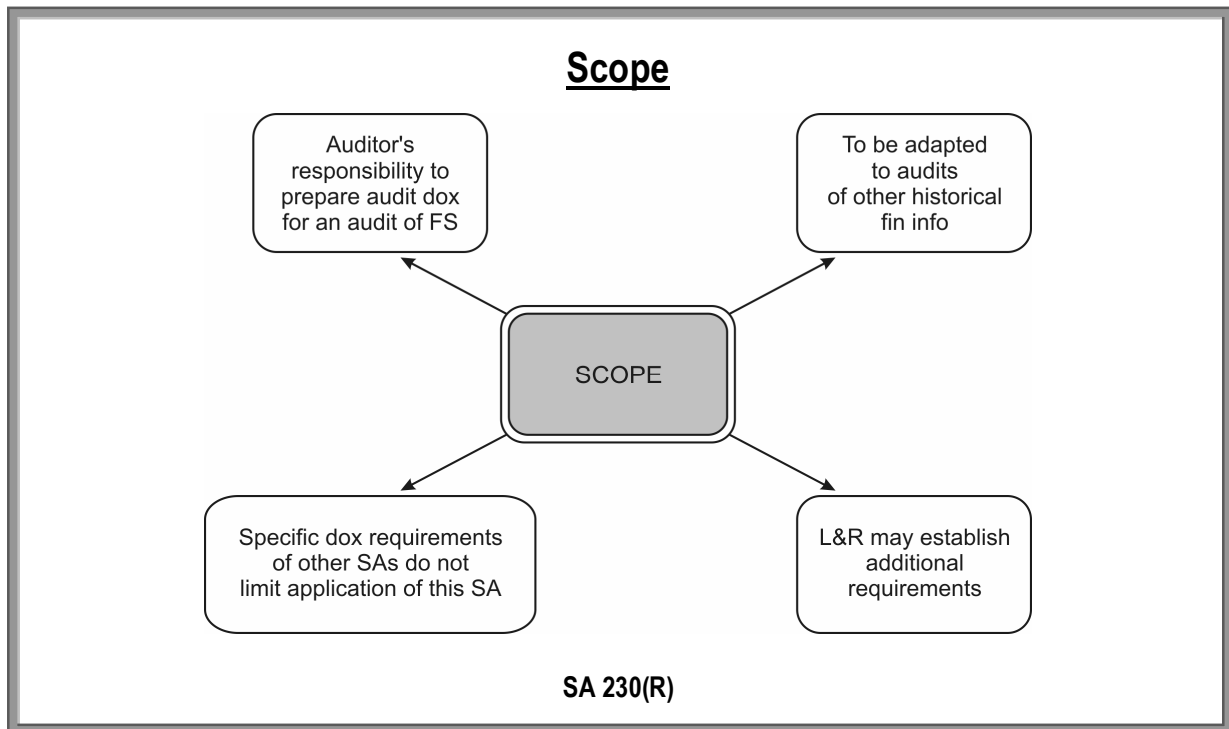
Also known as “working papers”, “work papers”.

SA 230(R)

Audit File

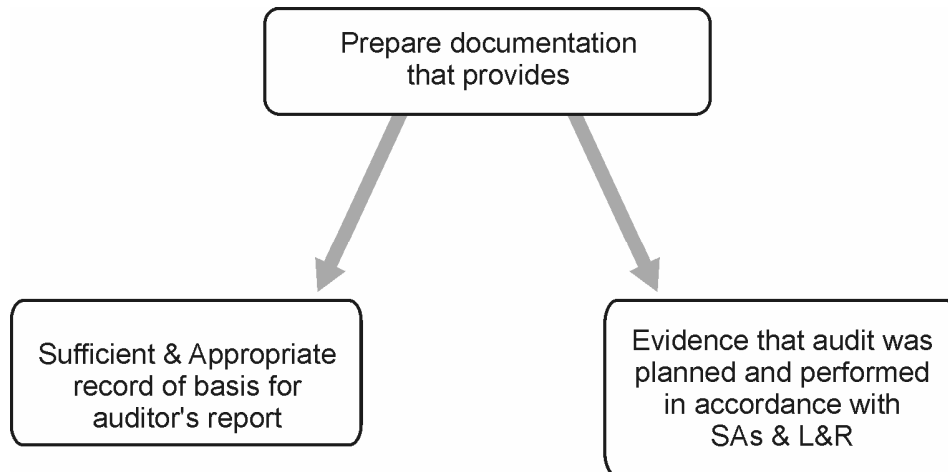
- one or more folders or other storage media.
- in physical or electronic form.
- containing records that comprise audit documentation for a specific engagement.

SA 230(R)





Objective



SA 230(R)

Experienced Auditor

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

- audit processes.
- SAs and applicable L&R reqts.
- business environment .
- auditing and financial reporting issues.

SA 230(R)



Timely Preparation of Audit Documentation

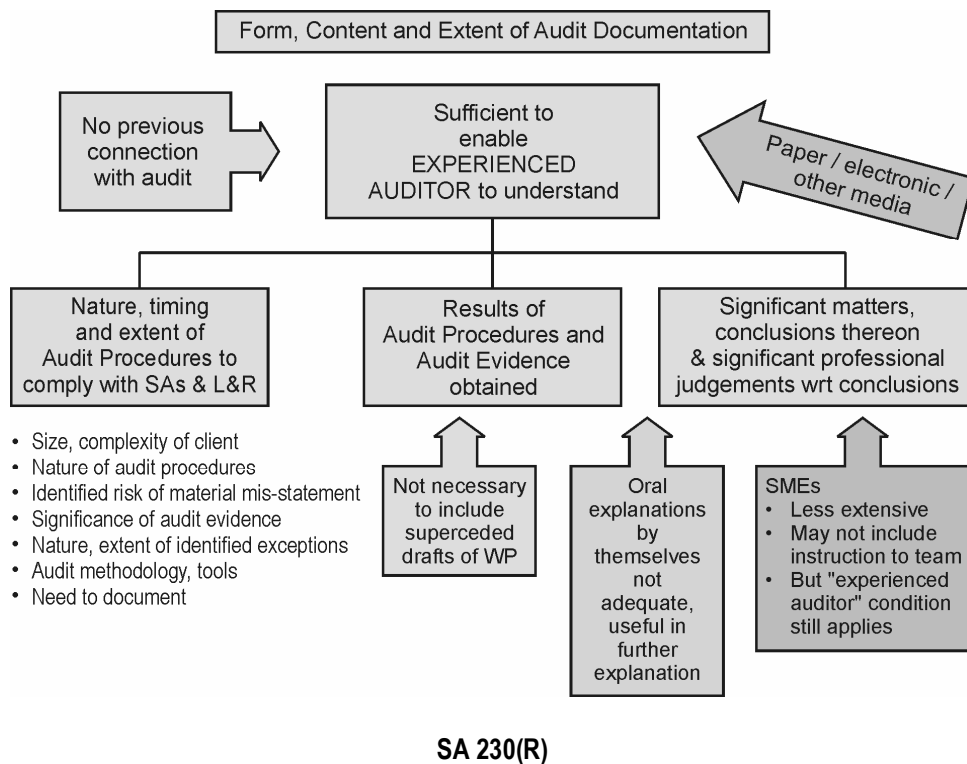
- ❖ **Prepare Sufficient Appropriate audit dox on a timely basis:**
 - Enhances quality of audit.
 - Facilitates effective review & evaluation of :
 - Audit evidence.
 - Conclusions reached.
 - Before report is finalized.
 - Dox prepared after audit is less accurate.

SA 230(R)



Training Manual on Engagement and Quality Control Standards

Documentation of the Audit Procedures & Audit Evidence



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



Compliance with SAs and L&R

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

SA 230(R)

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



Resolution of Significant Matters

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

SA 230(R)

Resolution of Significant Matters – Documenting Professional Judgment-I

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

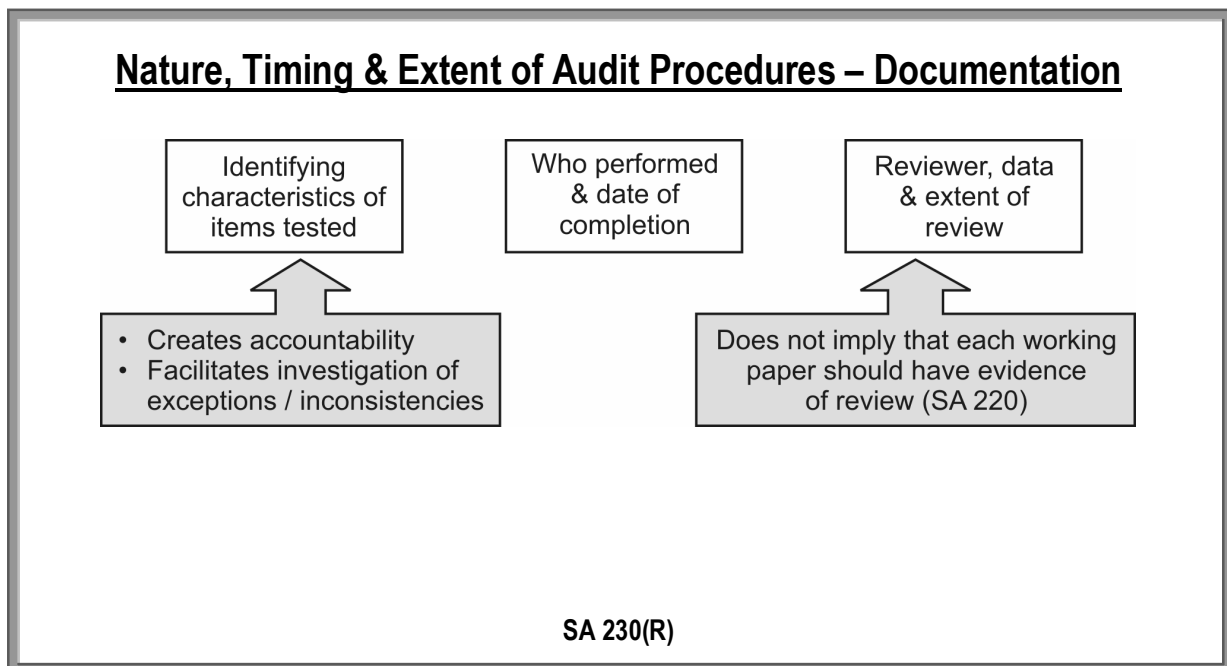
SA 230(R)



Resolution of Significant Matters- Documenting
Professional Judgment - II

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

SA 230(R)



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



Discussions with Management, TCWG, Others

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

SA 230(R)

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

Inconsistency *vis a vis* Final Conclusion

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

SA 230(R)



Departure from Relevant Requirement

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

SA 230(R)

- ❖ The documentation requirement applies only to requirements that are relevant in the circumstances. A requirement is not relevant only in the cases where:
 - The SA is not relevant for example, in a continuing engagement, nothing in Proposed SA 510 (Revised) is relevant; or
 - 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 Date of Audit Report

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

SA 230(R)



Assembly of Final Audit File

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

SA 230(R)

- ❖ **No deletion/ discarding permitted after final assembly except for example to clarify existing dox arising from internal/ external inspections:**
 - Document specific reasons for making them.
 - When & by whom made/ reviewed.
- Retention period – 10 years from date of audit report.

SA 230(R)



Ownership of Documentation

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

SA 230(R)



Revised SA 240

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

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

- ❖ Replaces SA 240 (Revised AAS 4), *The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements*, issued in January, 2003.

Overview of SA 240

- ❖ **Introduction**
 - Scope
 - Effective Date
- ❖ **Objectives**
- ❖ **Definitions**
- ❖ **Requirements**
 - Professional skepticism
 - Discussion among engagement team
 - Risk assessment procedures and related activities
 - Identification and assessment of risks of material misstatement due to fraud
 - Evaluation of audit evidence
 - Auditor unable to continue the engagement
 - Management Representations
 - Communication with those charged with governance and management
 - Communications to regulatory and enforcement authorities
 - Documentation
- ❖ **Application and Other Explanatory Material**
- ❖ **Appendices**

SA 240(R)

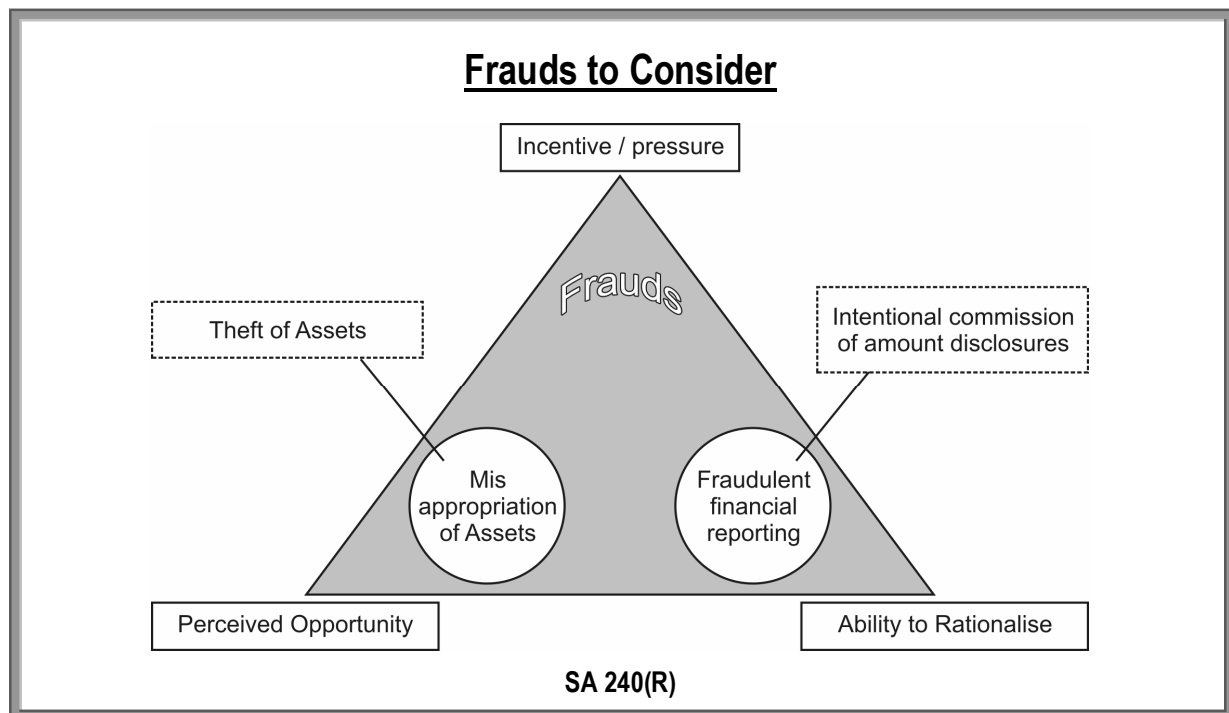
- ❖ 'R' Stands for Revised.



Scope

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

SA 240(R)



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

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

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



Responsibility for Fraud Prevention

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

SA 240(R)

Responsibility of Auditor

- ❖ Obtain reasonable assurance that financial statements are free of material misstatements.

Subject to:

- Inherent limitations of audit.
- Fraud – deliberately concealed so difficult to detect.

But exercise **PROFESSIONAL SKEPTICISM**.

SA 240(R)

- ❖ The auditor's ability to detect a fraud depends on factors such as:
 - skillfulness of the perpetrator.
 - frequency and extent of manipulation.
 - degree of collusion involved.
 - relative size of individual amounts manipulated.
 - seniority of those individuals involved.



Objectives of the Auditor

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

SA 240(R)

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

Definitions

- ❖ Fraud :
 - intentional act.
 - one or more persons.
 - use of deception.
 - obtain unjust advantage.
- ❖ Fraud Risk factors – indicate :
 - Incentive/ pressure to commit fraud.
 - Provide opportunity for fraud.

SA 240(R)

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



Professional Skepticism

- ❖ Attitude that **includes**:
 - Questioning mind.
 - Critical assessment of audit evidence:
 - Reliability of audit evidence.
 - Controls over preparation & maintenance of information.
- ❖ Do not take client integrity and honesty for granted.
- ❖ Documents may be accepted as genuine if no contrary indications:
 - But when in doubt, may:
 - Confirm directly with 3rd party.
 - Engage expert to assess authenticity.
 - Investigate-response to inquiries is inconsistent.

SA 240(R)

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



Discussion Among the Engagement Team

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

SA 240(R)

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



Training Manual on Engagement and Quality Control Standards

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

SA 240(R)

Risk Assessment Procedures (RAPs) and Related Activities

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

SA 240(R)

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



RAPs - Management and Others in the Entity

- ❖ **Inquiries of management:**
 - Assessment of risk of material misstatement due to fraud in FS:
 - nature, extent, frequency of assessment.
 - Relevant controls for prevention & detection.
 - Process for identifying & responding to fraud risk:
 - any specific risk identified.
 - Communication with those charged with governance on above issues.
 - Communication to employees on its views on business practices & ethical behaviour.
- ❖ **Enquiries of management & others:**
 - Any knowledge about actual, suspected or alleged fraud affecting the entity.
- ❖ **Inquiries of internal auditors.**

SA 240(R)

- ❖ Management assessment:
 - Depends from entity to entity – detailed/ yearly/ continuous/ less structured/ less frequent.
 - The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. No assessment of the risk of fraud by management may indicate the lack of importance of internal control.
 - In smaller entities, the focus of management's assessment may be on the risks of employee fraud or misappropriation of assets.
- ❖ Management process : (ref. para 17(b), A14)
 - This includes any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist.
 - In multi-location clients, management's processes may include different levels of monitoring of operating locations, or business segments. Management may also have identified particular operating locations or business segments for which a risk of fraud may be more likely to exist.
- ❖ Enquiries of management & others:
 - Cannot provide information about risk of material misstatement due to management fraud.
 - Can get to know otherwise unknown information.
 - Enquire from:
 - Operating (non-financial personnel).
 - Employees with different level of authority.
 - Employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees.
 - In-house legal counsel.
 - Chief ethics officer or equivalent person.
 - The person or persons charged with dealing with allegations of fraud.
 - Management often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional skepticism, it might be necessary to corroborate responses to inquiries with other information.
- ❖ Inquiries of Internal Auditors:
 - Guided by SA 610 (AAS 7), Relying Upon the Work of an Internal Auditor.
 - Specific inquiries include:
 - Procedures performed in current year to detect fraud.
 - Whether management has satisfactorily responded to any findings of above procedures.



RAPs – Those Charge with Governance

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

SA 240(R)

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

RAPs – Unusual/Unexpected Relationships

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

SA 240(R)



RAPs – Other Information

- ❖ Whether other information obtained indicates risk of material misstatement due to fraud.

From:

- Discussion with engagement team.
- Information from client acceptance/ retention process.
- Experience from other engagements for the client.

SA 240(R)



RAPs – Evaluation of Fraud Risk Factors

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

SA 240(R)

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



Identification and Assessment of Risk of Material Misstatement

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

SA 240(R)

Risk of Fraud in Revenue Recognition

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

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

SA 240(R)

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



Responses to Assessed Risks of Material Misstatement Due to Fraud

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

SA 240(R)



Responses – Overall Responses

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

SA 240(R)

Responses – Overall Responses

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



Responses – At Assertion Level

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

SA 240(R)

Responses – At Assertion Level

- I. 1. Change in nature, timing and extent of audit procedures
 - ❖ Change **nature** to obtain more reliable/ relevant audit evidence or additional corroborative information:
 - Physical observation/ inspection of certain assets.
 - Use more CAATs w.r.t. electronic transactions.
 - ❖ Management under pressure to inflate revenue - external confirmations from customers supplemented by enquiry from non financial personnel as to change in terms of sales contract/ delivery.
2. **Timing** of substantive procedures
May decide to perform near the year end also because of assessed risk of fraud.
3. **Extent** changed:
 - ❖ Increase sample size.
 - ❖ Perform analytical procedures at more detailed level.
- II. If fraud risk in inventory >>> examine inventory records to identify location, items needing special attention during or after inventory count.
- III. If risk in many assertions & accounts >>>> understanding of entity and its environment would help.



Responses – Management Override of Controls

- ❖ This risk present in all entities.
- ❖ Unpredictability in how override could occur so it is a significant fraud risk.
- ❖ Assessment of this risk not withstanding:
 - Test appropriateness of journal entries.
 - Review accounting estimates for biases.
 - Evaluate business rationale for unusual transactions.
 - Any other audit procedure, if required.

SA 240(R)

Testing Appropriateness of Journal Entries

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

SA 240(R)

- ❖ 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.



Training Manual on Engagement and Quality Control Standards

❖ Matters to consider:

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

SA 240(R)

❖ Characteristics of fraudulent journal entries:

- made to unrelated/ unusual/ seldom used accounts.
- made by individuals who typically do not make journal entries.
- recorded at the end of the period/ post closing entry, having little/ no explanation.
- made before/ during the preparation of financial statements that do not have numbers.
- contain round numbers/ consistent ending numbers.

❖ Nature & complexity of accounts:

- contain transactions that are complex or unusual in nature.
- contain significant estimates and period-end adjustments.
- have been prone to misstatements in the past.
- have not been reconciled on a timely basis or contain unreconciled differences.
- contain inter-company transactions.
- are otherwise associated with an identified risk of material misstatement due to fraud.

In audits of entities that have several locations or components, consideration is given to the need to select journal entries from multiple locations.

❖ Processed outside the normal course of business - Non standard journal entries – no adequate internal controls.



Review of Accounting Estimates

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

SA 240(R)

Retrospective review of management assumptions

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

Unusual / Significant Transactions

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

SA 240(R)



Evaluation of Audit Evidence

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

SA 240(R)

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



Auditor Unable to Continue the Engagement

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

SA 240(R)

Auditor Unable to Continue the Engagement

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



Management Representations

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

SA 240(R)

Management Representations

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



Communications – Management & Those Charged With Governance

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

SA 240(R)

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



Communication – Regulators

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

SA 240(R)

Documentation

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

SA 240(R)

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



Revised SA 250

Consideration of Laws and Regulations (L & R) in an Audit of Financial Statements

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

- ❖ Replaces SA 250 (AAS 21), "Consideration of Laws and Regulations in an Audit of Financial Statements", issued in July 2001.

Coverage

- ❖ Introduction
 - Scope
 - Effective date
- ❖ Objectives
- ❖ Definition
- ❖ Requirements
 - Responsibility for compliance with L&R
 - The Auditor's consideration of compliance with L & R
 - Auditor's procedures when non-compliance is identified/ suspected
 - Reporting of identified/ suspected non compliance
 - Documentation
- ❖ Application and Other Explanatory Material on these Aspects

SA 250(R)

- ❖ 'R' Stands for Revised.



Training Manual on Engagement and Quality Control Standards

Scope

- ❖ Deals with the auditor's responsibility to consider L & R while auditing FS.
- ❖ Does not apply to assurance engagements where testing & reporting on compliance with L&R is the specific objective.
- ❖ Compliance with legal & regulatory Framework.
- ❖ L&R having direct effect on FS.
- ❖ L&R to be complied with when undertaking business.
- ❖ Non – compliance may result in:
 - penalties/ fines/litigation.
 - Going concern issues.

SA 250(R)

What is Non Compliance?

For SA 250:

- ❖ acts of omission or commission.
- ❖ either intentional or unintentional.
- ❖ which are contrary to the prevailing laws or regulations.
- ❖ does not include personal misconduct (unrelated to the business activities of the entity) by TCWG, Mgt., employees of the entity.

SA 250(R)

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



Mgt. Responsibility for Compliance with L & R

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

SA 250(R)

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

Auditor's Responsibility

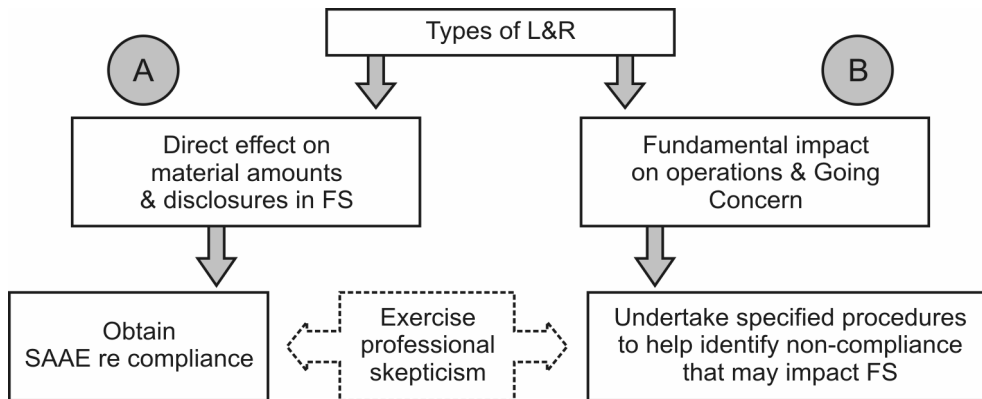
- ❖ **Auditor responsible for obtaining reasonable assurance that FS taken as a whole are free from Material Misstatement, whether by fraud or error.**
- ❖ SA assists auditor in identifying material misstatements in FS due to non-compliance.
- ❖ **Auditor is not, responsible for preventing non compliance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

SA 250(R)

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



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



SA 250(R)

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

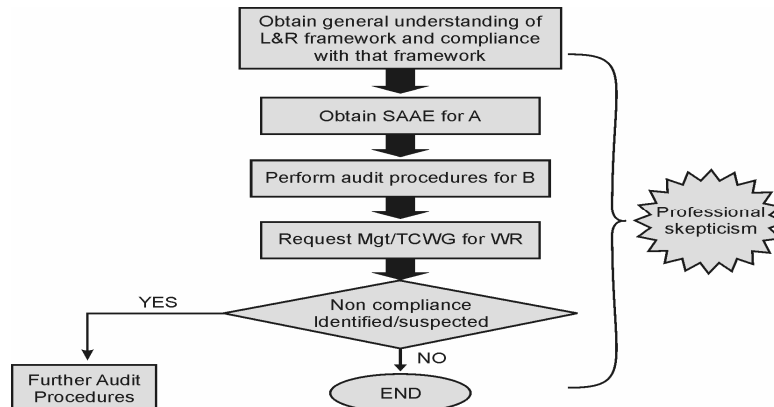
Auditor's Objectives

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

SA 250(R)



Auditor's Consideration of L&R



SA 250(R)

Understanding

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

Procedures

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

SAAE for A

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

Procedures for B

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

Professional Skepticism

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

Written representations

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



Indications of Non-Compliance with Laws and Regulations-I

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

SA 250(R)

Indications of Non-Compliance with Laws and Regulations-II

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

SA 250(R)



Non compliance Suspected / Identified

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

SA 250(R)

Evaluating effect on FS – relevant matters

- Potential financial consequences of possible non-compliance on FS.
- Need to disclose potential financial consequences.
- Negative effect of potential consequences on true & fair view or otherwise, they make FS misleading.

Discussion with TCWG

- ❖ May provide additional evidence.
- ❖ TCWG may have same understanding of non-compliance as the auditors have.

Legal Advice

- ❖ Consult entity's inhouse/ external legal counsel re:
 - application of L&R.
 - possibility of frauds.
 - possible effects on FS.
- ❖ If auditor is not satisfied, he may consult his own legal counsel re:
 - Contravention of L&R.
 - Possible legal consequences.
 - Possibility of fraud.
 - Further action, if any, needed.

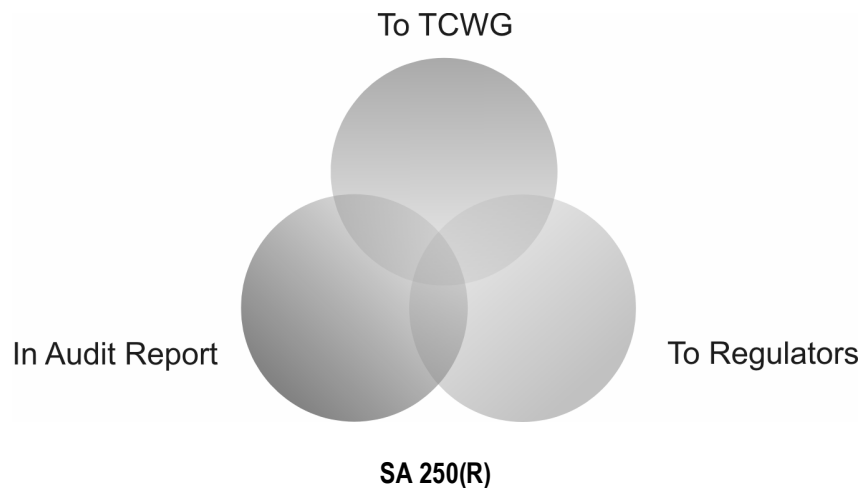


Withdrawal from Engagement

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

SA 250(R)

Reporting of Identified/ Suspected Non compliance



- ❖ These reportings are not mutually exclusive.

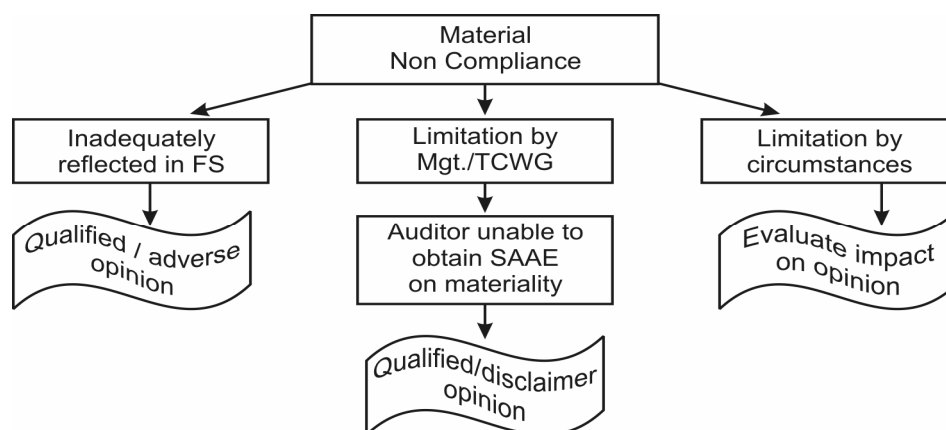


TCWG

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

SA 250(R)

Audit Report



SA 250(R)



Regulators

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

SA 250(R)

Documentation

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

SA 250(R)



Revised SA 260

Communication with Those Charged with Governance

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

- ❖ Replaces SA 260 (AAS 26), "Communications of Audit Matters with Those Charged with Governance", issued in January, 2003.

Overview of SA 260

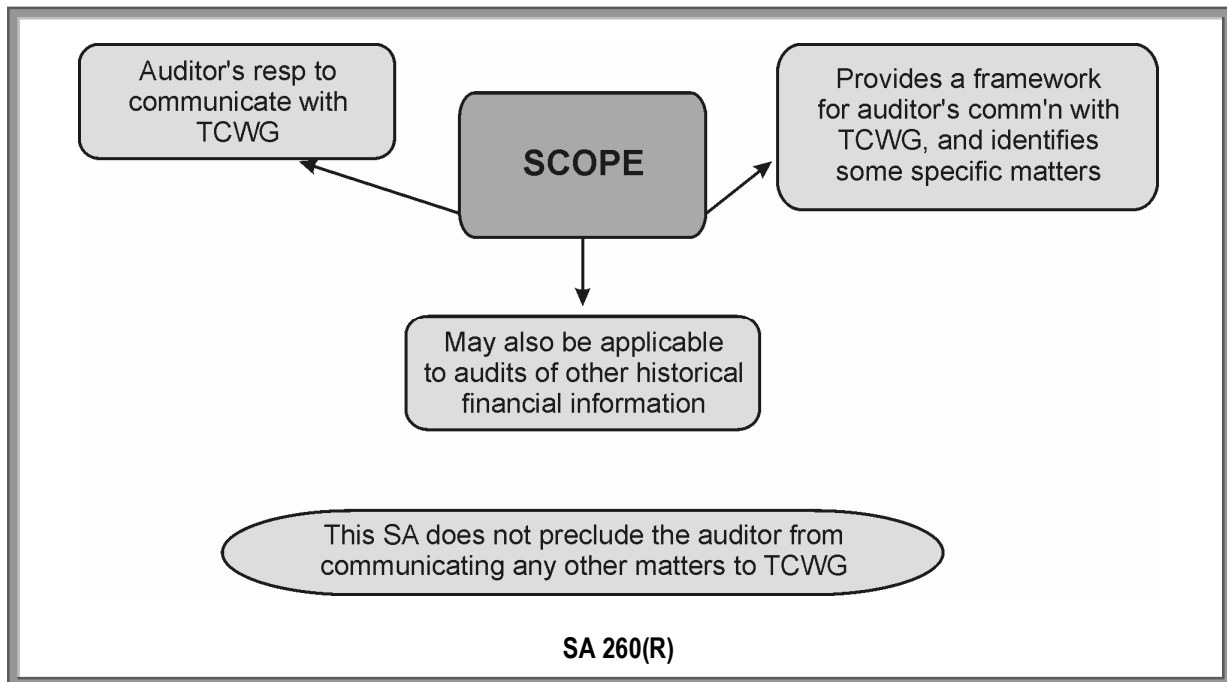
- ❖ **Introduction**
 - Scope
 - Effective Date
- ❖ **Objectives**
- ❖ **Definitions**
- ❖ **Requirements**
 - The Role of Communication
 - Those Charged with Governance
 - Matters to be Communicated
 - The Communication Process
 - Documentation
- ❖ **Application and Other Explanatory Material on these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

SA 260(R)

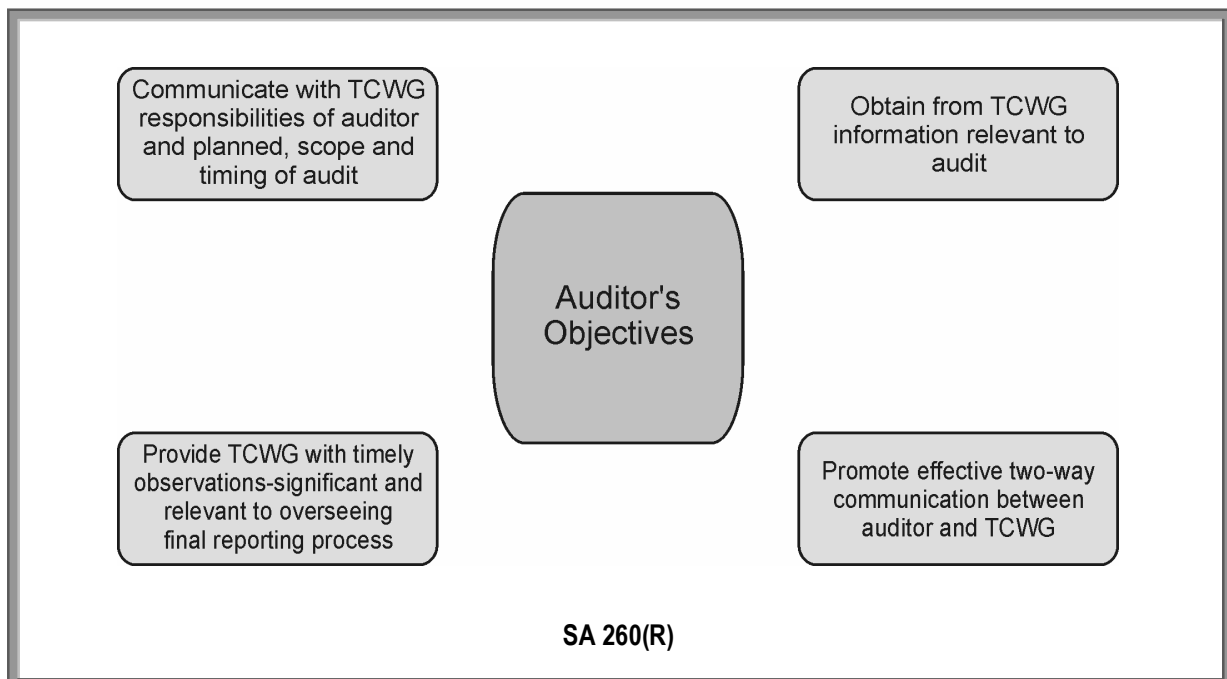
- ❖ 'R' Stands for Revised.

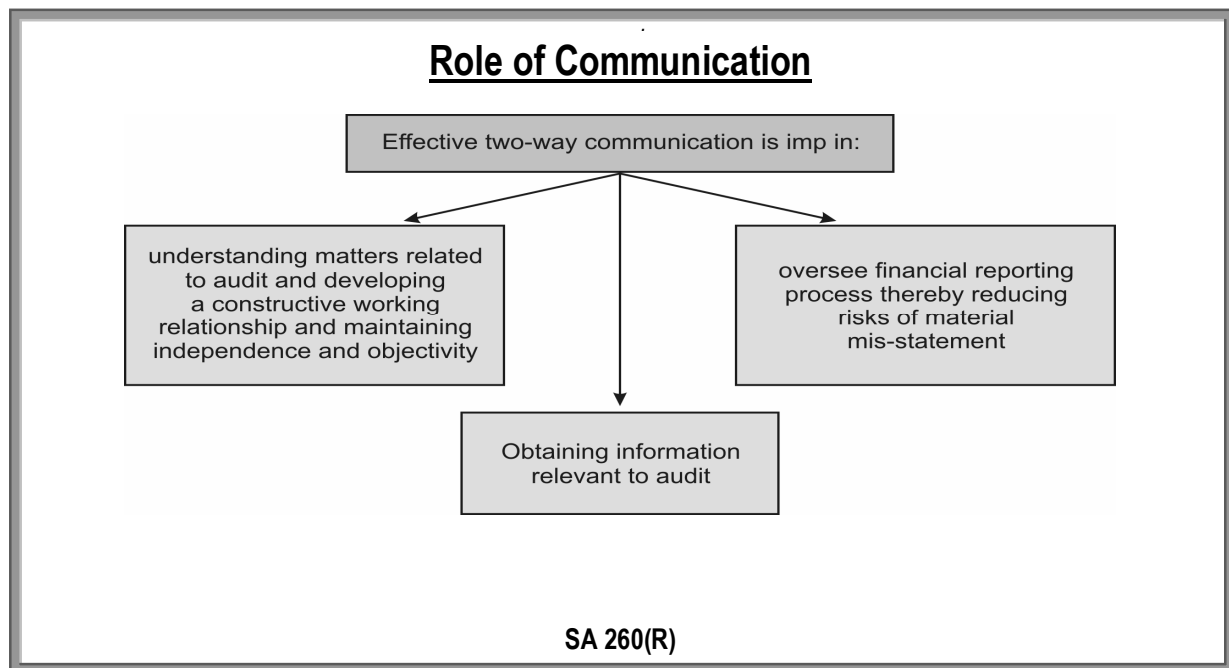


Training Manual on Engagement and Quality Control Standards



- ❖ 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.





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



Training Manual on Engagement and Quality Control Standards

Definitions-I

Those charged with governance:

- ❖ person(s) or organization(s).
- ❖ with responsibility for overseeing the strategic direction of the entity.
- ❖ and obligations related to the accountability of the entity.
- ❖ may include management personnel.
- ❖ In some cases, responsible for approving entity's FS.

SA 260(R)

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

Definitions-II

Management:

- ❖ person(s) with executive responsibility for the conduct of the entity's operations.
- ❖ For some entities, mgt includes some or all of TCWG.
- ❖ Management is responsible for the preparation of the FS, overseen by TCWG.
- ❖ in some cases management is also responsible for approving the entity's FS.

SA 260(R)



Those charged with Governance

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

SA 260(R)

Communication with a Subgroup of Those Charged with Governance:

- when auditor communicates with a subgroup of TCWG, for eg, an audit committee, or an individual, the auditor shall determine whether there is also a need to communicate with the governing body.
- auditor may need to discuss and agree with the engaging party the relevant person(s) with whom to communicate.

When considering communicating with a subgroup of TCWG, auditor may take into account such matters as:

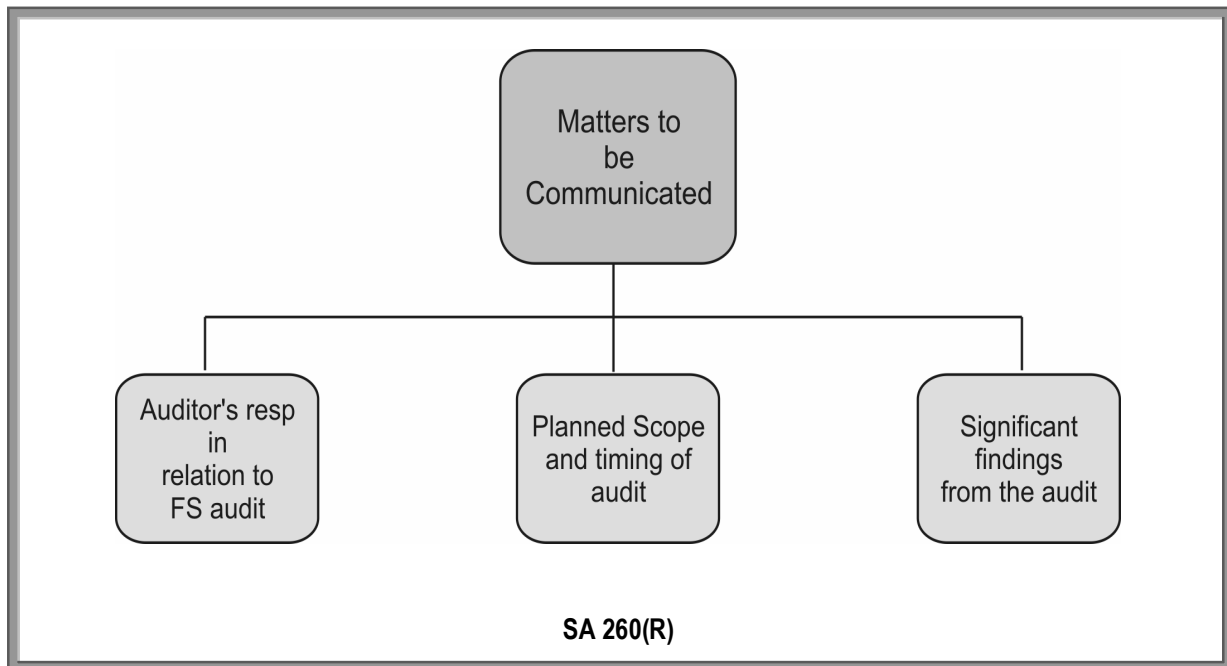
- respective responsibilities of subgroup and governing body.
- nature of matter to be communicated.
- relevant legal or regulatory req.
- whether subgroup has authority to take action and can provide further information and explanations.
- *Communication form, i.e., in full or in summary form, influenced by the auditor's assessment of how effectively and appropriately the subgroup communicates relevant information with the governing body. The auditor may retain the right to communicate directly with the governing body in the terms of engagement.*

When All of TCWG are Involved in Managing the Entity:

- *In some cases, all of those charged with governance are involved in managing the entity, and the application of communication requirements is modified to recognize 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).*
- the matters need not be communicated again with those same person(s) in their governance role.



Training Manual on Engagement and Quality Control Standards



The Auditor's Responsibilities in Relation to the FS Audit

- ❖ Auditor shall communicate with TCWG that:
 - auditor is responsible for forming and expressing an opinion on the FS.
 - audit of the FS does not relieve mgt or TCWG of their responsibility.
- ❖ Auditor's responsibility are included in Engagement Letter. Providing TCWG with a copy of that EL may be an appropriate way to communicate regarding such matters.
L&R, an agreement with the entity or additional requirements applicable to the engagement may provide for broader communication with TCWG.

Planned Scope and Timing of the Audit

Communication regarding planned scope and timing of audit may:

- (a) Assist TCWG:
 - to understand better the consequences of the auditor's work,
 - to discuss issues of risk and materiality with auditor,
 - 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.

Matters communicated may include:

- how the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error.
- auditor's approach to internal control.
- application of materiality.

Other Planning matters:

- Extent of use of an internal audit function by the auditor.
- How external and internal auditors can best work together in a constructive and complementary manner.
- The views of TCWG on various matters such as to whom communicate, allocation of responsibilities, entity's objectives and strategies, and the related business risks that may result in material misstatements, matters which requires additional attention, Significant communications with regulators, etc.
- Control Environment.
- The responses of TCWG to previous communications with the auditor.



Communication of Significant Finding from the Audit

- ❖ Auditor's view on significant qualitative aspects of entity's accounting practices.
- ❖ Significant difficulties encountered.
- ❖ Unless all TCWG are involved in managing the entity, communicate, which have already communicated to mgt.:
 - Material Weaknesses.
 - Significant matters.
 - WR.
 - Other matters required to be discussed as per auditor's professional judgment.
- ❖ May request TCWG for further information to complete audit evidence.

SA 260(R)

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



Auditor Independence

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

SA 260(R)

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



The Communication Process

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

SA 260(R)

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



Forms of Communication

- ❖ Oral communication not adequate.
- ❖ Communicate in **writing** with TCWG regarding significant findings from the audit and auditor independence (Para 13 – Listed Entities).
- ❖ Written communication need not include all matters that arose during the course of audit.

SA 260(R)

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



Timing of Communications

Auditor shall communicate with TCWG on a timely basis.

SA 260(R)

- ❖ **The appropriate timing for communications will vary with the significance and nature of the matter, and the action expected to be taken by TCWG. For example:**
 - Communications regarding planning matters may be made early in the audit engagement.
 - a significant difficulty encountered during the audit as soon as practicable.
 - material weaknesses in the design, implementation or operating effectiveness of internal control as soon as practicable.
 - Communications regarding independence may be appropriate whenever significant judgments are made about threats to independence and related safeguards.
 - When auditing both general purpose and special purpose financial statements, it may be appropriate to coordinate the timing of communications.
- ❖ **Other factors that may be relevant to the timing of communications include:**
 - size, operating structure, control environment, and legal structure of the entity being audited.
 - Any legal obligation to communicate certain matters within a specified timeframe.
 - The expectations of 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., noncompliance with a law) in time for preventive action to be taken, but communication of the matter may enable remedial action to be taken.



Communication with Those Charged with Governance

Evaluate two way communications for adequacy of Communication process, based on observation:

- app and timeliness of actions taken by TCWG in response to matters raised by auditor.
- apparent openness of TCWG in communication with auditor.
- willingness and capacity of TCWG to meet auditor without mgt.

SA 260(R)

Adequacy of the Communication Process

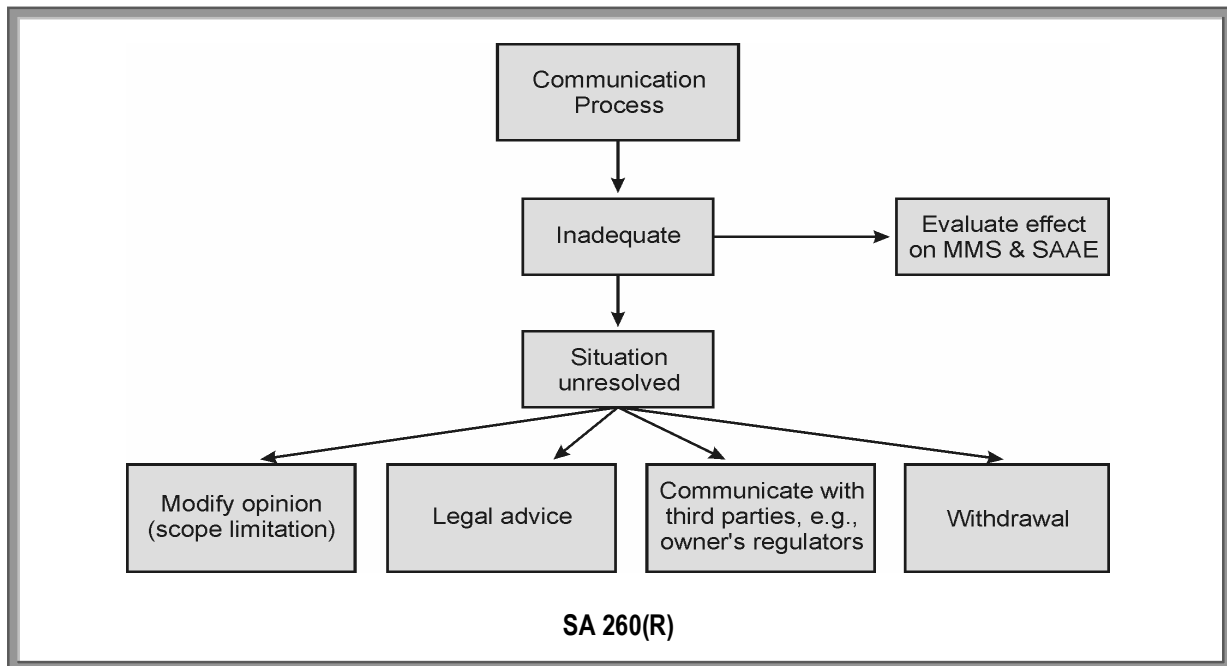
- ability of TCWG to fully comprehend matters raised by auditor.
- difficulty in establishing Mutual understanding with TCWG.
- when TCWG are managing entity, apparent awareness of how matters discussed with auditor affect their governance and mgt. responsibility.
- whether two-way communication b/w auditor and TCWG meets applicable L&R requirements.

SA 260(R)

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



Engagements Standards



Documentation

- ❖ matters communicated orally- doc by auditor and also when and to whom.
- ❖ communicated in writing- auditor to retain a copy of the communication.

SA 260(R)

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



SA 299

Responsibility of Joint Auditors

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

- ❖ Issued in November 1996.

Introduction

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

SA 299

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



Division of Work

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

SA 299

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

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

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

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

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

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

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

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

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

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

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

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

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



Coordination

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

SA 299

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

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

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

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



Relationship among Joint Auditors

- ❖ Responsible only for work allocated, whether or not separate report therefor is made.
- ❖ Jointly and severally responsible for:
 - undivided work.
 - nature, timing, extent of audit procedures.
 - compliance with disclosure requirements.
 - audit report compliance with statute requirements.
 - matter brought to notice of all by any one of them, and on which there is an agreement.

SA 299

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

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

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

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

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



Joint Allocation

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

SA 299

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

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



Own Areas - Execution

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

SA 299

Assumption

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

SA 299

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

Ans.: It is the **separate and specific responsibility** of each joint auditor to exercise his **judgement** with regard to the **necessity of visiting such divisions/branches in respect of which the work is allocated to him** (para 8). Thus in the above case P might be held responsible for not visiting branch X. The fact that Q did not visit branch Y will not have any bearing on P. As regards review of work by any joint auditor of other joint auditors AAS 12 specifies that each joint auditor is entitled to **assume** that the **other joint auditors** have **carried out** their part of the audit work **in accordance** with the generally accepted audit procedures. It is **not necessary** for a joint auditor **to review the work** performed by other joint auditors.

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



Reporting

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

SA 299

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

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

300 – 499: Risk Assessment & Response to Assessed Risks

- ❖ **Revised SA 300-Planning an Audit of Financial Statements***
- ❖ **SA 315-Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment****
- ❖ **SA 320 – Audit Materiality**
- ❖ **SA 330 - The Auditor's Responses to Assessed Risks****
- ❖ **SA 402 – Audit Considerations Relating to Entities Using Service Organisations**

**Hitherto known as SA 300, "Audit Planning".*

***Due to issuance of this Standard (along with SA 330) , the existing Standard on Auditing (SA) 310, "Knowledge of the Business", SA 400, "Risk Assessments and Internal Control", and SA 401, "Auditing in a Computer Information Systems Environment", issued in June 2002, April 2000 and January 2003, respectively, stands withdrawn.*



Revised SA 300

Planning an Audit of Financial Statements

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

- ❖ Replaces SA 300 (AAS 8), “Audit Planning”, issued in April, 1989.

Overview of SA 300

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

SA 300(R)

- ❖ 'R' Stands for Revised.



Training Manual on Engagement and Quality Control Standards

Scope

- ❖ Auditor's responsibility to plan audit of financial statements.
- ❖ Recurring engagements.
- ❖ Separate considerations for initial engagements.

SA 300(R)

Scope –

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



Objective

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

SA 300(R)

Involvement of Key Engagement Team Members

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

SA 300(R)

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



Preliminary Engagement Activities

- ❖ Procedures required under SA 220, Quality Control for Audit Work:
 - Client continuation, etc.
- ❖ Compliance with ethical requirements including independence.
- ❖ Establish understanding of terms of engagement, SA 210, Terms of Audit Engagement.

SA 300(R)

Preliminary engagement activities

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



Planning Activities

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

SA 300(R)

Planning activities

Scope:

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

Considerations Specific to Smaller Entities

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



Training Manual on Engagement and Quality Control Standards

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

SA 300(R)

Contents of audit plan

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

Update audit plan

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

Direction, supervision & review

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



Documentation

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

SA 300(R)

Documentation

Considerations Specific to Smaller Entities :

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



Additional Considerations in Initial Engagement

- ❖ Before starting initial engagement:
 - Perform procedures under SA 220 – client acceptance, etc.
- ❖ Communicating with predecessor auditor.
- ❖ Audit strategy:
 - Any major issues discussed with management.
 - Audit procedures regarding opening balances.
 - Other procedures required by auditor's QC system.

SA 300(R)

Special considerations for initial engagements - Audit strategy :

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



SA 315

Identifying and Assessing the Risk of Material Misstatements Through Understanding the Entity & Its Environment

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

- ❖ The date SA 315 (along with SA 330) becomes effective the existing Standard on Auditing (SA) 400 (AAS 6), "Risk Assessment and Internal Control", Standard on Auditing (SA) 310 (AAS 20), "Knowledge of the Business" and Standard on Auditing (SA) 401 (AAS 29), "Auditing in a Computer Information Systems Environment" would stand withdrawn.

Overview of SA 315

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

SA 315



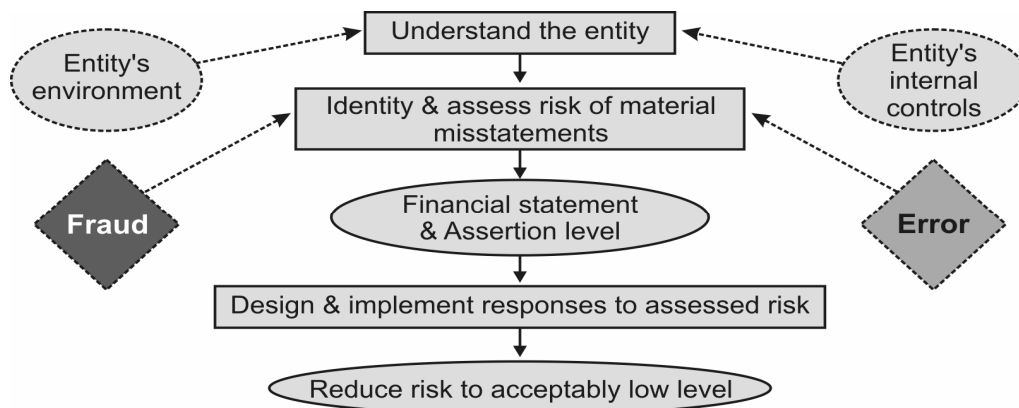
Training Manual on Engagement and Quality Control Standards

Scope

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

SA 315

Objective – of the Auditor



SA 315



Important Definitions

❖ **Assertions:**

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

❖ **Business Risk:**

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

SA 315

❖ **Internal control (IC):**

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

SA 315



Training Manual on Engagement and Quality Control Standards

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

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

❖ **Significant Risk:**

- Risk of material misstatement requiring special audit consideration.

❖ **Material Weakness:**

- A weakness in internal control that could have a material effect on the financial statements.

SA 315

Risk Assessment Procedures – Need

Establish frame of reference for:

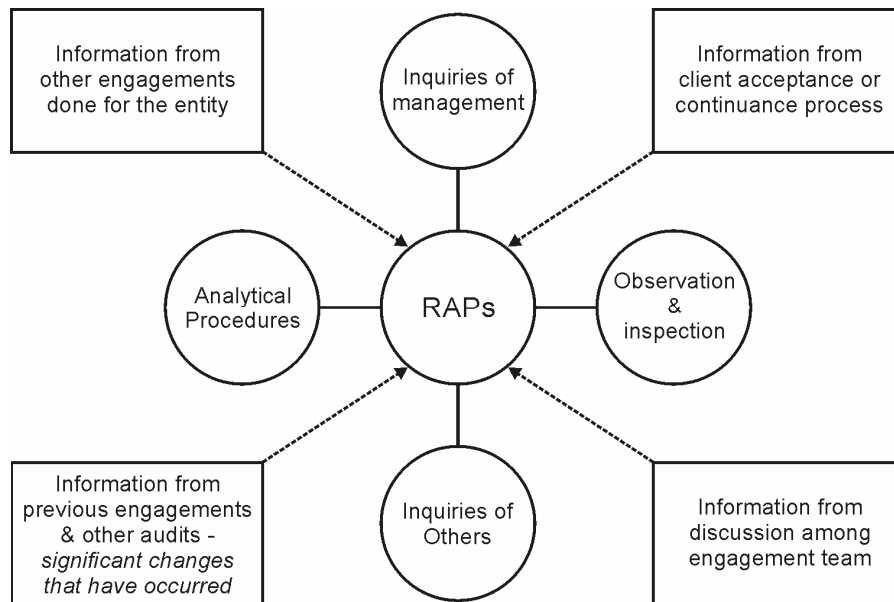
- ❖ Assessing risk of material misstatements in FS.
- ❖ Establishing and assessing continued relevance of established materiality levels.
- ❖ Evaluating appropriateness of accounting policies-selection & application, disclosures.
- ❖ Identifying areas needing special audit consideration.
- ❖ Developing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

SA 315

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



RAPs – Types



SA 315



RAPs – Inquiry of Management

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

SA 315

Inquiry

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

RAPs – Analytical Procedures

- ❖ Identify unusual transactions/ relationships, etc. (possibility of fraud).
- ❖ APs on data aggregated at high level gives only broad initial indication of material misstatement.

SA 315



RAPs – Observation & Inspection

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

SA 315

RAPs – Some important aspects - I

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

SA 315



RAPs – Some important aspects - II

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

SA 315

RAPs – Some important aspects - III

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

SA 315

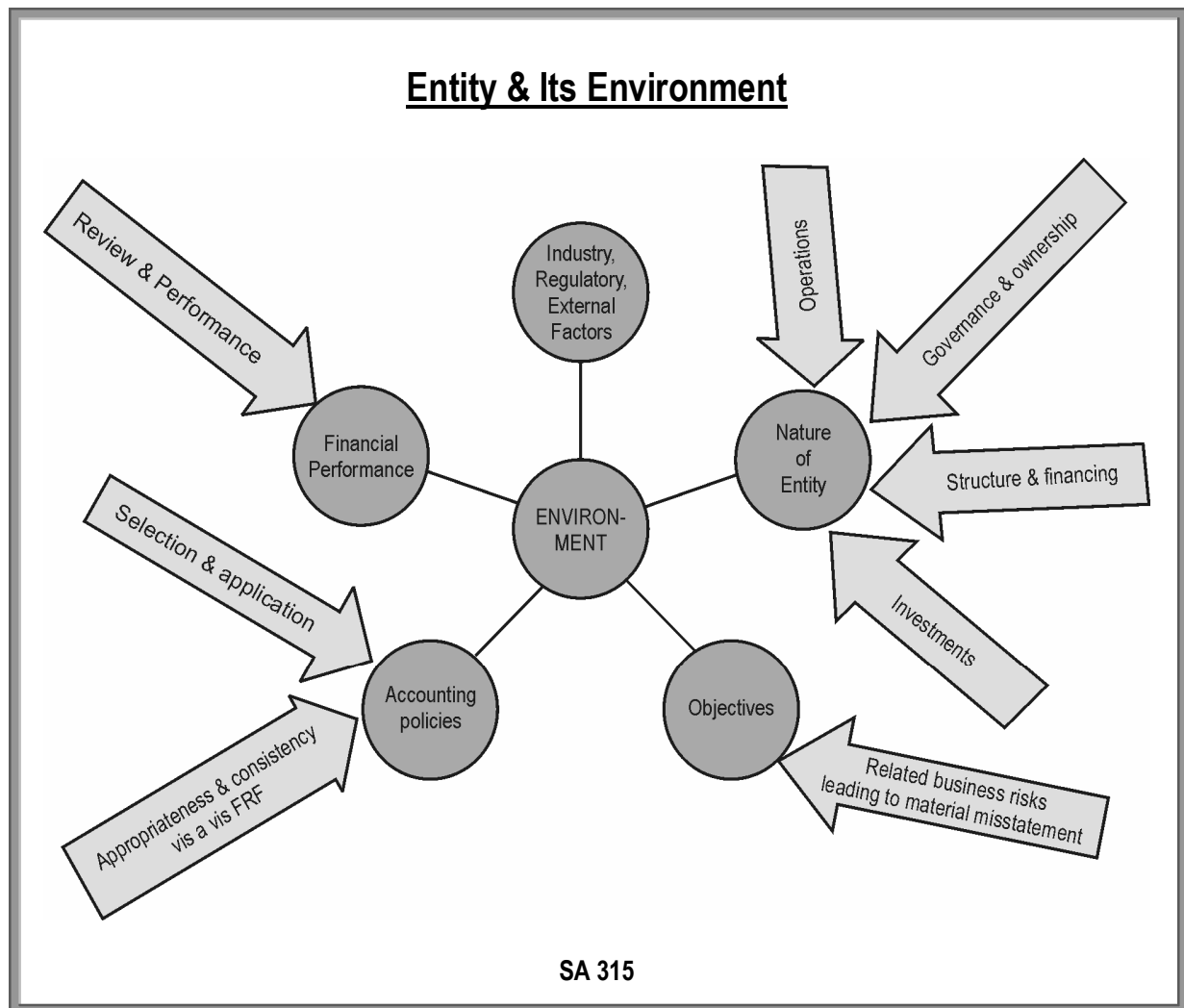
- ❖ **Note:** It is not necessary for all of the members of the engagement team to be informed of all of the decisions reached in the discussion. *Not necessary:*
 - to include all Engagement Team Members in a Single discussion.
 - Informed about all the decisions reached.



Smaller Entity Considerations

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

SA 315



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



Entity & Its Environment – Industry, Regulatory & Other Factors

❖ **Industry Factors:**

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

Type of industry may give rise to specific risk factors

❖ **Regulatory Factors:**

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

❖ **Other External Factors:**

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

SA 315

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



Entity & Its Environment – Nature of the Entity - I

- ❖ **Helps in understanding:**
 - Structure of the entity – complex/ simple.
 - Ownership and related parties.
- ❖ **Business operations:**
 - Nature of revenue sources.
 - Conduct of operations.
 - Stages of production.
 - Joint ventures/outourcing etc.
 - Geographic location.
 - Key customers & suppliers.
 - R & D activities.
 - Related party transactions.

SA 315

Entity & Its Environment – Nature of the Entity - II

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

SA 315



Entity & Its Environment – Nature of the Entity - III

❖ **Financial Reporting:**

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

SA 315

Entity & Its Environment – Selection & application of accounting policies

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

SA 315



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

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

SA 315

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

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

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

SA 315



Entity & Its Environment – Measurement & review of financial performance

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

SA 315

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

Small Entity Considerations

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

SA 315



Internal Controls-I

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

Smaller Entity Consideration:

- Internal controls – less structures & simple

SA 315

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

Internal Controls-II

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

Small Entity Considerations

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

SA 315



Internal Controls – Manual vs Automated

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

SA 315

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

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



Training Manual on Engagement and Quality Control Standards

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

SA 315

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

Understanding Controls Relevant to Audit - I

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

SA 315



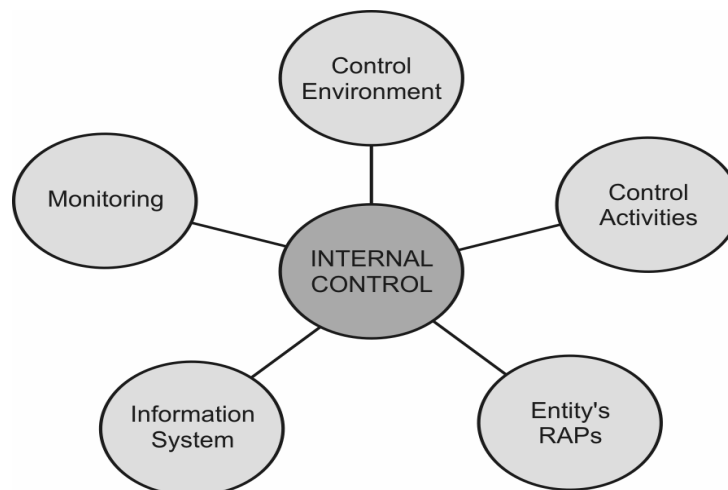
Understanding Controls Relevant to Audit - II

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

SA 315

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

Internal Control – Components



SA 315



Training Manual on Engagement and Quality Control Standards

Control Environment – Elements



SA 315

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

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



Control environment – important Audit considerations

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

SA 315

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

Internal Control – Control Environment

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

SA 315

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

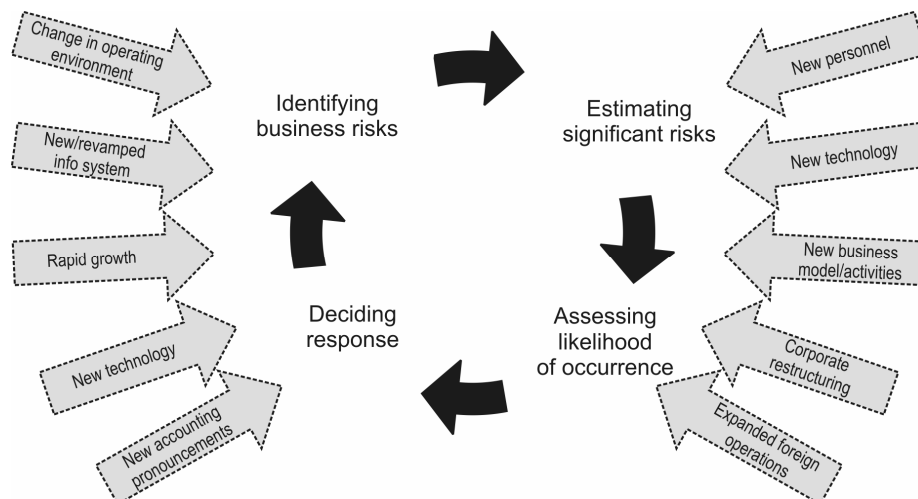


Smaller Entity Considerations

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

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Entity's RAPs – Elements & Risk Factors



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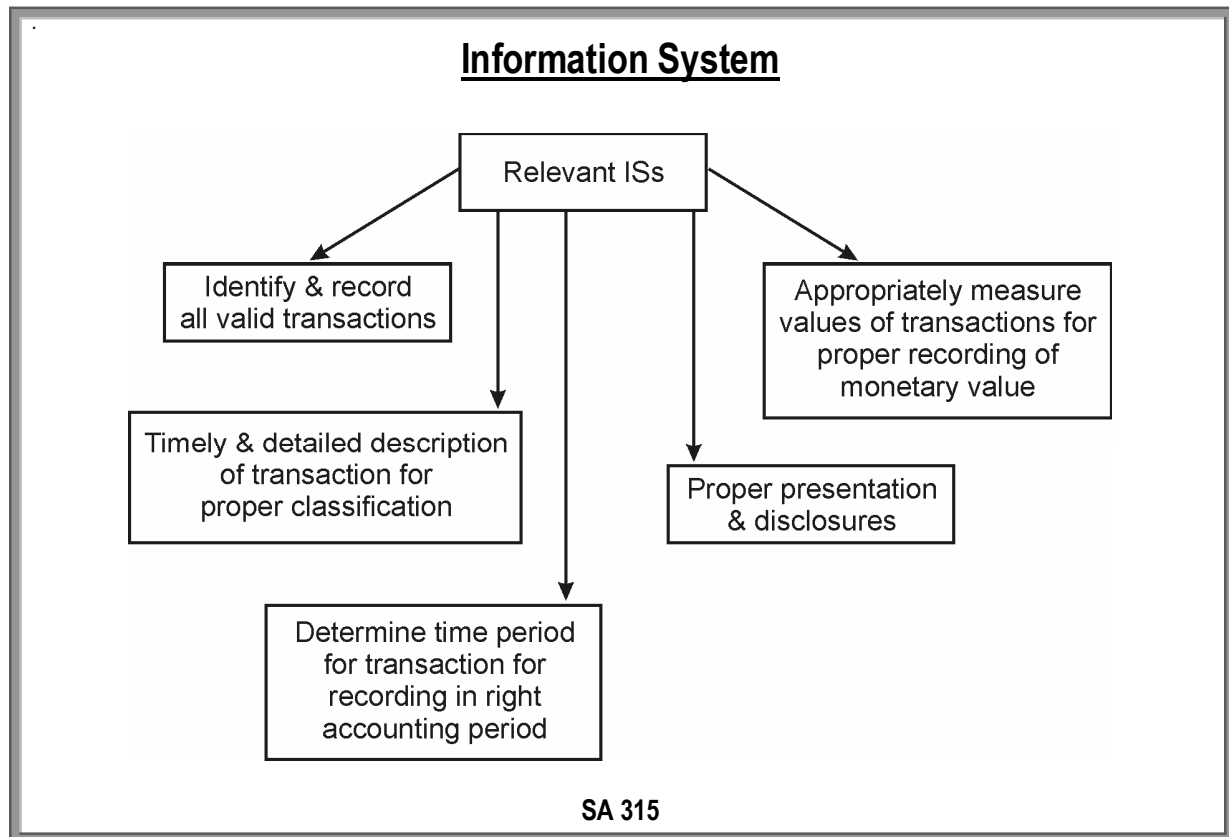


Entity's RAPs – Important aspects

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

SA 315

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





Information System – important aspects

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

SA 315

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



Information System – important Audit considerations

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

SA 315

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

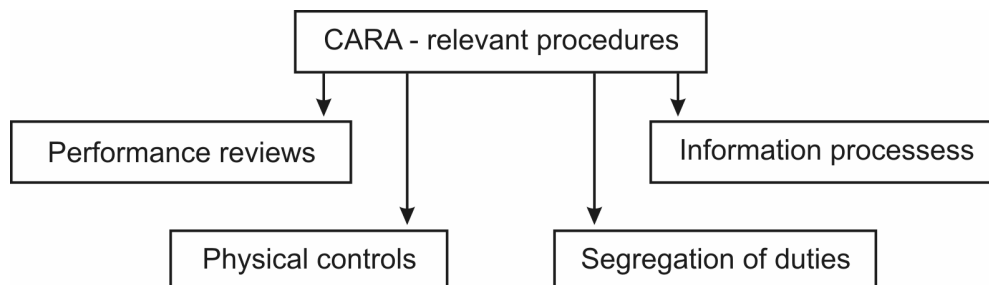
Smaller Entity Considerations

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

SA 315



Control Activities relevant to Audit (CARA) – relevant procedures



SA 315

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

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

SA 315

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



Training Manual on Engagement and Quality Control Standards

Smaller Entity Considerations

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

SA 315

IT Risks & Controls

General IT Controls	Application Controls
Policies & procedures relating to many applications	Manual / automated controls operating at business process level
Apply to mainframe, miniframe, end user	Apply to processing of individual transactions
Maintain integrity of information & security of data	Ensure authorization, completeness, accuracy & processing of transaction.
Coverage : • data centre & network operations • system s/w acquisition, change & maintenance • program change • access security • application system acquisition, development & maintenance	Coverage: • initiation • recording • processing • reporting of transaction & other financial data

SA 315



Monitoring Controls – important aspects

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

SA 315

Monitoring Controls – important Audit aspects

- ❖ Understand:
 - Major monitoring activities.
 - Entity's Corrective Actions to controls.
 - Sources of information used in monitoring activities.
 - Basis upon which management assesses reliability of information.

Smaller Entity Considerations:

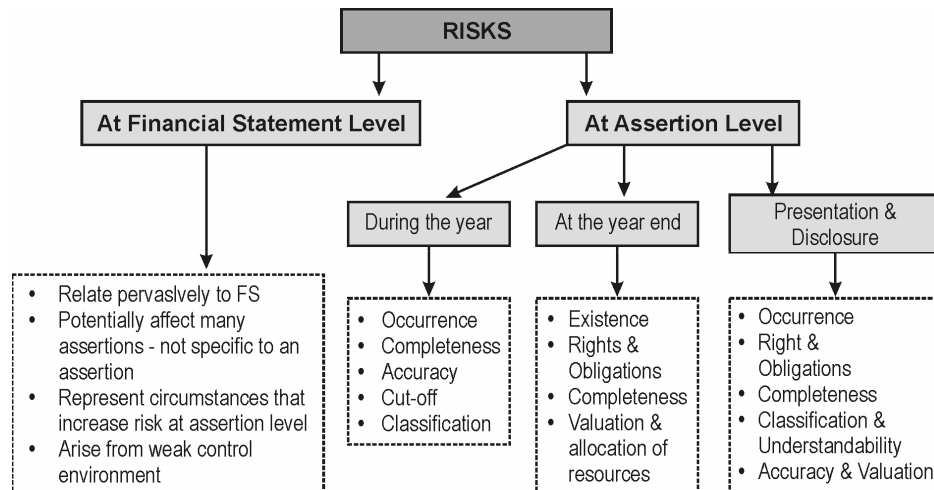
- ❖ Monitoring often accomplished by owners' close involvement in operations.

SA 315

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



Identifying & Assessing Risks of Material Misstatement



SA 315

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



Identifying & Assessing Risks of Material Misstatement – Audit aspects

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

SA 315

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

Special Aspects of Risks

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

SA 315



Identifying Significant Risks

Significant Non Routine Transactions	Judgmental matters
• Unusual due to size / nature. • Occur infrequently.	• Include development of accounting estimate for significant measurement uncertainty.
Risk areas : • Management intervention to specify accounting treatment. • Manual intervention for data collection & processing. • Complex calculations / accounting principles. • Nature of non routine transactions → difficulty in implementing effective controls over risks.	Risk areas : • Required judgment may be subjective / complex or require assumptions re-effects of future events. • Accounting principles for accounting aspects subject to differing interpretations.

SA 315



Controls related to Significant Risks

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

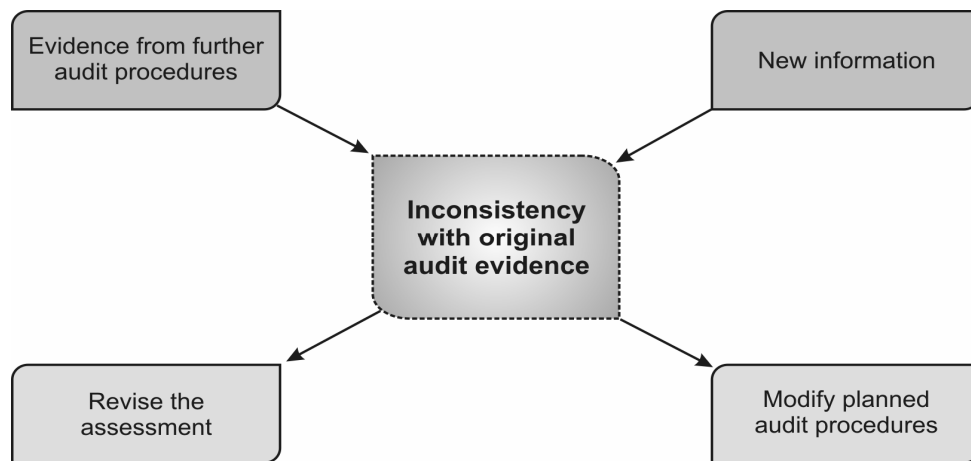
SA 315

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

SA 315



Revision of Risk Assessment



SA 315

Material Weakness in Internal Control

- ❖ Types:
 - Risks of material misstatement identified by auditor but not controlled by entity/ control is inadequate.
 - Weakness in entity's RAPs.
 - Absence of entity's RAPs, where there should have been one.
- ❖ Could be in controls that prevent/ detect & correct frauds/ errors.
- ❖ Evaluate, whether he has identified Material weaknesses.
- ❖ Weakness could be in design, implementation, maintenance.
- ❖ Communicate on timely basis to management & those charged with governance.

SA 315

- ❖ In case of certain audit engagements - additional communication requirement to the regulators.



Documentation

- ❖ Discussion with engagement team and significant decisions reached.
- ❖ Key elements of understanding of entity, its environment & ICs.
- ❖ Identified & assessed risks of material misstatements at financial statement & assertion level.
- ❖ Risks that require special audit consideration.
- ❖ Risks for which substantive procedures alone do not suffice.

SA 315

- ❖ Form & extent of documentation depends upon:
 - Nature, size & complexity of entity & ICs.
 - Availability of information from entity.
 - Audit methodology.
 - Technology used in audit.

SA 315



SA 320

Audit Materiality

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

- ❖ Issued in January 1997.

Introduction

- ❖ Deals with materiality & its relation with audit risk.
- ❖ Consider materiality & its relationship with audit risk when conducting audit:
 - Determining nature, timing & extent of audit procedures.
 - Evaluating effects of misstatements.

SA 320



Materiality

- ❖ Misstatement – omission or erroneous statement.
- ❖ Material – influence on economic decisions of the users taken on the basis of financial information.
- ❖ Materiality:
 - depends on size and nature of item.
 - provides a threshold or cut-off point.
- ❖ Influenced by:
 - Legal & regulatory requirements.
 - Considerations relating to individual account balances & relationships.
- ❖ Both qualitative & quantitative factors are relevant.
- ❖ Small amounts could be material in aggregate.

SA 320

- ❖ Materiality depends upon professional judgment of the auditor.

Relationship with Audit Risk

- ❖ Inverse relationship between materiality and degree of audit risk.
- ❖ Preliminary assessment of materiality used to determine what to examine & whether to use sampling/ analytical procedures.
- ❖ If after planning for specific procedures, acceptable materiality level is lower, audit risk is increased. Compensate by either:
 - reducing the assessed degree of control risk.
 - reducing detection risk.

SA 320

- ❖ Reduce the assessed degree of control risk, where this is possible, and support the reduced degree by carrying out extended or additional tests of control.
- ❖ Reduce detection risk by modifying nature, timing and extent of planned substantive procedures.



Evaluating Evidence - I

- ❖ Assessment of materiality and risk may be different at initial planning stage.
- ❖ Evaluate whether effect of aggregate uncorrected misstatements on financial information is material.
- ❖ Consider qualitative aspects also.
- ❖ Analytical procedure may identify indications of possible misstatement but not its appx amount:
 - Employ other procedures to aggregate misstatement.

SA 320

- ❖ Assessment of materiality at initial planning stage might be different from that at the time of evaluating the results of his audit procedures because:
 - Change in circumstances or a change in the auditor's knowledge as a result of the audit.
 - 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.
- ❖ The aggregate of uncorrected misstatements comprises:
 - specific misstatements identified by the auditor, including the net effect of uncorrected misstatements identified during the audit of previous periods; and
 - auditor's best estimate of other misstatements which cannot be specifically identified (that is, projected errors).



Evaluating Evidence -II

- ❖ Audit sampling may throw up misstatement; project the amount to the population.
- ❖ If aggregate of uncorrected misstatements is material and management refuses to adjust the financial information, express qualified or adverse opinion, as appropriate.

SA 320

SA 320 – Example 1

- ❖ Since materiality becomes the professional judgment of the auditor, factors that could be considered at both overall financial information level and in relation to individual account balances and classes of transactions level may be the following:
- ❖ For a publicly traded company – Equity share capital, Profit after tax etc.
- ❖ An example of calculation of materiality using Profit after tax has been presented below:

SA 320



Sample Computation of Audit Materiality

DESCRIPTION	Ref	CALCULATIONS	Remarks
Key factor for audit materiality		Profit after tax	Here, the key factor is identified such as Equity share capital, Revenue, Profit after tax etc.
Key factor balance	(A)	199,056,600	The amount of the key factor is captured here.
Discount factor	(B)	10.00%	The key component balance is factored / discounted generally not exceeding 10% i.e. disaggregated for the various balances that constitute the key factor.
Audit materiality	(C) = (A) x (B)	19,905,660	
Expected errors in the financial statements as a %	(D)	20.00%	The error rate is input after assessing the overall errors that might be present at the financial statement. Generally, they are within a range of 10% to 20%.
Discounted materiality before tax rate	(E) = (C) x [1-(D)]	15,924,528	
Rate of tax	(F)	33.99%	This is the current tax rate. The key factor which was considered is Profit after tax which was net of tax. Hence, the same has been grossed up with the tax rate.
Threshold	(G) = (E) / [1-(F)]	24,124,418	This is the threshold which shall be used for the purposes of testing.

SA 320



SA 320 – Example 2

- ❖ For other entities such as a non-listed public limited company, private limited company, Partnership firms, etc. – Revenue / Sales Income, Current Assets, Expenditure during the period etc.
- ❖ An example of calculation of materiality using Revenue has been presented below.

SA 320



Training Manual on Engagement and Quality Control Standards

DESCRIPTION	Ref	CALCULATIONS	Remarks
Key factor for audit materiality		Revenue	Here, the key factor is identified such as Equity share capital, Revenue, Profit after tax etc.
Key factor balance	(A)	27,608,640	The amount of the key factor is captured here.
Discount factor	(B)	1.00%	The key component balance of revenue alone is factored / discounted generally within a range of 0.5% to 3% i.e. disaggregated for the number of entries constituting revenue.
Audit materiality	$(C) = (A) \times (B)$	276,086	
Expected errors in the financial statements as a %	(D)	20.00%	The error rate is input after assessing the overall errors that might be present at the financial statement. Generally, they are within a range of 10% to 20%.
Discounted materiality before tax rate	$(E) = (C) \times [1-(D)]$	220,869	
Rate of tax	(F)	33.99%	This is the current tax rate. The key factor which was considered is Profit after tax which was net of tax. Hence, the same has been grossed up with the tax rate.
Threshold	$(G) = (E) / [1-(F)]$	334,599	This is the threshold which shall be used for the purposes of testing.

SA 320



SA 330

The Auditor's Response to Assessed Risks

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

- ❖ The date SA 330 (along with SA 315) becomes effective, the existing Standard on Auditing (SA) 400 (AAS 6), "Risk Assessment and Internal Control", Standard on Auditing (SA) 310 (AAS 20), "Knowledge of the Business" and Standard on Auditing (SA) 401 (AAS 29), "Auditing in a Computer Information Systems Environment" would stand withdrawn.

Overview of SA 330

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

SA 330



Scope

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

SA 330

Objective

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

SA 330



Definitions

- ❖ Substantive Procedures:
 - Audit Procedures designed to detect material misstatements at assertion level:
 - Tests of details – *classes of transactions/ account balances/ disclosures*.
 - Substantive analytical procedures.
- ❖ Tests of Controls:
 - Audit Procedure for evaluating operating effectiveness of controls in preventing/ detecting & correcting material misstatement at assertion level.

SA 330



Overall Responses-I

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

SA 330

Overall Responses-II

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

SA 330

- ❖ Benefits of effective control environment are :
 - more confidence in internal control.
 - the reliability of internally generated audit evidence.



Audit Procedures Responsive to Risks at Assertion Level-I

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

SA 330

Audit Procedures Responsive to Risks at Assertion Level-I

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

SA 330



Further Audit Procedures-I

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

SA 330

Further Audit Procedures-II

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

SA 330

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



Further Audit Procedures-II

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

SA 330

Smaller Entity Considerations

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

SA 330



Tests of Controls - I

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

SA 330

Tests of Controls - II

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

SA 330

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



Test of Controls - III

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

SA 330

Tests of Controls – Nature & Extent - I

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

SA 330

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



Tests of Controls – Nature & Extent - II

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

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

SA 330

Test of Controls – Nature & Extent - III

❖ **IT systems inherently consistent → increased testing of automated control may not be necessary.**

❖ **But check that:**

- Changes to programs are not made without subjecting to program change control.
- Authorised version of program is used.
- Other relevant general controls are effective.

SA 330



Tests of Controls – Timing

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

SA 330

Using Audit Evidence Obtained During Interim Period

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

SA 330



Using Audit Evidence Obtained in Previous Audits - I

❖ **Factors to consider before retesting operating effectiveness:**

- Effectiveness of other elements of IC, including control environment, entity's monitoring of controls, entity's RAPs.
- Risks from characteristics of controls – manual/ automated.
- Effectiveness of general IT controls.
- Effectiveness of control & its application by entity.
- Whether lack of change in a control poses risk.
- Risks of material misstatement & extent of reliance on the control.

SA 330

Using Audit Evidence Obtained in Previous Audits - II

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

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

SA 330



Using Audit Evidence Obtained in Previous Audits - III

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

SA 330

Controls over Significant Risks

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

SA 330



Evaluating Operating Effectiveness of Controls - I

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

SA 330

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

Evaluating Operating Effectiveness of Controls - II

- ❖ Evaluate if ToC has identified a material weakness in operating effectiveness.
- ❖ Communicate material weakness to TCWG.

SA 330



Substantive Procedures - I

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

SA 330

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

Substantive Procedures - II

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

SA 330



Substantive Procedures - III

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

SA 330

Substantive Procedures - IV

- ❖ Responsive to Significant Risks:
 - Substantive procedures should be specifically responsive to that *significant* risk:
 - Include ToD.
- ❖ Timing of Substantive Procedures:
 - Audit evidence from substantive procedures of previous audit provides no evidence for current period.
 - At interim date – cover the balance period by:
 - Substantive procedures combined with ToC; or
 - Only substantive procedures (depending on auditor's judgment).

SA 330



Substantive Procedures - V

❖ **Interim date substantive procedures – factors to consider:**

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

SA 330

- ❖ Compare and reconcile balance of the period end with the comparable information at the interim date to:
- Identify amounts that appear unusual.
 - Investigate any such amounts.
 - Perform substantive analytical procedures or tests of details to test the intervening period.

Substantive Procedures - VI

❖ **Interim date APs between interim period & period end:**

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

SA 330



Substantive Procedures - VII

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

SA 330

Adequacy of Presentation & Disclosure

- ❖ Evaluate whether overall presentation of financial statements & disclosures is in accordance with applicable financial reporting framework.

SA 330

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



Sufficiency & Appropriateness of Audit Evidence - I

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

SA 330

Sufficiency & Appropriateness of Audit Evidence - II

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

SA 330



Documentation

❖ Document:

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

SA 330

SA 402

Audit Considerations relating to Entities Using Service Organisations

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

❖ Issued in August 2002.



Introduction

- ❖ Establishes standards for an auditor whose client uses SOs and description of the report of the auditor of SOs.
- ❖ Consider impact of SOs on client's accounting and Internal Control System (ICs) to plan an effective audit.

SA 402

- ❖ SOs undertake wide range of activities, e.g., information processing, maintenance of accounting records, etc. Some activities performed by SOs may have significant impact on the entity's FS.
- ❖ SO maintains accountability – client needs to rely on SO policies & procedures.
- ❖ Client maintains accountability – client MIGHT be able to implement effective policies & procedures within its organisation.



Auditor's Considerations - I

- ❖ Possibilities:
 - SO executes transactions & maintains accountability, **OR**
 - SO processes transactions & related data, client retains authorization & accountability.
- ❖ Determine significance of activities of SOs and relevance w.r.t. Control Risk assessment of the client.
- ❖ AAS inapplicable if Control Risk assessment is not affected.

SA 402

- ❖ Factors to determine significance of SO activities are as under:
 - nature of the services provided by the SO.
 - terms of contract and relationship between client and SO.
 - material FS assertions affected by use of SO.
 - inherent risk.
 - extent of interact with SO internal control systems.
 - client's internal controls applied to transactions processed by SO.
 - SO's capability and financial strength.
 - information about SO.
 - information available on general controls.
 - availability of third party reports from SOs auditors, IAS.



Auditor's Considerations - II

- ❖ Activities of SOs are signification to entity:
 - obtain sufficient information to understand accounting and ICS of SOs.
 - assess control risk if tests of control are performed.
- ❖ Consider availability of 3rd party reports from SO auditors, internal auditors or regulators re SO ICs.

SA 402

Auditor's Considerations – III

- ❖ Obtain Information to assess Control Risk.
- ❖ If insufficient information:
 - request service organization auditor to supply information in the form of a Report (Type A/Type B).
 - if report not available within reasonable time, consider need to visit SO.

SA 402

- ❖ 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.
- ❖ When using SO's auditor's report:
 - assess his professional competence if he is not a member of ICAI.
 - consider nature & content of that report.



SO Auditor's Report

TYPE A	TYPE B
Description of SO accounting & ICs, prepared by SO management	Description of SO accounting & ICs, prepared by SO management
SO auditor's opinion:	SO auditor's opinion:
❖ above description is accurate.	❖ above description is accurate.
❖ system's controls have been placed in operation.	❖ system's controls have been placed in operation.
❖ accounting & ICs suitably designed to achieve their stated objectives.	❖ accounting & ICs suitably designed to achieve their stated objectives.
-----	❖ accounting & ICs are operating effectively based on results of ToC. (alongwith description of ToC & related results).

SA 402

- ❖ Report of SO's auditor may ordinarily contain restrictions as to its use.
- ❖ Auditor may request SO's auditor to perform Agreed Upon Procedures (AUP) and supply information in the form of SO Auditor's Report.

Usefulness of SO Auditor's Reports

- ❖ Type A:
 - Used to understand SO accounting and internal control systems.
 - Cannot be used to reduce assessment of Control Risk.
- ❖ Type B:
 - Used to reduce the assessment of control risk:
 - whether SO controls tested are relevant to client transactions.
 - whether ToC and results are adequate.
- ❖ No reference in the client's auditor's report to SO's auditor's report.

SA 402

- ❖ When assessing ToC & results, two key considerations are the length of the period covered by ToC & the time elapsed since performance of ToC.



500 – 599: Audit Evidence

- ❖ Revised SA 500-Audit Evidence*
- ❖ SA 501– Audit Evidence – Additional Considerations for Specific Items
- ❖ SA 505 – External Confirmations
- ❖ SA 510-Initial Engagements—Opening Balances
- ❖ SA 520 – Analytical Procedures
- ❖ Revised SA 530-Audit Sampling**
- ❖ Revised SA 540-Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures***
- ❖ SA 550 -Related Parties
- ❖ Revised SA 560-Subsequent Events****
- ❖ Revised SA 570-Going Concern*****
- ❖ Revised SA 580-Written Representations*****

*Hitherto known as SA 500, "Audit Evidence".

**Hitherto known as SA 530, "Audit Sampling".

***Hitherto known as SA 540, "Auditing of Accounting Estimates".

****Hitherto known as SA 560, "Subsequent Events".

*****Hitherto known as SA 570, "Going Concern".

*****Hitherto known as SA 580, "Representations by Management".

Revised SA 500

Audit Evidence

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

- ❖ Replaces SA 500 (AAS 5), "Audit Evidence", issued in May, 1988.



Training Manual on Engagement and Quality Control Standards

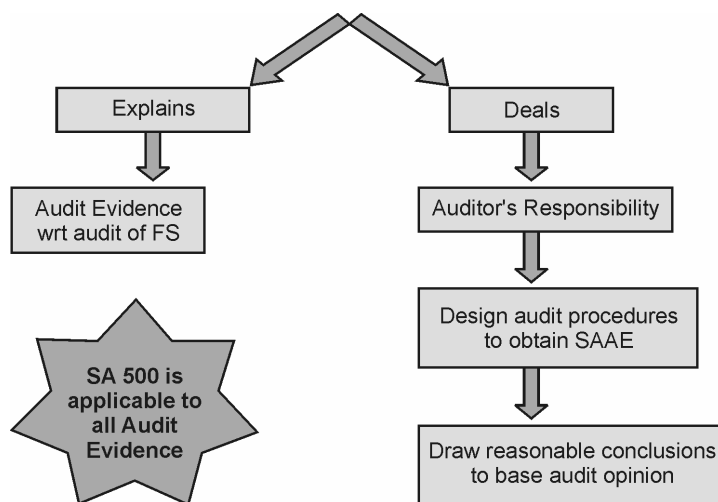
Overview

- ❖ Introduction
 - Scope
 - Effective date
- ❖ Objective
- ❖ Definitions
- ❖ Requirements
 - Sufficient Appropriate Audit Evidence (SAAE)
 - Information to be used as audit evidence
 - Selecting items for testing to obtain audit evidence
 - Inconsistency/ doubts over reliability of audit evidence
- ❖ Application and Other explanatory Material on these Aspects

SA 500(R)

- ❖ 'R' Stands for Revised.

Scope



SA 500(R)

- ❖ Other SAs deal with:
 - Specific aspects of audit (SA 315).
 - Audit evidence to be obtained in relation to particular topic (SA 570).
 - Specific procedures to obtain audit evidence (SA 520).
 - Evaluation whether SAAE has been obtained (SA 330).



Objective of the Auditor

- ❖ Design & perform audit procedures:
 - In such a way that.
 - Enable him to obtain SAAE.
 - To be able to draw reasonable conclusions.
 - On which to base the auditor's opinion.

SA 500(R)

Definitions

- ❖ **Accounting Records**
 - Records of initial accounting entries and supporting documents.
 - ❖ **Audit Evidence**
 - Information used by auditor in arriving at conclusions on which audit opinion is based.
 - ❖ **Appropriateness**
 - Measure of quality of audit evidence:
 - Relevance; and
 - Reliability,
- In supporting the conclusions on which audit opinion is based.

SA 500(R)

- ❖ Revised SA 500 contains five definitions – accounting records, audit evidence, appropriateness of audit evidence, sufficiency of audit evidence and management's expert.
- ❖ Examples of accounting records:
 - Cheques and records of electronic funds transfer.
 - Invoices.
 - Contracts.
 - General & subsidiary ledgers.
 - Journal entries and any adjustments thereto.
 - Worksheets to support reconciliations, cost allocations, etc.
- ❖ Audit evidence includes:
 - Information contained in underlying accounting records.
 - Other information.



Training Manual on Engagement and Quality Control Standards

❖ **Sufficiency**

- Measure of quality of audit evidence.

❖ **Management's Expert**

- An individual/ organization.
- Possessing expertise in a field.
- Other than accounting/ auditing.
- Whose work is used by the entity.
- In preparing financial statements.

SA 500(R)

❖ **SUFFICIENCY is affected by:**

- Auditor's assessment of Risk of Material Misstatements.
- Quality of such audit evidence.

❖ **MANAGEMENT'S EXPERT:**

- The revised SA 620, *Using the Work of an Auditor's Expert* replaces the erstwhile ISA 620, *Using the Work of an Expert* on which our erstwhile AAS 9 is based. The old ISA contained guidance on using the work of an expert whether employed by the auditor or by the client.



SAAE

- ❖ Design and perform audit procedures.
- ❖ Appropriate in circumstances.
- ❖ For obtaining SAAE.
- ❖ Auditor to use professional judgment to decide if SAAE has been obtained:
 - Affected by:
 - Nature of audit procedures.
 - Timeliness of financial reporting.
 - Balance between cost and benefits.

SA 500(R)

SAAE

- ❖ Para in Requirements and 25 paras in A&E guidance.
- ❖ Sufficiency & appropriateness are interrelated but obtaining more audit evidence does not compensate its poor quality.
- ❖ SAAE is related to the concept of reasonable assurance (SA 200). Reasonable assurance is obtained when the auditor has obtained SAAE to reduce audit risk to an acceptable low level.
- ❖ Audit risk means the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated.
- ❖ Reliability affected by:
 - Source.
 - Nature.
 - Circumstances under which obtained.

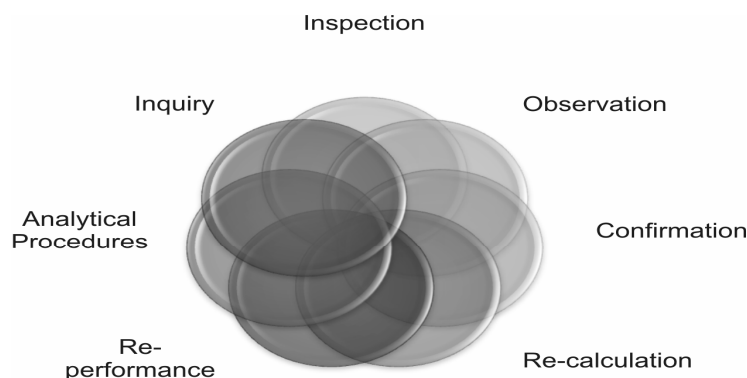


Training Manual on Engagement and Quality Control Standards

- ❖ Other important facts about audit evidence:
 - Is cumulative in nature.
 - Primarily obtained from audit procedures during an audit.
 - Information from other sources:
 - previous audits (re-evaluate before using).
 - QC policies of audit firm (client acceptance & continuance).
 - Accounting records of client.
 - Other sources – internal/ external to entity.
 - Audit evidence comprises both information that corroborates and that contradicts management assertions.
 - Absence of information is also sometimes used as audit evidence.

SA 500(R)

Obtaining Audit Evidence – I



Inquiry alone, ordinarily, does not provide SAAE

SA 500(R)

- ❖ **Sources of Audit Evidence:**
 - Audit evidence obtained by performing audit procedures to test the accounting records enables the auditor to determine that the accounting records are internally consistent and agree to FS.
 - More assurance is ordinarily obtained from consistent audit evidence obtained from different sources/ nature than from items of audit evidence considered individually.
 - More assurance from corroborating information obtained from a source independent of the entity than from audit evidence that is generated internally.
 - Information from sources independent of the entity that the auditor may use as audit evidence may include confirmations from third parties, analysts' reports, and comparable data about competitors (benchmarking data).



Obtaining Audit Evidence – II

- ❖ Obtained by performing:
 - Risk assessment procedures, AND
 - Further audit procedures:
 - Tests of controls.
 - Substantive procedures:
 - Tests of details.
 - Substantive analytical procedures.
- ❖ Nature and timing of audit procedures affected by:
 - Availability of audit evidence in electronic form only.
 - Availability of audit evidence at certain points/ periods in time.

SA 500(R)

- ❖ Procedures described in previous slide can be used as risk assessment procedures, ToC or substantive procedures, depending upon context in which applied.
- ❖ Certain electronic information may not be retrievable after a specified period of time. Accordingly, the auditor may find it necessary to request the entity to retain some information for the auditor's review or to perform audit procedures at a time when the information is available.

Audit Evidence – Inspection

- ❖ Involves examining records or documents.
- ❖ Internal/ external.
- ❖ In paper form/ electronic/ other media.
- ❖ Or physical examination of an asset:
 - Reliability depends upon source:
 - Internal documents – reliability depends upon effectiveness of controls over their production.

SA 500(R)

- ❖ Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value.
- ❖ Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets.



Audit Evidence – Observation

- ❖ Consists of looking at a process or procedure being performed by others:
 - Audit evidence provided is limited to:
 - Point in time at which observation takes place.
 - The fact that auditor is observing may affect the manner in which process/ procedure is performed.

SA 500(R)

- ❖ For more guidance, pl refer SA 501, “*Audit Evidence – Special Considerations for Specific Items*” (AAS 34).

Audit Evidence – External Confirmation

- ❖ Audit evidence obtained as direct written response to the auditor from the 3rd party, in paper form, electronic/ other medium.
- ❖ Normally used to confirm account balances but may also be used to confirm agreements/ transactions.

SA 500(R)

- ❖ See SA 505 (AAS 30), “*External Confirmations*” for further guidance.



Audit Evidence – Recalculation

- ❖ Checking mathematical accuracy of documents/ records.
 - May be done manually/ electronically.

Audit Evidence – Re-performance

- ❖ Involves auditor's independent execution of procedures/ controls that were originally performed as entity's internal controls.

SA 500(R)

Audit Evidence – Analytical Procedures

- ❖ Consists of evaluations of financial information.
- ❖ made by study of plausible relationships.
- ❖ Among both financial and non financial data.
 - Also encompass investigation of identified fluctuations/ relationships that are inconsistent with other relevant information/ show significant deviations from predictions.

SA 500(R)

- ❖ Refer SA 520, “Analytical Procedures” (AAS 14) for further guidance.



Audit Evidence – Inquiry

- ❖ Consists of seeking information of knowledgeable persons.
- ❖ Both financial & non financial.
- ❖ Within/ outside the entity:
 - May be written/ oral.
 - Evaluation of responses to inquiries is an integral part of inquiry process.
- ❖ Obtain WR from mgt. and TCWG to confirm responses to the inquiry.

SA 500(R)

- ❖ Responses to inquiries may provide the auditor with:
 - information not previously possessed, or
 - with corroborative audit evidence.
 - information that differs significantly from other information that the auditor has obtained.
 - In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.
- ❖ In the case of inquiries about management intent, the information available to support management's intent may be limited. The following may provide information to corroborate the evidence obtained through inquiry:
 - understanding management's past history of carrying out its stated intentions,
 - management's stated reasons for choosing a particular course of action, and
 - management's ability to pursue a specific course of action.
 - may provide relevant information to corroborate the evidence obtained through inquiry.



Information to be used as Audit Evidence

- ❖ When designing & performing audit procedures, consider relevance & reliability of information to be used as audit evidence.

SA 500(R)

- ❖ ToC – designing ToC includes identifying:
 - Conditions that indicate performance of control.
 - Deviations that indicate departures from adequate performance.
- ❖ Designing substantive procedures include:
 - Identifying conditions relevant to purpose of the test that constitute a misstatement in the relevant assertion.

- ❖ **Relevance**
 - Deals with logical connection with, or bearing upon,
 - the purpose of the audit procedure, and
 - where appropriate, the assertion under consideration.
 - Affected by direction of testing.
- ❖ **Reliability:**
 - Affected by
 - Source.
 - Nature.
 - Circumstances under which obtained.
 - Controls over preparation & maintenance.
- ❖ Generalization regarding reliability are subject to important exceptions.

SA 500(R)



Training Manual on Engagement and Quality Control Standards

More Reliability	Lesser Reliability
Source is external to & independent of client.	
	Sources external to entity and is not knowledgeable or mgt. expert lacks objectivity.
Internal source only if related controls are effective.	
Evidence obtained directly by auditor.	Evidence obtained indirectly or by inference.
Documentary evidence – paper / electronic / other medium.	Oral evidence.
Original.	Photocopy / fax / filmed documents.

SA 500(R)



Audit Evidence Prepared by Management's Expert

- ❖ Having regard to the significance of such work to audit:
 - Evaluate competence, capabilities & objectivity of expert.
 - Obtain an understanding of his work.
 - Evaluate appropriateness of his work as audit evidence.

SA 500(R)

- ❖ Entity, when needed, may employ expert in preparing FS. Failure to do so may lead to risk of material misstatement.
- ❖ When information to be used as audit evidence has been prepared using the work of a management's expert, the requirements given in this slide apply. For example, an individual or organization may possess expertise in the application of models to estimate the fair value of securities for which there is no observable market. If the individual or organization applies that expertise in making an estimate which the entity uses in preparing its financial statements, the individual or organization is a management's expert and the requirements given in this slide apply.
If, on the other hand, that individual or organization merely provides price data regarding private transactions not otherwise available to the entity which the entity uses in its own estimation methods, such information, if used as audit evidence, is subject to requirements of the previous slide, but is not the use of a management's expert by the entity.
- ❖ Auditor's procedures wrt use of management's experts work are affected by:
 - Nature and complexity of the matter.
 - Risks of material misstatement.
 - Availability of alternative sources of audit evidence.
 - Nature, scope and objectives of his work.
 - Whether the management's expert is employed by the entity, or is a party engaged by it to provide services.
 - Extent of entity's control or influence over the work.
 - Applicability of technical performance/other standards.
 - Auditor's knowledge & experience of the management's expert's field of expertise.
 - Auditor's previous experience of the work of that expert.



Competence, Capability & Objectivity (CCO) of Management's Expert

- ❖ **Competence:**
 - Relates to nature & level of expertise.
- ❖ **Capability:**
 - Ability to exercise that competence.
- ❖ **Objectivity:**
 - Relates to possible effects that bias, conflict of interest or influence of others may have on the professional/business objectivity of mgt's expert.

SA 500(R)



- ❖ Sources of Information on CCO:
 - Personal experience with previous work.
 - Discussions with that expert.
 - Discussions with others who are familiar with that expert's work.
 - Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
 - Published papers or books written by that expert.
 - An auditor's expert.

SA 500(R)

- ❖ Other matters that may be relevant include:
 - the relevance of the management's expert's competence:
 - to the matter for which that expert's work will be used, including any areas of specialty within that expert's field.
 - to relevant accounting requirements that are consistent with the applicable financial reporting framework.
 - Whether unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures indicate that it may be necessary to reconsider the initial evaluation of the competence, capabilities and objectivity of the management's expert as the audit progresses.
- ❖ A broad range of circumstances may threaten objectivity, for example, self-interest threats, advocacy threats, familiarity threats, self-review threats and intimidation threats. Safeguards may reduce such threats, and may be created either by external structures (for example, the management's expert's profession, legislation or regulation), or by the management's expert's work environment (for example, quality control policies and procedures).
- ❖ Although safeguards cannot eliminate all threats to a management's expert's objectivity, threats such as intimidation threats may be of less significance to an expert engaged by the entity than to an expert employed by the entity, and the effectiveness of safeguards such as quality control policies and procedures may be greater. Because the threat to objectivity created by being an employee of the entity will always be present, an expert employed by the entity cannot ordinarily be regarded as being more likely to be objective than other employees of the entity.
- ❖ When evaluating the objectivity of an expert engaged by the entity, it may be relevant to discuss with management and that expert any interests and relationships that may create threats to the expert's objectivity, and any applicable safeguards, including any professional requirements that apply to the expert; and to evaluate whether the safeguards are adequate. Interests and relationships creating threats may include:
 - Financial interests.
 - Business and personal relationships.
 - Provision of other services.



Understanding the Expert's Work

- ❖ Includes understanding relevant field of expertise:
 - Auditor himself may have the expertise to evaluate.
 - Auditor may use services of auditor's expert.
- ❖ Understanding may include:
 - Areas of specialty within field of expertise.
 - Applicable professional or other standards, and regulatory or legal requirements.
 - Assumptions and methods are used, their general acceptability within that expert's field and appropriateness for financial reporting purposes.
 - Nature of internal and external data or information the auditor's expert uses.

SA 500(R)

- ❖ Evaluating the agreement between management & expert to assess appropriateness of:
 - Nature, scope and objectives of the work.
 - Respective roles & responsibilities of management/ expert.
 - Nature, timing and extent of communication between management & expert.
 - Includes form of report.

SA 500(R)



- ❖ Evaluating Appropriateness of Expert's Work:
 - The relevance and reasonableness of that expert's findings or conclusions;
 - Consistency with other audit evidence;
 - Whether they have been appropriately reflected in the financial statements;
 - Relevance and reasonableness of assumptions and methods; and
 - Relevance, completeness, and accuracy of the source data.

SA 500(R)

Evaluate Reliability of Information Produced by Entity

- ❖ Obtain audit evidence about the accuracy and completeness of the information:
 - Concurrently with actual audit procedures where obtaining audit evidence is integral part of audit procedures.
 - ToC over preparation & maintenance of information.
- ❖ Evaluate whether the information is sufficiently precise and detailed for the auditor's purposes.

SA 500(R)



Selecting Items for Testing to Obtain Audit Evidence

- ❖ When designing ToC and ToD,
- ❖ Determine means of selecting items for testing.
- ❖ That is effective in meeting purpose of audit procedures.
- ❖ Means available:
 - Selecting all items (100%).
 - Selecting specific items.
 - Audit sampling.

SA 500(R)

	100%	Specific Items	Sampling
Suitability	• Significant risk & other means do not provide SAAE • Repetitive nature of calculation • Small number of large value items	• High value / key items • All items over certain amount • Item to obtain information	Guidance in SA 530
Relevant factors		• Auditor's understanding of entity • Assessed RMM • Characteristics of population being tested	

SA 500(R)



Inconsistency/Doubts wrt Reliability of Audit Evidence

- ❖ If:
 - Audit evidence from one source inconsistent with that from another source; OR
 - Doubts over reliability of info to be used as audit evidence.
- ❖ Determine:
 - Modifications/ additions required to audit procedures.
 - Effect on other aspects of audit.

Documentation as per SA 230 (Revised)

SA 500(R)

SA 501

Audit Evidence- Additional Considerations for Specific Items

Effective for all audits relating to accounting periods beginning on or after
April 1, 2005

- ❖ Issued in March, 2005.



Introduction

- ❖ Establishes standard on auditor's responsibilities, audit procedures and provides additional guidance with respect to:
 - Attendance at Physical Inventory Counting.
 - Inquiry regarding Litigations and Claims.
 - Valuation and Disclosure of Long-term Investments.
 - Segment Information.

SA 501

Attendance at Physical Inventory Counting

- ❖ Perform audit procedures to obtain sufficient appropriate audit evidence during attendance at physical inventory counting.
- ❖ Physical verification:
 - responsibility of management of entity.
 - ordinarily at least once in a year.
- ❖ When inventory is material to FS, obtain audit evidence regarding:
 - existence and condition.
 - attend inventory counting unless impracticable, due to factors such as nature and location of inventory.

SA 501

- ❖ Refer paragraph 3 of Accounting Standard (AS) 2 for definition of "inventory".
- ❖ The attendance at physical inventory count will enable the auditor to inspect inventory, to observe compliance with operation of management's procedures and also provides evidence.



Inventory Attendance

- ❖ Unable to attend physical inventory count on the date planned:
 - take or observe some physical counts on an alternative date.
 - perform alternative audit procedures.
- ❖ Attendance at a Inventory Counting impossible:
 - perform alternative procedures to provide evidence of existence and condition of inventory to conclude that there is no scope limitation.

SA 501

Inventory Planning

- ❖ In planning attendance at the physical inventory count, the auditor would consider the following:
 - Nature of accounting, internal control systems.
 - Inherent, control and detection risks, and materiality.
 - Check whether adequate procedures are established and proper instructions issued.
 - Timing of the count.
 - Location/ nature of Inventory.
 - Need of expert.

SA 501

- ❖ When inventory is situated at various locations, consider at which locations attendance is appropriate.



Inventory - Review Managements' Instructions - I

- ❖ Review management instructions:
 - application of control procedures.
 - accurate identification of stage of completion of work in progress, slow moving, obsolete, damaged or rejected items.
 - appropriate arrangements made regarding the movement of inventory.
- ❖ Consider cut-off procedures.
- ❖ If use of procedures to estimate physical quantity, ensure reasonableness of procedures.

SA 501

- ❖ The auditor should consider cut-off procedures including movement details just prior to, during and after count to ensure that these are appropriately included / excluded from such inventory.

Inventory - Review Managements' Instructions - II

- ❖ Assurance that management's procedures are adequately implemented.
- ❖ To obtain assurance that management's procedures are adequately implemented, auditor should:
 - observe physical verification procedures performed by employees and perform test counts.
 - test both completeness and accuracy of count records by tracing items.
- ❖ Assess reasons for significant differences between perpetual inventory system and physical count.
- ❖ Perform audit procedures over the final inventory listing.
- ❖ Inventory under custody and control of a third party-obtain direct confirmation from the third party.

SA 501

- ❖ The physical inventory count may be conducted at a date other than period end. This will ordinarily be adequate for audit purposes when the control risk is assessed at less than high.
- ❖ When Inventory under custody and control of a third party, the auditor would also consider the following:
 - Conduct of the third party in the past with the entity and independence of the third party.
 - Arranging for another auditor to observe the physical inventory count and obtaining other auditor's report.
 - Inspecting documentation.
 - Subsequent receipt of goods from third parties.



Inventory – Management Representation and Reporting

- ❖ Obtain written representation:
 - completeness of information.
 - adherence to procedures laid down for physical count.
- ❖ Audit Conclusions and Reporting:
 - Scope Limitation: unable to obtain sufficient appropriate evidence regarding existence or adequacy of procedures.
 - Qualified Opinion: inventory not discussed appropriately in F/S.

SA 501

Inquiry Regarding Litigation and Claims-I

- ❖ Perform audit procedures to become aware of any material litigation having material affect on FS.
- ❖ Audit procedures:
 - appropriate inquiries of management including obtaining representations.
 - review board/committee minutes and correspondence with entity's lawyers.
 - examine legal, other relevant expense accounts.
 - use any information including information obtained from discussions with in-house legal department, if any.

SA 501

- ❖ Litigation- lawsuit or legal action including all proceedings therein.
- ❖ Claims – right to payment or right to an equitable remedy for breach of performance.



Litigation: Communication with Lawyers-II

- ❖ Maintain Control over preparation of letter seeking direct communication with entity's lawyers/other professionals.
- ❖ Letter should specify:
 - list of litigation and claims.
 - management's assessment of outcome.
 - request that the lawyer confirm reasonableness of management's assessments.
- ❖ Consider status up to date of audit report.

SA 501

Litigation: Communication with Lawyers -III

- ❖ Matter is complex or there is a disagreement between management and the entity's lawyers- auditor meets the entity's lawyers, with management's permission and in attendance of a management representative, to discuss the likely outcome of litigation and claims.
- ❖ Management refuses to give auditor permission to communicate - constitute limitation on scope of auditor's work.
- ❖ Obtain a written representation from management regarding completeness and adequacy of information.

SA 501



Valuation and Disclosure of Long Term Investments (LTI)

- ❖ Obtain sufficient appropriate audit evidence regarding their valuation and disclosure of LTI.
- ❖ Audit procedures include obtaining evidence of:
 - ownership and existence.
 - ability to continue to hold investments on long term basis.
 - discussing with management whether the entity will continue to hold the investments as LTI and obtaining written representations to that effect.

SA 501

- ❖ Refer paragraph 3 of Accounting Standard 13 for definition of "long term investment".

LTI - Other Procedures

- ❖ Quoted securities – consider related FS and other information like, market quotations.
- ❖ Unquoted securities – ascertain method adopted by entity for determining value.
- ❖ Other than securities – ensure that market value has been ascertained on the basis of authentic market reports, and/or based on expert's opinion if warranted.

SA 501

- ❖ If such values do not exceed carrying amounts, auditor would consider whether a write-down is required.



LTI - Management Representations and Reporting

- ❖ Obtain written representation regarding:
 - Completeness.
 - Valuation.
 - Intention.
- ❖ Qualified opinion or Disclaimer of opinion: unable to obtain sufficient appropriate evidence concerning existence, valuation of LTI or their disclosure in FS not adequate.

SA 501

Segment Information (SI)

- ❖ Obtain sufficient appropriate audit evidence regarding SI disclosure in accordance with applicable identified financial reporting framework.
- ❖ Perform audit procedures like analytical procedures and other appropriate tests.

SA 501

- ❖ Information to be disclosed as per Accounting Standard 17, "Segment Reporting".
- ❖ 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.



SI Management Representations and Reporting

- ❖ Obtain written representations concerning:
 - Completeness.
 - Appropriateness.
 - Organisational structure.
- ❖ *Qualified or Disclaimer*: If unable to obtain sufficient appropriate evidence concerning SI or disclosures in FS is not adequate.

SA 501

SA 505

External Confirmations

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

- ❖ Issued in August, 2003.



Introduction - I

- ❖ Establishes standard on auditor's use of ECs as a means of obtaining audit evidence.
- ❖ **Definition** - Process of obtaining, evaluating evidence through direct communication from third party about FS assertions made by management.

SA 505

- ❖ Examples of ECs:
 - Bank balances and other information from bankers.
 - Account receivable balances.
 - Stock held by third party.
 - Property title deed held by third parties.
 - Investment purchased but delivery not taken.
 - Loans from lenders.
 - Accounts payable balances.
 - Long outstanding share application money.

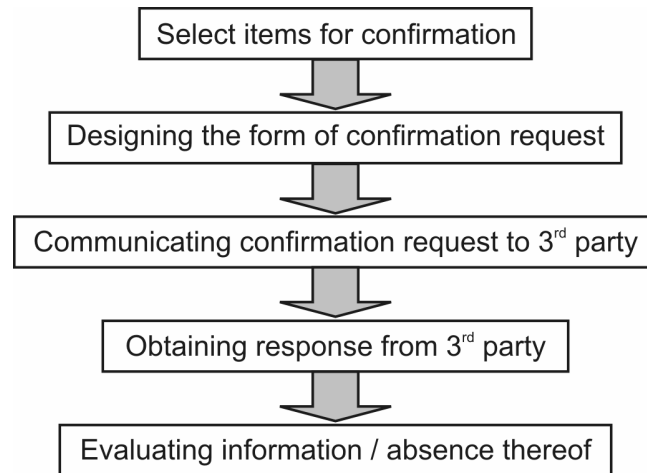
Introduction - II

- ❖ Factors to consider:
 - Necessity as sufficient appropriate audit evidence.
 - Materiality.
 - Assessed level of inherent and control risk.
 - Impact on audit risk.
- ❖ Employ EC procedures in consultation with management.

SA 505



EC process



SA 505

Factors affecting reliability of evidence from EC

- ❖ Application of appropriate procedures:
 - In designing EC request.
 - In performing EC procedures.
 - In evaluating results of EC procedures.
- ❖ Auditor's control over requests & responses.
- ❖ Characteristics of respondents.
- ❖ Any restriction imposed by management.
- ❖ Any restriction included in the response(s).

SA 505



Relationship with Assessments of Risk

- ❖ Assess evidence provided by ECs and consider:
 - Materiality of account balance.
 - Assessment of inherent and control risk.
- ❖ Perform additional procedures in case evidence obtained by ECs alone insufficient.

SA 505

- ❖ Lower the assessed level of inherent and control risk, less assurance required from substantive procedures.
- ❖ Unusual or complex transactions associated with higher level of risks.

Assertions addressed by ECs

- ❖ Assertions addressed:
 - Existence.
 - Rights and obligation.
 - Completeness and valuation (to a limited extent).
 - Cut off procedures.
- ❖ Assertions not adequately addressed by ECs, other audit procedures to complement confirmation procedures.

SA 505

- ❖ Ability of EC to provide evidence relevant to particular FS assertion varies.



Timing & Design

- ❖ Normally at the date of FS or as at any other date close to it.
- ❖ Alternatively, in consultation with management.
- ❖ Design of ECs request in relation to the specific audit objective and following factors:
 - effectiveness of internal control.
 - apparent possibility of disputes.
 - inaccuracies and irregularities in the accounts.
 - Materiality.

SA 505

- ❖ The date may be, alternatively, settled in consultation with management. If the date is other than the date of FS, examine the movement that occur between the date of EC and date of FS.

Nature of Information

- ❖ Consider type of information respondents will be able to confirm readily.
- ❖ Obtain an understanding of substance of such arrangements and transactions.
- ❖ If EC request contains management's authorization, respondents:
 - more willing to respond.
 - in some cases, unable to respond otherwise.
- ❖ Consider prior experience.

SA 505



Form of ECs requests–Positive

- ❖ Respondent to reply in all cases either by:
 - indicating agreement with given information.
 - asking respondent to fill in information.
- ❖ Preferable when:
 - individual account balances are large.
 - weak internal control.
 - substantial number of accounts in dispute or inaccurate or irregular.
- ❖ Blank confirmation - lower response rates.

SA 505

- ❖ Ordinarily expected to provide reliable audit evidence.
- ❖ Risk that respondent may reply without verifying that information is correct.

Form of ECs requests -Negative

- ❖ Reply only in event of disagreement with the information provided in ECs.
- ❖ Preferable when:
 - assessed risk level is low.
 - a large number of small balances is involved.
 - a substantial number of errors is not expected, and
 - no reason to believe that respondents will disregard these requests.

SA 505

- ❖ Less reliable evidence, consider to use other substantive procedures to supplement.
- ❖ Combination of positive and negative EC can be used.



Characteristics of Respondents

- ❖ Ensure that ECs request directed to appropriate individual.
- ❖ Assess whether certain parties may not provide an objective or unbiased response.
- ❖ Consider information relating to respondent's competence, knowledge, motivation, ability or willingness to respond in designing the request.

SA 505

ECs Process

- ❖ Maintain control over process of ECs:
 - selection of respondents.
 - preparation and sending of requests, and
 - responses obtained.
- ❖ Other Controls:
 - auditor sends requests himself.
 - requests are properly addressed.
 - all replies, undelivered confirmations are delivered directly to auditor.
- ❖ Perform alternative procedures in case response is not received to positive EC.

SA 505

- ❖ Less reliable evidence, consider to use other substantive procedures to supplement.
- ❖ Combination of positive and negative EC can be used.



ECs Process - Reliability of Responses

- ❖ Consider any indication that responses may not be reliable.
- ❖ Consider the authenticity and perform appropriate procedures to dispel any doubts.
- ❖ Verify sources / responses through telephone call, mail, fax, if required.
- ❖ Oral confirmations should be documented in the work papers e.g., telephonic enquiry.

SA 505

EC Process - Causes and Frequency of Exceptions

- ❖ Perform additional procedures in case alternative procedures do not provide sufficient appropriate audit evidence.
- ❖ Request management to verify and reconcile the discrepancies.
- ❖ Re-consider the nature, timing and extent of audit procedures if exceptions indicate misstatement.
- ❖ Evaluate the results of EC Process.

SA 505

- ❖ Considerations to assess additional procedures:
 - reliability of the confirmations and alternative procedures.
 - nature of any exceptions.
 - evidence provided by other procedures.



Management Requests

- ❖ Management requests auditor not to follow confirmation process:
 - ask for written request in detail with detailed reasoning along with valid grounds.
 - document reasons in case request accepted.
- ❖ Consider impact on audit report, i.e., scope limitation in case request not accepted.
- ❖ Check the management integrity to identify any fraud or error.

SA 505

SA 510

Initial Engagements- Opening Balances

Effective for all audits commencing on or after July 1, 2001

- ❖ Issued in July, 2001



Introduction

- ❖ Establishes standards regarding audit of opening balances in case of initial engagements.
- ❖ **Initial engagements** means:
 - when the FS are audited for the first time, or
 - when the FS for the preceding period were audited by another auditor.
- ❖ Opening Balances means account balances existing at the beginning of the period.

SA 510

- ❖ AAS 22 would also be considered so that auditor becomes aware of contingencies and commitments existing at the beginning of the current period.
- ❖ Opening balances are closing balances of the preceding period brought forward and reflect the effect of:
 - transactions and other events of preceding periods.
 - accounting policies applied in preceding period.

Initial Audit Engagements

- ❖ Obtain sufficient appropriate audit evidence that:
 - closing balances correctly brought forward from preceding period;
 - no material misstatements in opening balances; and
 - appropriate accounting policies are consistently applied.

SA 510



Audit Procedures

- ❖ Sufficiency and appropriateness of audit evidence depends upon:
 - accounting policies of the entity.
 - type of audit report, if any, issued for the preceding period.
 - nature of opening balances, including risk of their misstatement in FS.
 - materiality of opening balances relative to FS of current period.
- ❖ Obtain copies of audited FS, if preceding period FS audited by another auditor.
- ❖ If Unaudited or if current auditor is not satisfied, perform audit procedures.

SA 510

- ❖ Audit procedures :
 - For fixed assets, investments, long-term debts, etc.:
 - examine the records underlying the opening balances.
 - obtain third party confirmation, where required.
 - For current assets and current liabilities, audit evidence is obtained as a part of current period audit.

Audit Conclusion and Reporting

- ❖ Unable to obtain sufficient appropriate audit evidence, express:
 - qualified opinion, or
 - disclaimer of opinion.
- ❖ Opening balances contain material misstatements and the effect is not properly accounted for/adequately disclosed, express:
 - qualified opinion, or
 - adverse opinion.

SA 510



SA 520

Analytical Procedures

*Effective for all audits relating to accounting periods beginning on or after
April 1, 1997*

Analytical Procedures

- ❖ Establishes standards on the application of analytical procedures (AP) during audit.
- ❖ AP means:
 - analysis of significant ratios and trends.
 - resulting investigation of fluctuations & inconsistent relationships/ deviations.
- ❖ Apply AP at:
 - planning stage.
 - overall review stage.
 - may also be applied at other stages.

SA 520



Nature and Purpose - I

- ❖ Comparison of client financial information:
 - prior period information.
 - anticipated results of an entity such as budgets or forecasts.
 - predictive estimates by auditor.
 - similar industry information.
- ❖ Consideration of relationships:
 - among elements of financial information expected to conform to a predictable pattern.
 - between financial information and relevant non-financial information.

SA 520

- ❖ Analytical procedures include:
 - Inter firm Comparison e.g (Comparison of the ratios of the enterprise with those of other enterprises or industry average).
 - Intra firm Comparison e.g (Comparison of current information with the corresponding information for a prior period or periods).
 - Comparison of Current information with anticipated results such as budgets or forecasts.
 - Study of relationships includes that among elements of Financial information and that between Financial information and non Financial Information.
- ❖ Examples of the above types of Procedures:
 - Debtor's turnover ratio, Average collection period.
 - Variation analysis of Expenses of the current period with the corresponding last year or years.
 - Analysis of variance of Actuals with budgets/forecasts.
 - Gross profit margin shows the relationship between certain elements of Profit and Loss account ,whereas the relationship between payroll costs and No of employee.

Nature and Purpose – II

- ❖ AP are used for following purposes:
 - to determine the nature, timing and extent of other audit procedures.
 - as substantive procedures to reduce detection risk.
 - for overall review of FS.

SA 520

- ❖ Application of various methods using professional judgment like:
 - simple comparison to complex analyses using advanced statistical techniques.
 - applied to Consolidated FS, components of entity, individual items of FS.



APs in Planning Stage

- ❖ Assist in:
 - understanding the business.
 - Identifying areas of potential risk.
- ❖ Use both financial & non financial information.

SA 520

AP as Substantive Procedures

- ❖ Use judgment to evaluate effectiveness and efficiency of available procedures in reducing detection risk for specific FS assertions.
- ❖ Inquire management as to availability and reliability of information needed to apply AP and results of any such procedures performed.

SA 520

- ❖ Factors to be considered in using APs as substantive procedures are:
 - objective of AP and extent to which their results can be relied upon.
 - nature of entity and degree to which information can be disaggregated.
 - availability of information.
 - reliability, relevance, comparability and source of information available.
 - knowledge gained during previous audits.
 - understanding of the effectiveness of the accounting and internal control systems.



AP in Overall Review

- ❖ To assess whether FS as a whole are consistent with auditor's knowledge of business.
- ❖ In some cases, as a result of AP, auditor find areas where further procedures need to be applied before auditor can form an overall conclusion about FS.

SA 520

- ❖ Conclusions drawn from results of AP intended to corroborate conclusions formed during audit of individual components or elements of FS and assist in arriving overall conclusion as to reasonableness of FS.



Extent of Reliance on AP

- ❖ Based on expectation that relationships among data exist and continue in the absence of known conditions to contrary.
- ❖ Factors to determine extent of reliance:
 - materiality of items involved.
 - other audit procedures directed towards the same objectives.
 - accuracy of expected results of Analytical procedure.
 - assessment of inherent and control risks.

SA 520

- ❖ Presence of these relationships provides evidence on completeness, accuracy and validity of data produced by the accounting system.
- ❖ Reliance on the results depends upon assessment of risk that AP may identify relationships as expected when, in fact, a material misstatement exists.
- ❖ The extent of reliance that the auditor places on the results of analytical procedures depends on the following factors:
 - *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;
 - *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;
 - *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
 - *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.
- ❖ The auditor will need to test controls over financial/non-financial information used in applying APs.



Investigating Unusual Items

- ❖ Investigate and obtain adequate explanation and appropriate corroborative evidence.
- ❖ Investigation begins with inquiries of management followed by:
 - corroboration of management's response.
 - consideration of the need to apply other audit procedures based on results of such inquiries.

SA 520

Example 1

(Rs. In lacs)

Particulars	YE Mar 2007	YE Mar 2006
Sales	4,712.57	3,692.66
Net Profit before tax	911.14	903.31
Increase in sales as %	27.62%	
Increase in PBT as %	0.87%	
NP Ratio	517.22%	408.79%

Reasons for variance:

During the current year ended 31st March 2007, the client had initiated marketing campaigns due to which there was an increase sale by around 28%. Though this is an impact only on the sales, the PBT has more or so remained constant because of the huge marketing costs for around Rs. xx lakhs. Since the advertising costs have been charged off entirely during the current year & there are no carry-forwards, in the ensuing year 2007 - 2008, there shall be more net profit as estimated by the management.

Specific Audit objective:

- Since there has been increase in sales, it needs to be ensured how the working capital cycle has been monitored.
- The huge marketing costs for Rs. xx lakhs need to be specifically tested including the Board approval, the amounts, etc.

SA 520



Example 2

(Rs. In lacs)

Particulars	As on Mar 2007	As on Mar 2006
Equity, Reserves and Surplus	8,937.58	4,480.68
Debt consisting secured & unsecured loans	4,914.21	
Debt-Equity Ratio	0.55	-

Reasons for variance:

During the current year ended 31st March 2007, there has been increase in Equity share capital as well as secured loans. The Debt-Equity ratio is at a healthy 0.55 which is according to the industry norms.

The client had issued further xxx equity shares of Rs. 10 each at a premium of Rs. 225 per share as part of IPO during October 2006. This was approved in the Board meeting held on 13th August 2006. The client has also utilized the secured term loan offered by M/s. XYZ Bank during the year approved by the Board of Directors vide resolution dt. 12th February 2007.

Specific Audit Objectives:

- Since there was an IPO, the secretarial procedures as well as the costs incurred during IPO need to have an incisive approach.
- The secured term loans also need to be gone through for the terms of charge on the assets, conveyance etc. The charge register to be maintained U/s. 301 of the Companies Act, 1956 along with the interest computation need to be verified.

SA 520



Example 3

Particulars	Reference	Amount	Remarks
Rental expense per month	(A)	30,000	The rental expense per month has been agreed between the parties i.e. the client Ms/. ABC & Co. and the (landlord Mrs. XXX vide agreement dt. 16th December 2005. Refer the filed copy of the agreement in A-1. Terms of the agreement: 1. The per month rental fee shall be fixed at Rs. 30,000 p.m. with a rental deposit for 10 months i.e. Rs. 3,00,000. The tenure of occupancy shall be for 2 years commencing from 1st April 2007. 2. The rent shall be credited directly to the Savings Bank A/c of the landlord maintained in M/s. EFG Bank bearing A/c No. 112233. 3. TDS at the appropriate rates shall also be deducted before making the remittance. 4. The rent shall be remitted on the 5th of every subsequent month of occupation. 5. Penalty @ 1% for every day shall be made for delay in remittance exceeding the agreed date of remittance.
No. of months of occupation for the year ended 31st March 2007	(B)	12	
Total expected rental expense	(C) = (A) x (B)	360,000	
Rental expense as per G/L	(D)	375,000	
Difference	(E) = (D) - (C)	15,000	
Reason for difference			Penalty clause was applicable due to delay in remittance by 5 days during the month of October 2007 calculated on 1% for every day on Rs. 30,000 which is equal to Rs. 15,000.

SA 520



Revised SA 530

Audit Sampling

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

- ❖ Replaces SA 530 (AAS 15) , “Audit Sampling”, issued in April 1998.

Overview of SA 530

- ❖ Introduction
 - Scope
 - Effective Date
- ❖ Objective
- ❖ Definitions
- ❖ Requirements
 - Sample Design, Size and Selection of Items for Testing
 - Performing Audit Procedures
 - Nature and Cause of Deviations and Misstatements
 - Projecting Misstatements
 - Evaluating Results of Audit Sampling
- ❖ Application and Other Explanatory Material on these Aspects
- ❖ Four Appendices

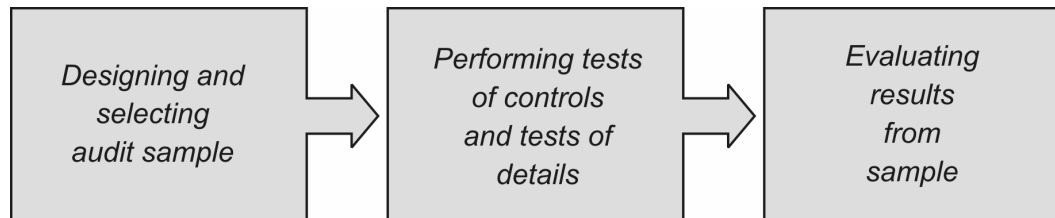
SA 530(R)

- ❖ 'R' Stands for Revised



Scope

- Applies when auditor decides to use audit sampling in performing audit procedures.
- Deals with auditor's use of statistical and non-statistical sampling when -



- Complements SA 500.

SA 530(R)

Objective

- ❖ Objective of Auditor when using Audit Sampling is:
 - To provide a reasonable basis.
 - To draw conclusions.
 - About population from which sample is selected.

SA 530(R)



Training Manual on Engagement and Quality Control Standards

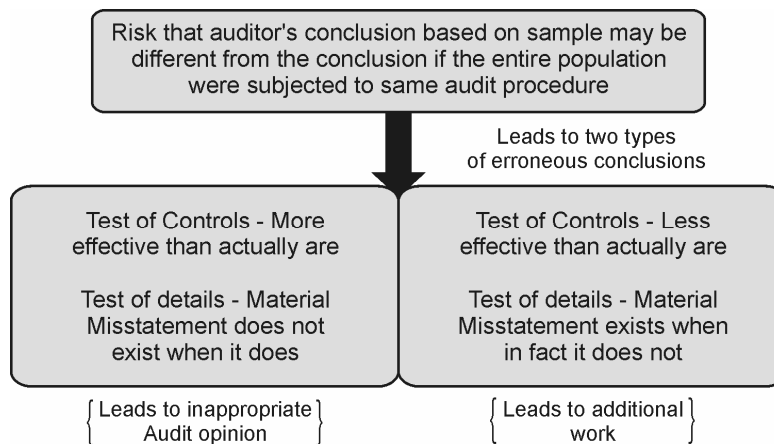
Definitions - I

- ❖ Audit sampling:
 - application of audit procedures to less than 100% of items within a population of audit relevance.
 - such that all sampling units have a chance of selection.
 - to provide a reasonable basis on which to draw conclusions about entire population.
- ❖ Population:
 - Entire set of data from which sample is selected and about which auditor wishes to draw conclusions.

SA 530(R)

Definitions - II

- ❖ Sampling risk:



SA 530(R)

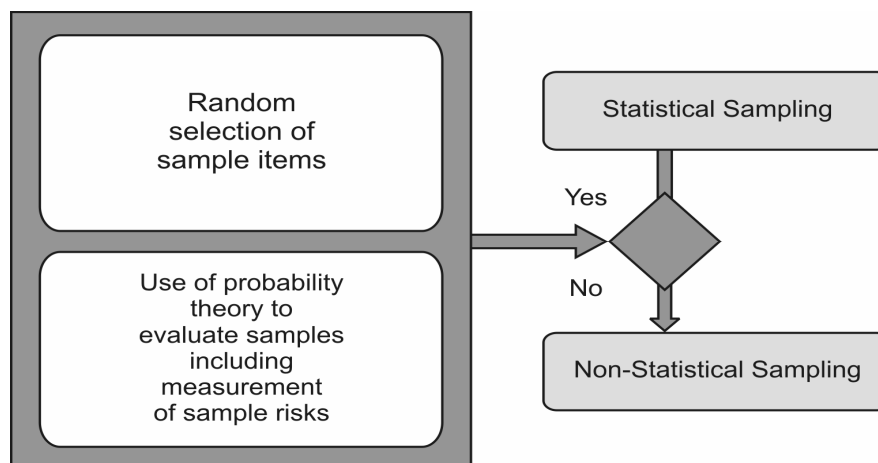


Definitions - III

- ❖ **Non-sampling risk :**
 - Risk that auditor reaches an erroneous conclusion for any reason not related to sampling risk (e.g., *inappropriate audit procedures/ misinterpretation of evidence/failure to recognise a misstatement/ deviation*).
- ❖ **Anomaly :**
 - misstatement or deviation.
 - demonstrably not representative of misstatements or deviations in a population.
- ❖ **Sampling Unit :**
 - Individual items constituting a population.
(*physical items or monetary units*)

SA 530(R)

Definitions – IV



SA 530(R)



Definitions - V

❖ **Stratification :**

- process of dividing a population into sub-populations.
- each of which is a group of sampling units.
- having similar characteristics (often monetary value).

❖ **Tolerable misstatement :**

- monetary amount set by auditor.
- respect of which obtain appropriate level of assurance.
- that monetary amount set is not exceeded by the actual misstatement in the population. {May be = < performance materiality as defined in SA 320}.

SA 530(R)

Definitions - VI

❖ **Tolerable rate of deviation :**

- rate of deviation from prescribed internal control procedures set by auditor.
- in respect of which auditor seeks to obtain an appropriate level of assurance.
- that rate of deviation is not exceeded by actual rate of deviation in the population.

SA 530(R)



Sample Design, Size and Selection of Item

(A) Sample Design:

- Purpose of audit procedure.
- Characteristics of population.
- ❖ **To design audit sample & determine sample size:**
 - Tests of controls – Assessment of expected rate of deviation.
 - Tests of details – Assessment of expected misstatement.
- ❖ **May determine that stratification or value-weighted selection is appropriate.**
- ❖ **Decision to use statistical or non-statistical is a matter for auditor's judgment – sample size is not a valid criterion.**

SA 530(R)

- ❖ Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn.
- ❖ In designing the audit sample, the auditor's consideration includes:
 - the specific purpose to be achieved.
 - the combination of audit procedures that is likely to best achieve that purpose.
 - nature of the audit evidence sought.
 - possible deviation or misstatement conditions or other characteristics relating to that audit evidence.
 - a clear understanding of what constitutes a deviation or misstatement.

(B) Sample Size:

- ❖ Auditor to determine sample size sufficient to reduce sampling risk to an acceptably low level:
 - Lower the risk auditor willing to accept, greater the sample size.
- ❖ Sample size determined by application of:
 - Statistically based formula, or.
 - Exercise of professional judgment.
- ❖ Appendices to this SA – Influence that various factors typically have on determination of sample size.

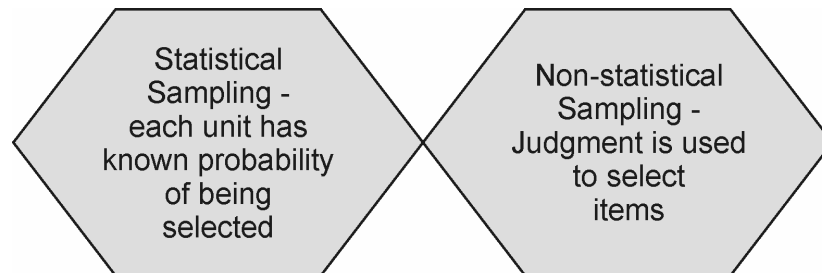
SA 530(R)



Training Manual on Engagement and Quality Control Standards

(C) Selection of Items for Testing

- ❖ Auditor to select representative sample – Each sampling unit in the population has a chance of selection:



SA 530(R)

Methods of selecting sample

Random selection	Applied through random generators, e.g., random number tables.
Systematic selection	Number of sampling units / sample size = sampling interval.
Monetary sampling unit	Type of value weighted selection – sample size, evaluation results in monetary amounts.
Haphazard selection	Selection without following structured technique.
Block selection	Selection of blocks of contiguous items from within the population.

SA 530(R)



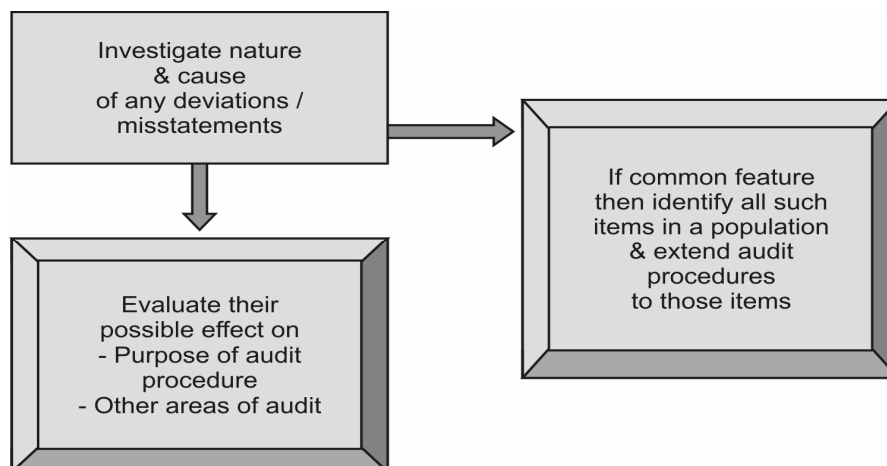
Performing Audit Procedures

- ❖ Perform audit procedures, appropriate to the purpose, on each item selected.
- ❖ If procedure not applicable to selected item, perform on replacement item (e.g., *cancelled check*).
- ❖ If unable to apply procedure/ alternative procedures, then deviation or misstatement (e.g., *documentation relating to item lost*).

SA 530(R)

- ❖ An example of a suitable alternative procedure might be the examination of subsequent cash receipts together with evidence of their source and the items they are intended to settle when no reply has been received in response to a positive confirmation request.

Nature & Cause of Deviations and Misstatements - I



SA 530(R)



Nature & Cause of Deviations and Misstatements - II

- ❖ In extremely rare circumstances, if deviation/misstatement is an anomaly:
 - Obtain high degree of certainty that it is not representative of population.
 - By performing additional audit procedures to obtain SAAE that misstatement/ deviation does not affect remainder of population.

SA 530(R)

Projecting Misstatements

- ❖ Tests of details – project misstatements to population:
 - Gives broad view of scale of misstatement but insufficient to determine amount to be recorded.
 - Exclude anomaly, however consider effect of uncorrected misstatement.
- ❖ Tests of controls - no explicit projection necessary:
 - Sample deviation rate is also projected deviation rate.

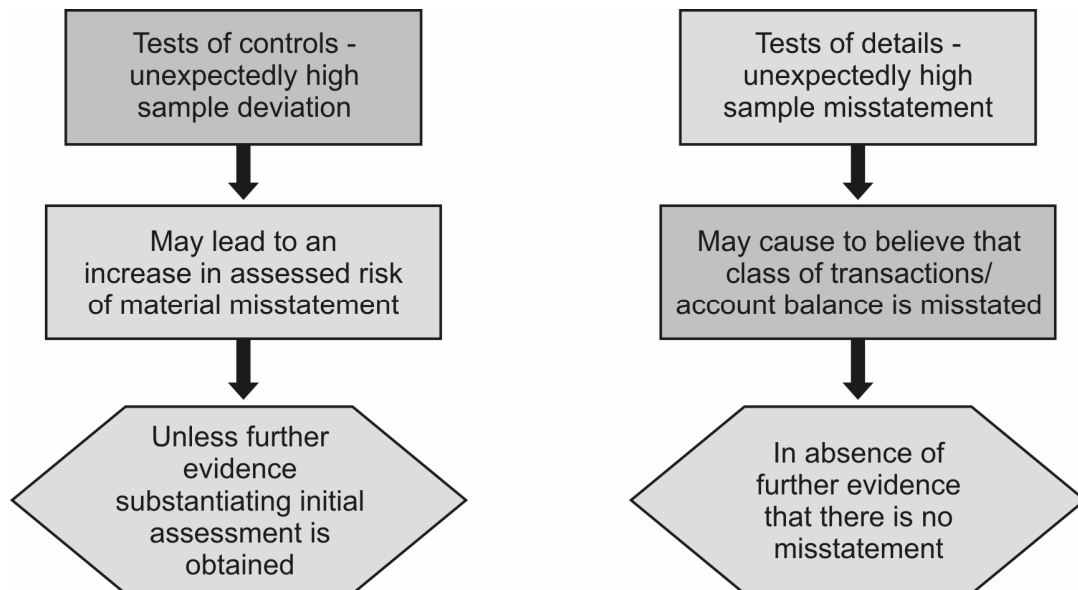
SA 530(R)



Evaluating Results of Audit Sampling - I

❖ Auditor or shall evaluate:

- Results of sample.
- Use of audit sampling provides a reasonable basis of conclusion.



SA 530(R)



Evaluating Results of Audit Sampling - II

- ❖ Tests of details:
 - If (projected misstatement + anomalous misstatement) > tolerable misstatement then sample does not provide reasonable basis for conclusions.
 - Closer (projected misstatement + anomalous misstatement) is to tolerable misstatement, the more likely that actual misstatement may exceed tolerable misstatement.
 - Risk may be reduced if additional audit evidence is obtained.

SA 530(R)

- ❖ 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.



Revised SA 540

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

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

- ❖ Replaces SA 540 (AAS 18), "Audit of Accounting Estimates", issued in April 2000.

Overview of SA 540-I

- ❖ Introduction
 - Scope
 - Effective date
- ❖ Objectives
- ❖ Definitions
- ❖ Requirements
 - Risk Assessment Procedures and Related Activities
 - Identifying and Assessing the Risks of Material Misstatement
 - Responses to the Assessed Risks of Material Misstatement

SA 540(R)

- ❖ 'R' Stands for Revised.

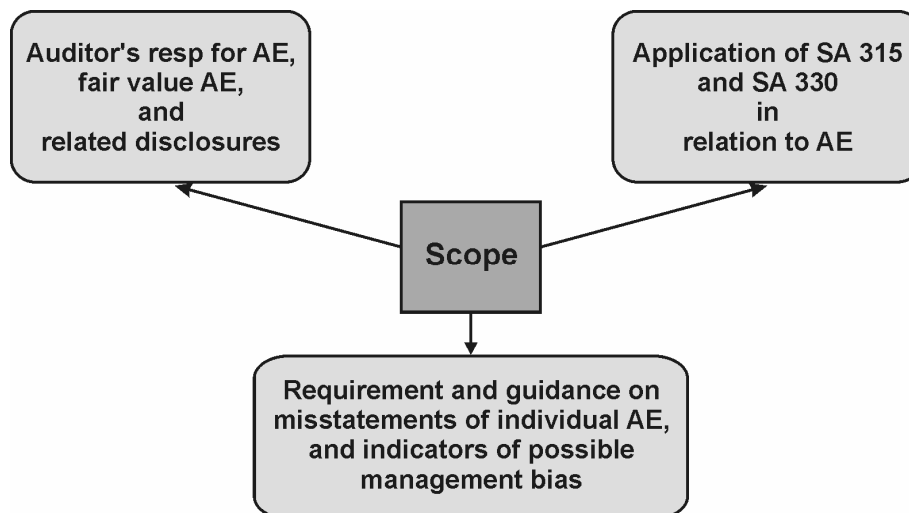


Overview of SA 540-II

- Further Substantive Procedures to Respond to Significant Risk
- Evaluating the Reasonableness of the Accounting Estimates (AE), and Determining Misstatements
- Disclosures Related to Accounting Estimates
- Indicators of Possible Management Bias
- Written Representations
- Documentation
- ❖ Application and Other Explanatory Material on these Aspects
- ❖ Appendix

SA 540(R)

Scope



SA 540(R)



Nature of Accounting Estimates

- ❖ FS items that cannot be measured precisely but can only be estimated.
- ❖ Measurement objective for some AE - To forecast the outcome of one or more transactions, events or conditions.
- ❖ Measurement objective for fair value AE - Expressed in terms of the value of a current transaction or FS item based on conditions prevalent at measurement date.
- ❖ Difference between outcome of an AE and amount originally disclosed in FS does not necessarily represent a misstatement of FS, particularly for fair value AE.

SA 540(R)

- ❖ The nature and reliability of information available to management to support the making of an accounting estimate varies widely, which thereby affects the degree of estimation uncertainty associated with accounting estimates. The degree of estimation uncertainty affects, in turn, the risks of material misstatement of accounting estimates, including their susceptibility to unintentional or intentional management bias.
- ❖ Lower the estimation uncertainty, lower will be the risk of material misstatement or higher the estimation uncertainty, higher will be the risk.
- ❖ Not all FS items require fair value due to non-availability of reliable information.
- ❖ Mgt. bias difficult to detect or can be detected when considered in the aggregate of groups of AE or all AE, or over a period of time.



Accounting Estimates - Examples

- ❖ Allowance for doubtful accounts.
- ❖ Inventory obsolescence.
- ❖ Warranty obligations.
- ❖ Depreciation method or asset useful life.
- ❖ Provision against the carrying amount of an investment.
- ❖ Outcome of long term contracts.
- ❖ Financial Obligations/ Costs arising from litigation settlements and judgments.

SA 540(R)

Fair value Accounting Estimates - Examples

- ❖ Complex financial instruments, which are not traded in an active and open market.
- ❖ Share-based payments.
- ❖ Property or equipment held for disposal.
- ❖ Certain assets or liabilities acquired in a business combination, including goodwill and intangible assets.
- ❖ Transactions involving the exchange parties without monetary consideration.

SA 540(R)



Objective

- ❖ Obtain SAAE in context of applicable FRF:
 - AE including fair value AE in the FS are reasonable.
 - related disclosures in the FS are adequate.

SA 540(R)

Definitions

- ❖ **Accounting estimate** - approximation of a monetary amt in the absence of a precise means of measurement.
- ❖ **Auditor's point estimate or auditor's range**- amount or range of amounts derived from audit evidence for use in evaluating mgt's point estimate.
- ❖ **Estimation uncertainty**- susceptibility of an AE and related disclosures to an inherent lack of precision in its measurement.
- ❖ **Management bias** – A lack of neutrality by mgt in the preparation and presentation of information.

SA 540(R)

- ❖ The term, "Accounting Estimate" is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. Where this SA addresses only accounting estimates involving measurement at fair value, the term "fair value accounting estimates" is used.



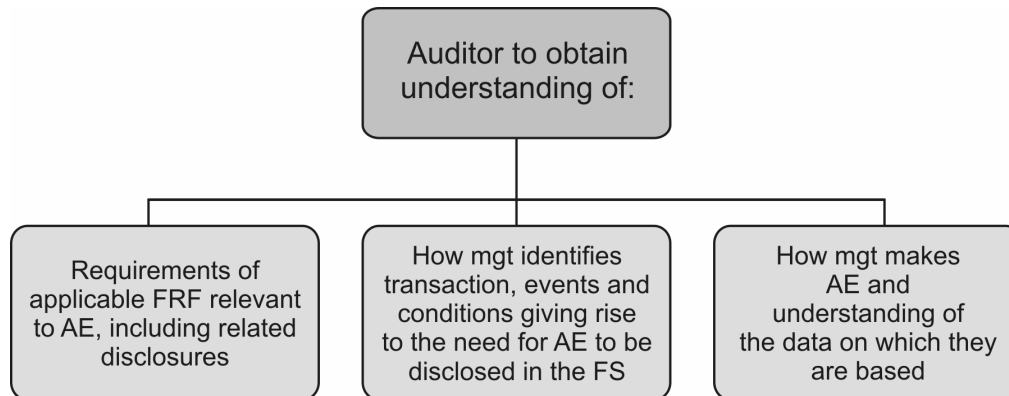
Definitions

- ❖ **Management's point estimate** – amount selected by mgt for recognition or disclosure in the FS as an AE.
- ❖ **Outcome of an AE**- actual monetary amt which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by the AE.

SA 540(R)



Risk Assessment Procedures and Related Activities-I



- ❖ Small Entities: Limited Business activities and less complex transactions.

SA 540(R)

- ❖ In obtaining the understanding on how mgt. identifies transactions/events/conditions, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.
- ❖ Understanding of applicable financial reporting framework assists the auditor in determining certain conditions for the recognition, or methods for the measurement, of AE, specifies certain conditions that permit or require measurement at a fair value, required disclosures:
 - provides the auditor with a basis for discussion with management about how management has applied those requirements relevant to the accounting estimate, and the auditor's determination of whether they have been applied appropriately.
 - Provide guidance for management on determining point estimates where alternatives exist.
- ❖ Management's identification of transactions, events and conditions that give rise to the need for accounting estimates is likely to be based on:
 - Management's knowledge of the entity's business and the industry in which it operates.
 - Management's knowledge of the implementation of business strategies in the current period.
 - Where applicable, management's cumulative experience of preparing the entity's financial statements in prior periods.

Obtaining an Understanding of How Management Makes the Accounting Estimates

- ❖ Management is responsible for establishing financial reporting processes for making accounting estimates, including adequate internal control. Such processes include the following:
 - Selecting appropriate accounting policies and prescribing estimation processes, including appropriate estimation or valuation methods, including, where applicable, models.
 - Developing or identifying relevant data and assumptions that affect accounting estimates.
 - Periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting estimates as necessary.
 - Matters 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 recognized 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.



Training Manual on Engagement and Quality Control Standards

Risk Assessment Procedures-II Manner of Making AE

- ❖ Method, including where applicable the use of model : Internally developed modules are riskier.
- ❖ Relevant controls.
- ❖ Whether management has used an expert.
- ❖ Assumptions underlying the accounting estimates.
- ❖ Change in the methods for making the accounting estimates.
- ❖ Whether and, if so, how management has assessed the effect of estimation uncertainty.

SA 540(R)

Method of Measurement, Including the Use of Models

- ❖ When the applicable financial reporting framework does not prescribe a particular method/model to be used in the circumstances, matters to be considered by the auditor include, for example:
 - How management selects a particular method considering the nature of the asset or liability being estimated.
 - Whether the entity operates in a particular business, industry or environment in which there are methods commonly used to make the particular type of accounting estimate.
- ❖ Greater risks of material misstatement, in cases mgt has internally developed model or is departing from a method commonly used in a particular industry or environment.

Relevant Controls

- ❖ Matters include the experience and competence of those who make the accounting estimates, and controls related to:
 - How management determines the completeness, relevance and accuracy of the data used to develop accounting estimates.
 - The review and approval of accounting estimates, including the assumptions or inputs used in their development.
 - The segregation of duties between those committing the entity to the underlying transactions and those responsible for making the AE.
 - May also include, for example, those established over:
 - The design and development, or selection, of a particular model for a particular purpose.
 - The use of the model.
 - The maintenance and periodic validation of the integrity of the model.

Management's Use of Experts

- ❖ Need may arise because of the specialised nature of the matter requiring estimation, technical nature of the models required to meet the relevant requirements of the FRF, unusual or infrequent nature of the condition/ transaction/ event.

Assumptions

- ❖ Matters include:
 - The nature of the assumptions.
 - How management assesses whether the assumptions are relevant and complete.
 - Where applicable, how management determines that the assumptions used are internally consistent.
 - Whether the assumptions relate to matters within the control of management, and how they conform to the entity's business plans and the external environment, or to matters that are outside its control.
 - The nature and extent of documentation, if any, supporting the assumptions.
- ❖ May be made or identified by an expert.
- ❖ Management may support assumptions with different types of information drawn from internal and external sources, the relevance and reliability of which will vary.
- ❖ With respect to fair value accounting estimates, assumptions or inputs vary in terms of their source and bases, as follows:
 - Those that reflect what marketplace participants would use in pricing an asset or liability developed based on market data obtained from sources independent of the reporting entity (sometimes referred to as "observable inputs" or equivalent).
 - Those that reflect the entity's own judgments about what assumptions marketplace participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

Changes in Methods for making Accounting Estimates

- ❖ Understand whether there has been or ought to have been a change from the prior period in the methods for making the AE.

Estimation Uncertainty

- ❖ Matters include:
 - Whether and, if so, how management has considered alternative assumptions or outcomes by, for example, performing a sensitivity analysis to determine the effect of changes in the assumptions on an accounting estimate.
 - How management determines the accounting estimate when analysis indicates a number of outcome scenarios.
 - Whether management monitors the outcome of accounting estimates made in the prior period, and whether management has appropriately responded to the outcome of that monitoring procedure.



Risk Assessment Procedures and Related Activities-III

Auditor to review outcome of AE included in the prior period FS, or, where applicable, their subsequent re-estimation for the purpose of current period.

SA 540(R)

- ❖ The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at that time.
- ❖ Auditor may obtain:
 - Information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process.
 - Audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates.
 - Audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.
- ❖ Review assists in identifying circumstances/conditions that increase the susceptibility of AE, or indicate the presence of, possible management bias. The auditor's attitude of professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.
- ❖ Retrospective Reviews to identify risk of material misstatements due to fraud.
- ❖ High estimation uncertainty-more detailed review.
- ❖ A difference between the outcome of an accounting estimate and the amount recognised in the prior period financial statements does not necessarily represent a misstatement of the prior period financial statements.



Identifying and Assessing the Risks of Material Misstatement

- ❖ Auditor to:
 - evaluate degree of estimation uncertainty associated with an AE.
 - determine whether any of the AE having high estimation uncertainty give rise to significant risks.

SA 540(R)

- ❖ The degree of estimation uncertainty associated with an accounting estimate may be influenced by factors such as:
 - The extent to which the accounting estimate depends on judgment.
 - The sensitivity of the accounting estimate to changes in assumptions.
 - The existence of recognised measurement techniques that may mitigate the estimation uncertainty.
 - The length of the forecast period, and the relevance of data drawn from past events to forecast future events.
 - The availability of reliable data from external sources.
 - The extent to which the accounting estimate is based on observable or unobservable inputs.
- ❖ Matters that the auditor considers in assessing the risks of material misstatement may also include:
 - The actual or expected magnitude of an accounting estimate.
 - The recorded amount of the accounting estimate (that is, management's point estimate) in relation to the amount expected by the auditor to be recorded.
 - Whether management has used an expert in making the accounting estimate.
 - The outcome of the review of prior period accounting estimates.
- ❖ Examples of AE have high estimation uncertainty include, judgmental AE, AE not calculated through recognized measurement techniques, substantial difference between the original AE and actual outcome. Fair AE for which a highly specialised entity-developed model is used.
- ❖ Where the auditor determines that an accounting estimate gives rise to a significant risk, the auditor is required to obtain an understanding of the entity's controls, including control activities.
- ❖ Check for GC assumption as per Revised SA 570.



Responses to the Assessed Risks of Material Misstatement-I

- ❖ Auditor shall determine:
 - whether mgt has appropriately applied requirement of applicable FRF relevant to AE.
 - whether methods for making AE are appropriate and have been applied consistently, and changes in AE or in the method for making them from the prior period are appropriate.

SA 540(R)

- ❖ In some situations, additional audit procedures, such as the inspection by the auditor of the current physical condition of an asset, may be necessary to determine whether management has appropriately applied the requirements of the applicable FRF.
- ❖ The application of the requirements of the applicable FRF requires management to consider changes in the environment or circumstances that affect the entity.
- ❖ Arbitrary changes in an AE result in inconsistent FS over time and may give rise to a FS misstatement or be an indicator of possible management bias.
- ❖ Use professional judgment in determining good reasons for change in AE.



Response to Assessed Risk-II

- ❖ Consider events up to the date of AR.
- ❖ Evaluate appropriateness of management's method of measurement.
- ❖ Evaluate reasonableness of management's assumption.
- ❖ Test the operating effectiveness of controls.
- ❖ Develop a point or range of estimates.

SA 540(R)

- ❖ Develop a point estimate or a range to evaluate management's point estimate. For this purpose:
 - When the auditor uses assumptions or methods that differ from management's, the auditor shall obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate.
 - When the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable.
- ❖ Consider whether specialised skills or knowledge in relation to one or more aspects of AE are required in obtaining SAAE.
- ❖ The auditor's decision as to which response, individually or in combination, to undertake to respond to the risks of material misstatement may be influenced by the nature of AE, the procedure(s) applied is expected to provide the auditor with SAAE, the assessed risk of material misstatement.
- ❖ Determining whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate may be an appropriate response when such events are expected to:
 - Occur; and
 - Provide audit evidence that confirms or contradicts the accounting estimate. (Apply procedures given in Revised SA 560).
- ❖ When the applicable financial reporting framework does not prescribe the method of measurement, evaluating whether the method used, including any applicable model, is appropriate in the circumstances is a matter of professional judgment. Matters to be considered include:
 - Management's rationale for the method selected is reasonable.
 - Management has sufficiently evaluated and appropriately applied the criteria, if any, provided in the applicable financial reporting framework to support the selected method.
 - The method is appropriate in the circumstances given the nature of the asset or liability being estimated and the requirements of the applicable financial reporting framework relevant to accounting estimates.
 - The method is appropriate in relation to the business, industry and environment in which the entity operates.
- ❖ Matters that the auditor may consider in evaluating the reasonableness of the assumptions used by management include, for example:
 - Whether individual assumptions appear reasonable.
 - Whether the assumptions are interdependent and internally consistent.
 - Whether the assumptions appear reasonable when considered collectively or in conjunction with other assumptions, either for that accounting estimate or for other accounting estimates.
 - In the case of fair value accounting estimates, whether the assumptions appropriately reflect observable marketplace assumptions.
- ❖ The assumptions on which accounting estimates are based may reflect what management expects will be the outcome of specific objectives and strategies.
- ❖ The reasonableness of the assumptions used may depend on management's intent and ability to carry out certain courses of action.
- ❖ Further, fair value accounting estimates may comprise observable inputs as well as unobservable inputs. Where fair value accounting estimates are based on unobservable inputs, matters that the auditor may consider include, for example, how management supports the following:
 - The identification of the characteristics of marketplace participants relevant to the accounting estimate.
 - Modifications it has made to its own assumptions to reflect its view of assumptions marketplace participants would use.
 - Whether it has incorporated the best information available in the circumstances.
 - Where applicable, how its assumptions take account of comparable transactions, assets or liabilities.
- ❖ Testing the operating effectiveness of the controls is required when:
 - The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls over the process are operating effectively; or
 - Substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level.
- ❖ Developing a point estimate or a range may be an effective or efficient response to the assessed risks.
- ❖ The ability of the auditor to make a point estimate, as opposed to a range, depends on several factors, including the model used, the nature and extent of data available and the estimation uncertainty involved with the accounting estimate. Further, the decision to develop a point estimate or range may be influenced by the applicable FRF.



Further Substantive Procedures to Respond to Significant Risks

- ❖ Evaluation of Estimation Uncertainty:
 - How mgt. has considered alternative assumption/ outcomes and why he has rejected them?
 - How mgt has addressed estimation uncertainty in making AE?
 - Whether significant assumptions used by mgt are reasonable?
 - Mgt's intent to carry out specific courses of action and its ability to do so?
 - Development of a range with which to evaluate the reasonableness of the accounting estimate?

SA 540(R)

- ❖ Management may evaluate alternative assumptions or outcomes of the accounting estimates through a number of methods, depending on the circumstances. (e.g., one possible method used by management is to undertake a sensitivity analysis.)
- ❖ Where management has not considered alternative assumptions or outcomes, it may be necessary for the auditor to discuss with management, and request support for, how it has addressed the effects of estimation uncertainty on the AE.
- ❖ Support for significant assumptions derived from management's knowledge may be obtained from management's continuing processes of strategic analysis and risk management.
- ❖ The auditor may view the efforts of management for addressing the effects of estimation uncertainty as inadequate. This may be the case, for example, where, in the auditor's judgment:
 - SAAE could not be obtained through the auditor's evaluation of how management has addressed the effects of estimation uncertainty.
 - It is necessary to explore further the degree of estimation uncertainty associated with an accounting estimate.
 - It is unlikely that other audit evidence can be obtained.
 - Indicators of management bias in the making of accounting estimates may exist.
- ❖ The auditor's range is useful and effective when it is sufficiently narrow to enable the auditor to conclude whether the accounting estimate is misstated.



Substantive Procedure-II Recognition and Measurement Criteria

- ❖ Auditor shall obtain SAAE whether the following are in accordance with the requirement of the applicable FRF:
 - mgt's decision to recognise, or to not recognise, the AE in the FS; and
 - the selected measurement basis for AE.

SA 540(R)

- ❖ The focus of the auditor's evaluation is on whether the measurement of the accounting estimate is sufficiently reliable to meet the recognition criteria of the applicable FRF.
- ❖ For non-recognised AE, the focus of the auditor's evaluation is on whether the recognition criteria of the applicable financial reporting framework have in fact been met. When the auditor concludes that this treatment is appropriate:
 - disclosure in the notes to the FS.
 - need to add EMP in the auditor's report.
- ❖ With respect to fair value AE, some financial reporting frameworks presume that fair value can be measured reliably as a prerequisite to either requiring or permitting fair value measurements or disclosures. In some cases, this presumption may be overcome then the focus of the auditor's evaluation is on whether management's basis for overcoming the presumption relating to the use of fair value set forth under the applicable financial reporting framework is appropriate.



Evaluating the Reasonableness of AE and Determining Misstatements

- ❖ Determine difference between management's estimate and auditor's estimate.
- ❖ Arbitrary change of AE by management.
- ❖ Misstatements may be caused by selection of accounting policies or on account of sampling or factual misstatements.

SA 540(R)

Disclosures Related to Accounting Estimates

- ❖ Obtain SAAE to ensure that:
 - Disclosures in the FS related to AE are in accordance with the requirements of the applicable FRF.
 - Evaluate adequacy of disclosure of estimation uncertainty.
 - Assumption; Method of Estimation; Basis for selection of method; Effect of change; Range of outcomes; FVAE; Qualitative & Quantitative Disclosures.
 - Evaluate the adequacy of the disclosure in respect of AE giving risk to significant risk of their estimation uncertainty in the FS in the context of the applicable FRF.

SA 540(R)



Indicators of Possible Management Bias

- ❖ Review the judgments and decisions made by mgt in the making of AE 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 AE.

SA 540(R)

- ❖ Examples of indicators of possible management bias with respect to accounting estimates include:
 - Changes in an accounting estimate, or the method for making it, where management has made a subjective assessment that there has been a change in circumstances.
 - Use of an entity's own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions.
 - Selection or construction of significant assumptions that yield a point estimate favourable for management objectives.
 - Selection of a point estimate that may indicate a pattern of optimism or pessimism.



Written Representations

- ❖ Obtain written representations from mgt whether mgt believes significant assumptions used by it in making AE are reasonable.
- ❖ Appropriateness of measurement process.
- ❖ Assumption reflect management's intent.
- ❖ Disclosures are complete and appropriate.
- ❖ No subsequent events require adjustment.

SA 540(R)

- ❖ 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 FRF have not been met.
 - The appropriateness of the basis used by management to overcome the presumption relating to the use of fair value set forth under the entity's applicable FRF, for those AE not measured or disclosed at fair value.

Documentation

- ❖ Basis for the auditor's conclusions about the reasonableness of AE and their disclosure that give rise to significant risks; and
- ❖ Indicators of possible management bias, if any.

SA 540(R)



SA 550

Related Parties

*Effective for all audits relating to accounting periods beginning on or after
April 1, 2001*

❖ Issued in September, 2001



Introduction - I

- ❖ Establishes standards on auditor's responsibilities & procedures re RP & RP transactions.
- ❖ Defined in AS 18.
- ❖ Management responsible to identify & disclose RP & RP transactions.

SA 550

- ❖ Definitions – Accounting Standard (AS) 18, Related Party Transactions.
- ❖ **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.
- ❖ 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 AAS will provide sufficient appropriate audit evidence regarding those assertions in the absence of any circumstance identified by the auditor that:
 - increases the risk of misstatement beyond that which would ordinarily be expected; or
 - 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.



Introduction - II

- ❖ Need for focus on RP transactions:
 - Disclosure requirements in Financial Reporting Framework (FRF).
 - Existence may affect FS.
 - RP transactions may be motivated by other than ordinary business considerations.
 - Affects reliability of internally generated audit evidence.

SA 550

- ❖ 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.
- ❖ Existence of related parties and transactions between such parties are considered ordinary features of business but auditor needs to be aware of them because of above stated reasons.

Existence & Disclosure of RP

- ❖ Review information provided by management.
- ❖ Identify names of all known RP.
- ❖ Perform procedures in respect of completeness of information.
- ❖ If risk of significant RP remaining undetected is low, reduce/modify procedures.
- ❖ Ensure that RP disclosure adequate as per financial reporting framework requirements.

SA 550



Audit Procedures

- ❖ For identifying names of all known RP:
 - review working papers for prior years for names of known RP.
 - review entity's procedures for identification of RP.
 - inquire as to affiliation of directors, key management personnel, officers with other entities.
 - determine names of principal shareholders.
 - review memorandum and articles of association, minutes of meetings and other statutory records.
 - inquire other auditors and review report of predecessor auditor.
 - review income tax returns and other information supplied to regulators.
 - review joint venture and other agreements.

SA 550

Transactions with RP

- ❖ Review information provided by directors, key management personnel identifying RP transactions and be alert for other material RP transactions.
- ❖ Consider adequacy of control procedures over authorisation and recording of RP transactions.
- ❖ Be alert for unusual transactions.

SA 550

- ❖ Obtain an understanding of accounting and internal control systems and making a preliminary assessment of control risk.
- ❖ Carry out procedures which may identify existence of transactions with RP.



Examining Identified RP Transactions

- ❖ Obtain sufficient appropriate audit evidence as to whether these transactions have been properly recorded and disclosed.
- ❖ Limited availability of evidence about RP transactions, consider performing procedures such as:
 - confirming terms and amount of transaction with RP.
 - obtaining confirmation.

SA 550

- ❖ Obtain confirmations from persons associated with transaction with related parties such as, banks, lawyers, guarantors and agents.

Management Representation

- ❖ Obtain written representations concerning:
 - completeness of information regarding identification of RP.
 - adequacy of RP disclosures in FS.

SA 550

- ❖ Appendix to AAS 23 sets out the example of a management representation letter regarding RP.



Audit Conclusion & Reporting

- ❖ Unable to obtain sufficient appropriate evidence; OR
- ❖ Transactions not adequately disclosed; OR
- ❖ Express qualified or disclaimer Opinion.

SA 550

Revised SA 560

Subsequent Events (SEs)

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

- ❖ Replaces SA 560 (AAS 19), "Subsequent Events" issued in April 2000.



Overview

- ❖ **Introduction**
 - Scope
 - Effective date
- ❖ **Objectives**
- ❖ **Definitions**
- ❖ **Requirements**
 - Events occurring between the date of the Financial Statements and the date of the Auditor's Report
 - Facts which become known to the Auditor after the date of the Auditor's Report but before the date the Financial Statements are issued
 - Facts which become known to the Auditor after the Financial Statements have been issued.
- ❖ Application and Other Explanatory Material on these aspects.

SA 560(R)

- ❖ 'R' Stands for Revised.

Scope

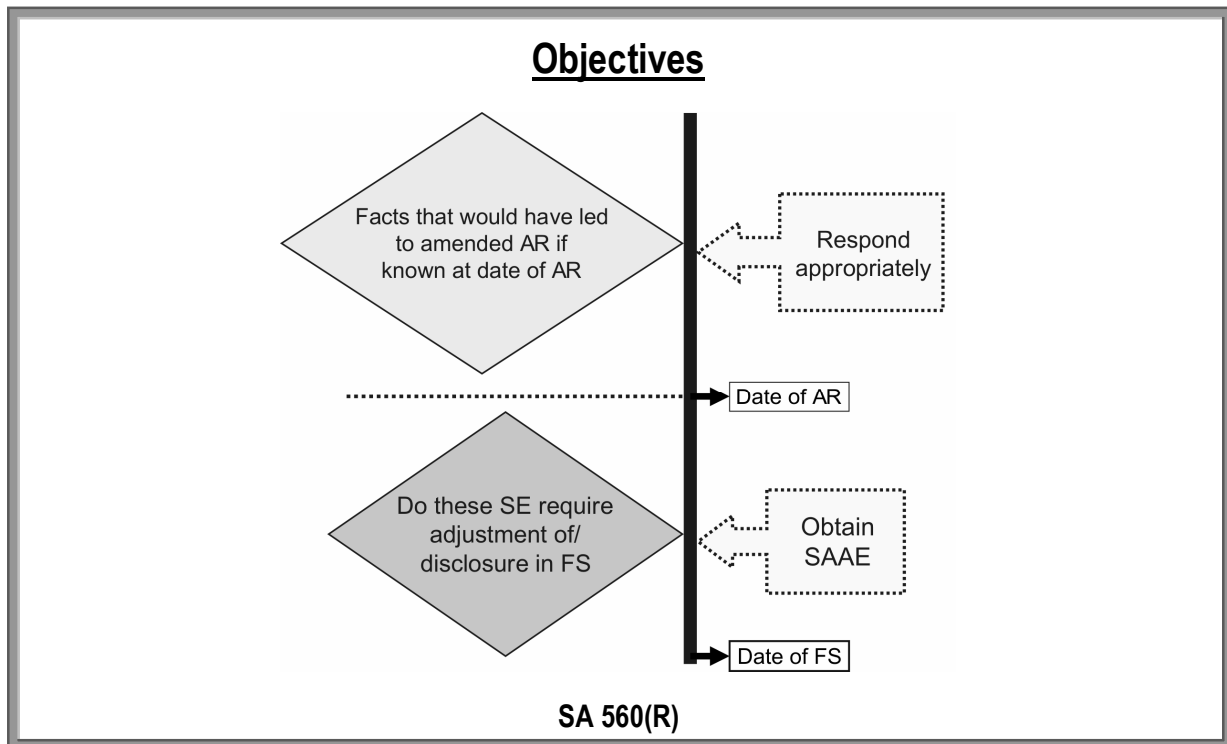
- ❖ **Auditor's responsibilities relating to SE in audit of FS:**
 - Consider additional responsibilities if audited FS included in other documents after the issuance of FS.
- ❖ **SEs:**
 - TYPE 1: provide evidence of conditions that existed at date of FS.
 - TYPE 2: provide evidence of conditions that arose after date of FS.

SA 560(R)

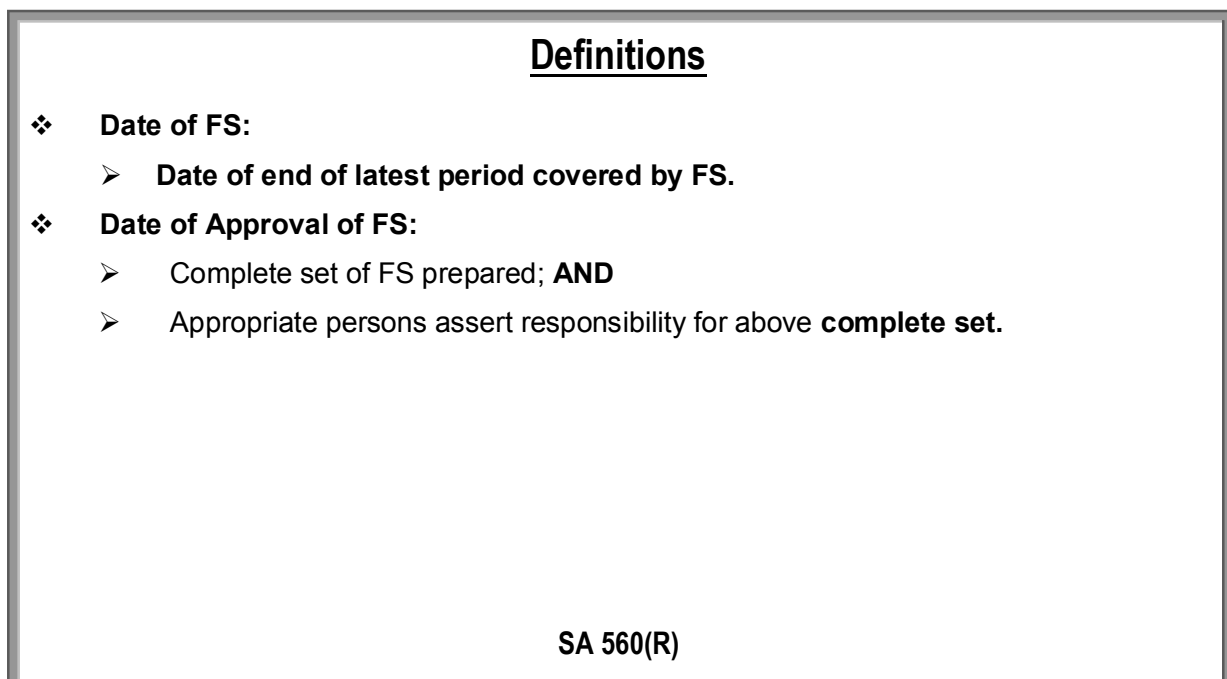
- ❖ **Other Documents**

For example, the auditor may be required to perform additional audit procedures to the date of the final offering document. These procedures may include those referred to in paragraphs 6 and 7 performed up to a date at or near the effective date of the final offering document, and reading the offering document to assess whether the other information in the offering document is consistent with the financial information with which the auditor is associated.
- ❖ **SEs**

SE can affect FS. Many FRFs provide for SEs.

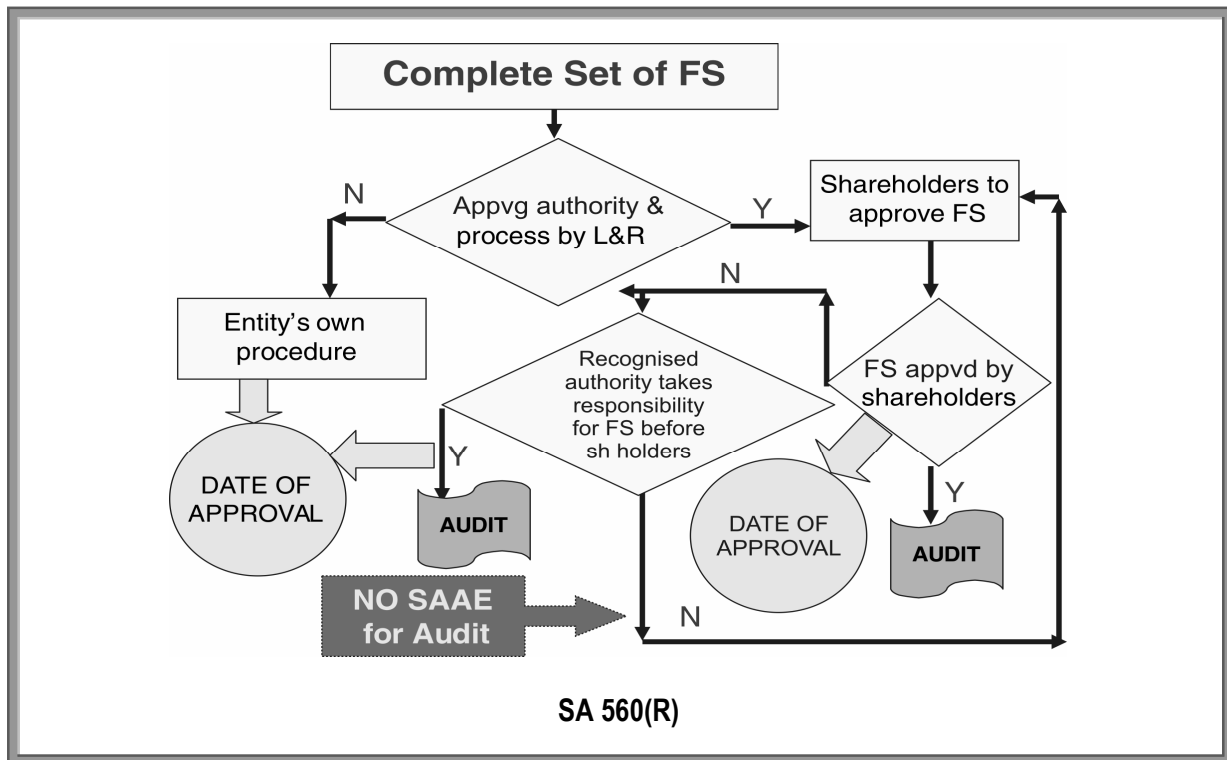


❖ The thick line depicts subsequent events





Training Manual on Engagement and Quality Control Standards



❖ Date of Auditor's Report:

- Date of AR on FS in acc with Proposed Revised SA 700.
- Cannot be before SAAE obtained to form opinion.
- Cannot be earlier than the date of approval of FS.

❖ Date of Issuance of FS:

- When AR & audited FS made available to 3rd parties.

SA 560(R)

❖ Date of AR:

A time period may elapse due to administrative issues between date of AR & date the AR is provided to entity.
(this time period has significance in the context of date of issuance of FS)

❖ Date of Issuance of FS:

- Depends on the regulatory environment of an entity.
- Only be at or later than the date of auditor's report and also be at or later than the date the auditor's report is provided to the entity.
- In case of certain entities, may be date of presentation of audited financial statements to the legislature or otherwise made public.



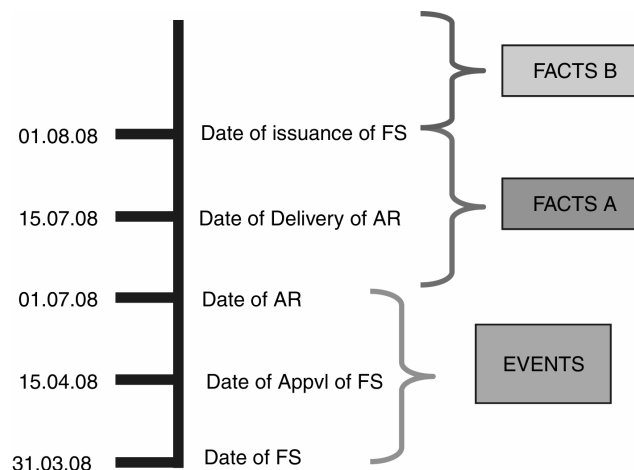
Subsequent Events

- ❖ **Events** that occur between:
 - The date of FS;
AND
 - The date of AR;
AND
- ❖ **Facts** that become known to auditor after date of AR.

SA 560(R)

- ❖ Note that the definition uses two distinct expressions, viz., EVENTS *vis a vis* FACTS. In respect of the time period between the date of FS & date of AR, the term used is EVENTS implying that something happens during that period. As against this, the expression used for the period after the date of AR, is FACTS, implying that it is not necessary that something should have happened in that period. It means that something could have happened or existed even before the date of AR but which became known to the auditor only after the AR has been signed.
- ❖ This also implies that the auditor does not have any responsibility w.r.t. events happening after the date of AR?

Dates covered by SA 560

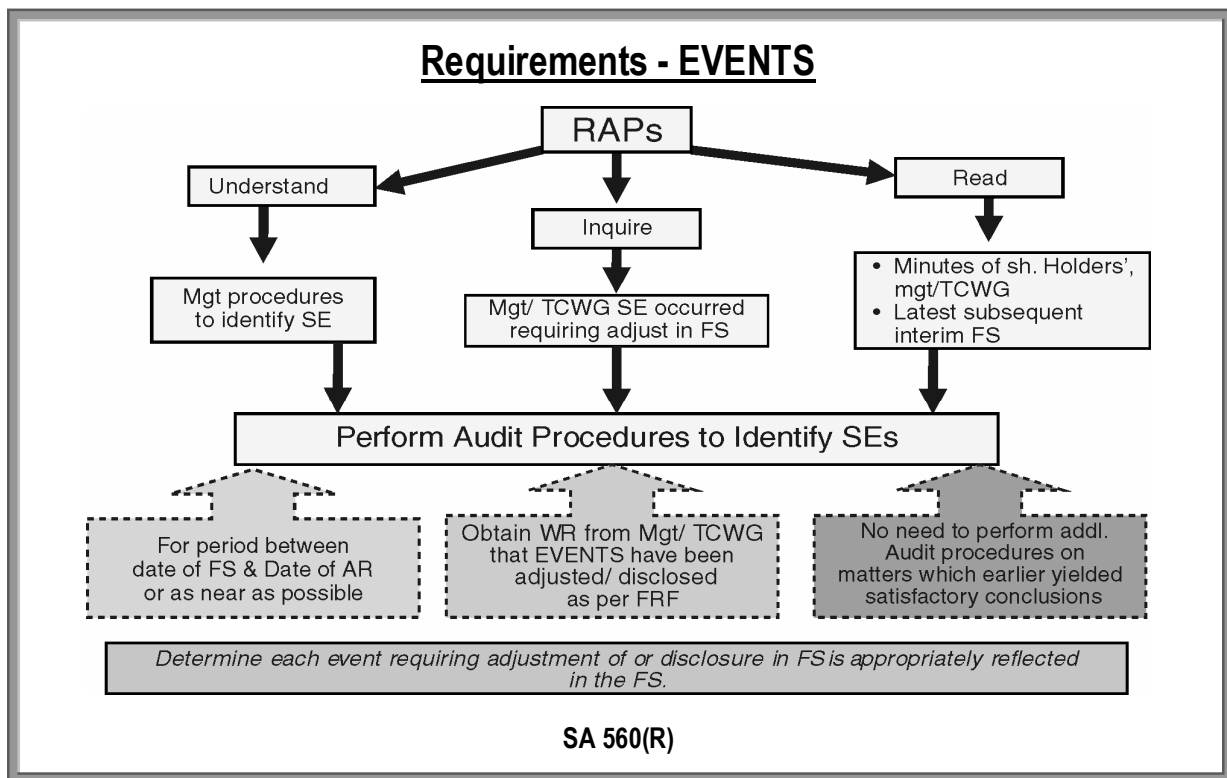


SA 560(R)

- ❖ To consider EVENTS only if they require adjustment/ disclosure in FS.
- ❖ To consider FACTS only if they would have impacted the AR.



Training Manual on Engagement and Quality Control Standards



Reading

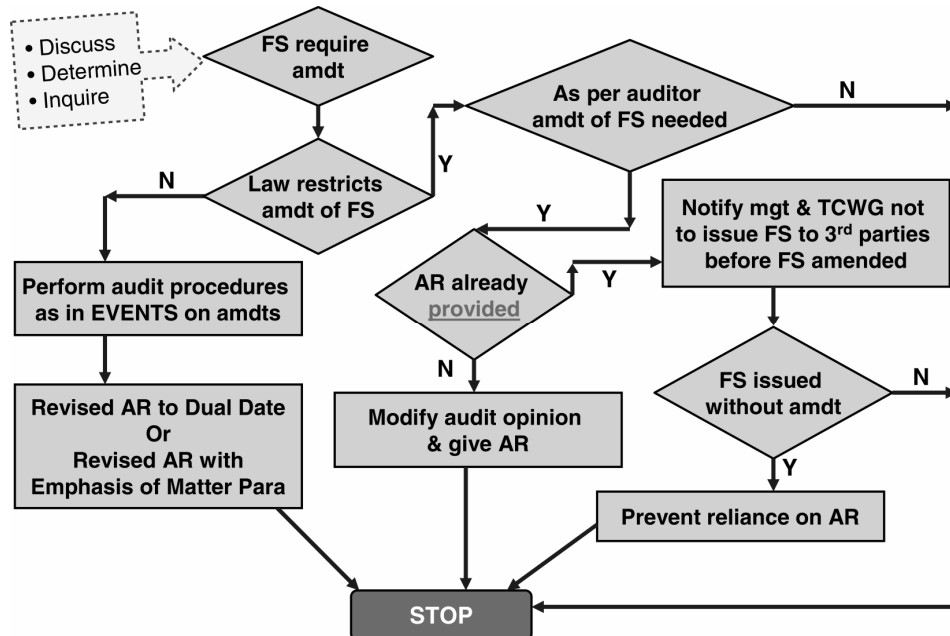
- ❖ If no interim financial info / minutes of mtgs available, inspect available books & records including bank statements. Additional matters to consider:
 - Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements;
 - Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims; or
 - Consider whether written representations covering particular subsequent events may be necessary to support other audit evidence and thereby obtain sufficient appropriate audit evidence.
 - In case of certain entities, auditor may read the official records of relevant proceedings of the legislature and inquire and inquire about the matters addressed in proceedings for which official records are not yet available.

Inquiry of Mgt/ TCWG

- ❖ The auditor may inquire as to the current status of items that were accounted for on the basis of preliminary or inconclusive data and may make specific inquiries about the following matters:
 - Whether new commitments, borrowings or guarantees have been entered into.
 - Whether sales or acquisitions of assets have occurred or are planned.
 - Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
 - Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.
 - Whether there have been any developments regarding contingencies.
 - Whether any unusual accounting adjustments have been made or are contemplated.
 - Whether any events have occurred or are likely to occur that will bring into question the appropriateness of accounting policies used in the financial statements, as would be the case, for example, if such events call into question the validity of the going concern assumption.
 - Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
 - Whether any events have occurred that are relevant to the recoverability of assets.



Requirements – FACTS A



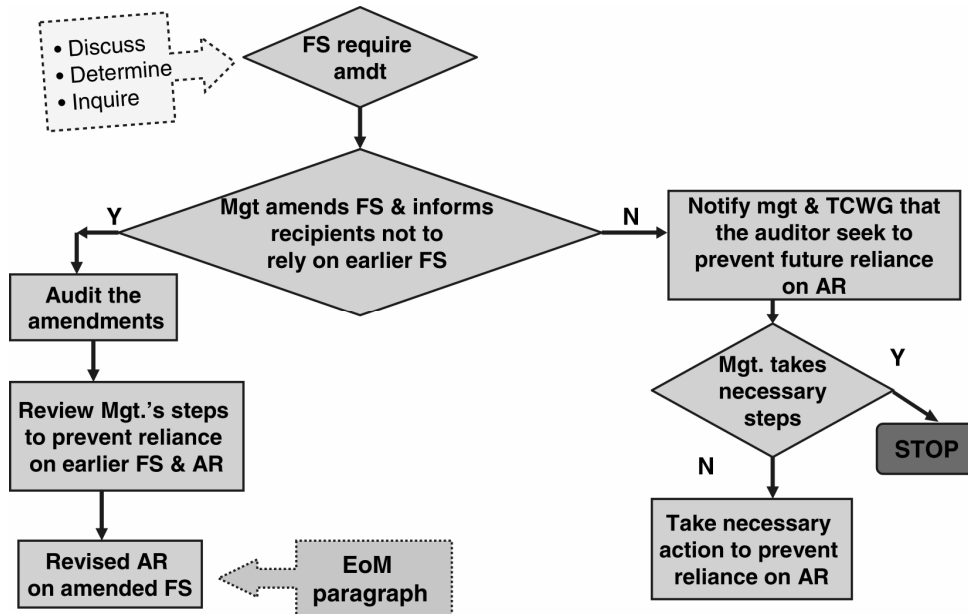
SA 560(R)

- ❖ No obligation to perform audit procedures re FS after date of AR.
- ❖ Discuss : matter with mgt/ TCWG.
- ❖ Determine : if FS need amdt, if yes then.
- ❖ Inquire : how mgt intends to address the matter in FS.
- ❖ Mgt needs to inform the auditor about all the relevant facts of which it become aware during the period from the date of AR and date of FS are issued.
- ❖ **Dual Dating**- When, the auditor amends the auditor's report to include an additional date restricted to that amendment, the date of the auditor's report on the financial statements prior to their subsequent amendment by management remains unchanged because this date informs the reader as to when the audit work on those financial statements was completed. However, an additional date is included in the auditor's report to inform users that the auditor's procedures subsequent to that date were restricted to the subsequent amendment of the financial statements.
- ❖ When management has issued the financial statements despite the auditor's notification not to issue the financial statements to third parties, the auditor may consider seeking legal advice.



Training Manual on Engagement and Quality Control Standards

Requirements – FACTS B



SA 560(R)

- ❖ Discuss : matter with mgt/ TCWG.
- ❖ Determine : if FS need amdt, if yes then.
- ❖ Inquire : how mgt intends to address the matter in FS.
- ❖ When the auditor believes that management, or those charged with governance, have failed to take the necessary steps to prevent reliance on the auditor's report on financial statements previously issued by the entity despite the auditor's prior notification, the auditor may consider it appropriate to seek legal advice.



Revised SA 570

Going Concern (GC)

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

- ❖ Replaces the SA 570 (AAS 16), "Going Concern", issued in September 2001.

Overview of SA 570

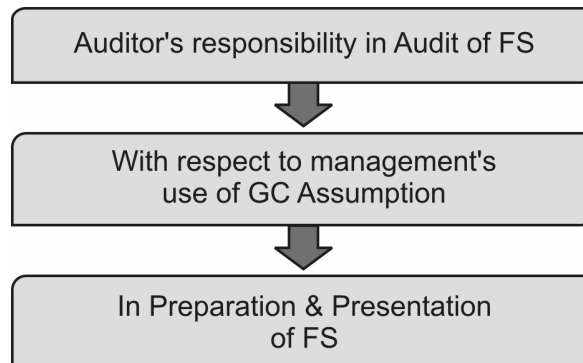
- ❖ Introduction:
 - Scope.
 - Effective Date.
- ❖ Objectives.
- ❖ Requirements:
 - Risk Assessment Procedures and Related Activities.
 - Evaluating Management's Assessment.
 - Period beyond Management's Assessment.
 - Additional Audit Procedures when Events or Conditions are identified.
 - Audit Conclusions and Reporting.
 - Use of Going Concern Assumption Appropriate but a Material Uncertainty Exists.
 - Use of Going Concern Assumption Inappropriate.
 - Management Unwilling to Make or Extend Its Assessment.
 - Communication with Those Charged with Governance.
 - Significant Delay in the Approval of the Financial Statements.
- ❖ Application & Other Explanatory Material on these Aspects.

SA 570(R)

- ❖ 'R' Stands for Revised.



Scope of this SA



SA 570(R)

GC Assumption

- ❖ Entity is viewed as continuing in business for the foreseeable future.

Responsibilities of Management

- ❖ GC - a fundamental principle in preparation of Financial Statements.
- ❖ Management to make a specific assessment of GC Assumption.
- ❖ Judgment about inherently uncertain future outcome of events/conditions:
 - Period- at least 12 months from date of FS.
 - Based on – Information available at particular point of time.
 - Affected by –Size & Complexity of entity, Nature & Condition of business.

SA 570(R)

Responsibilities of Management

- ❖ The financial reporting framework may require the mgt to make an assessment of the entity's ability to continue as a GC and prepare the financial statements on a GC basis unless the management intends to liquidate the entity or cease operations, or has no realistic alternative but to do so. In case in other financial reporting framework, there is no such explicit requirement for the mgt., mgt. is still required to prepare and present FS on GC basis.
- ❖ Appropriate disclosure together with the reason thereof, in case the FS are not prepared on a GC basis.
- ❖ The detailed requirements may also be set out in law or regulation.



Responsibilities of Auditor

Obtain Sufficient Appropriate Audit Evidence (SAAE) about appropriateness of management's use of GC assumption



Conclude whether there is material uncertainty about entity's ability to continue as GC

Absence of any GC uncertainty reference in Auditor's report not to be viewed as guarantee to entity's ability to continue as GC

SA 570(R)

Auditor's Objective

- ❖ Assumption in preparation & presentation of FS.
- ❖ Conclude, Obtain SAAE about appropriateness of management's use of GC based on evidence, whether a material uncertainty exists that may cast significant doubt on entity's ability to continue as GC.
- ❖ Determine implications for Auditor's report.

SA 570(R)



Risk Assessment Procedures-I

- ❖ Determine events/conditions that cast doubt on entity's ability to continue as GC:
 - *-Financial -Operating -Other*
- ❖ Auditor to remain alert throughout audit for these events /conditions.
- ❖ Smaller Entities:
 - Ability to withstand or respond quickly but may lack resources.
 - Possible loss of major customer, key employee, right to operate license or withdrawn of support by banks or lending agencies.

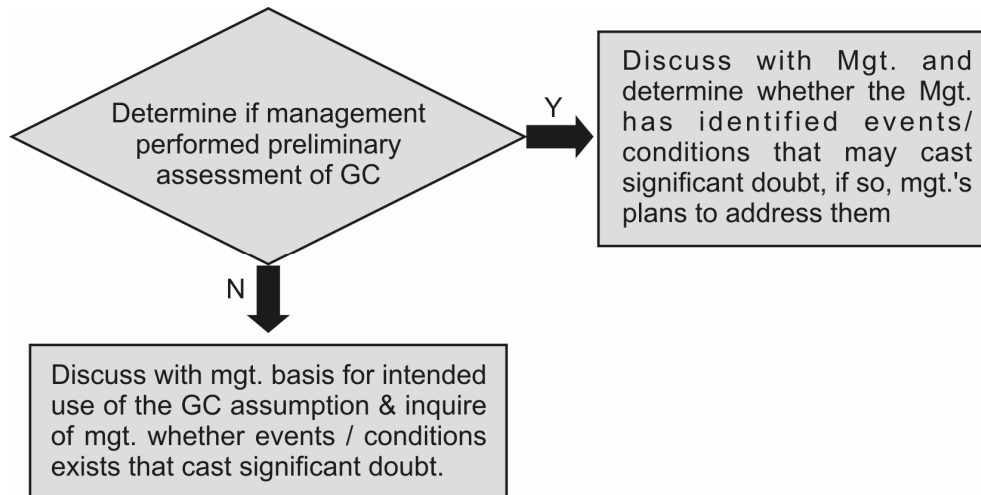
SA 570(R)

Examples of Events/ Conditions

- ❖ **Financial**
 - Net liability or net current liability position.
 - Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
 - Indications of withdrawal of financial support by creditors.
 - Negative operating cash flows indicated by historical or prospective financial statements.
 - Adverse key financial ratios.
 - Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
 - Arrears or discontinuance of dividends.
 - Inability to pay creditors on due dates.
 - Inability to comply with the terms of loan agreements.
 - Change from credit to cash-on-delivery transactions with suppliers.
 - Inability to obtain financing for essential new product development or other essential investments.
- ❖ **Operating**
 - Management intentions to liquidate the entity or to cease operations.
 - Loss of key management without replacement.
 - Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
 - Labour difficulties.
 - Shortages of important supplies.
 - Emergence of a highly successful competitor.
- ❖ **Other**
 - Non-compliance with capital or other statutory requirements.
 - Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
 - Changes in law or regulation or government policy expected to adversely affect the entity.
 - Uninsured or underinsured catastrophes when they occur.
- ❖ **Procedures under SA 315 and SA 330 need to be followed.**



Risk Assessment Procedures-II



SA 570(R)

Evaluating Management's Assessment

- ❖ Evaluate management's assessment of entity's ability to continue as GC.
- ❖ Assessment period:
 - Cover same period as that used by management as per the Financial Reporting Framework.
 - Or longer period if required by law/regulation.
 - If period less than 12 months from the date of the financial statements then request management to extend it to at least 12 months from that date.
- ❖ Consider whether assessment includes all relevant information of which auditor is aware as result of audit.

SA 570(R)

- ❖ Auditor is not responsible for rectifying the lack of analysis by mgt. to support its assessment for concluding whether management's use of the going concern assumption is appropriate in the circumstances. In this case, the auditor's evaluation of the appropriateness of management's assessment may be made without performing detailed evaluation procedures if the auditor's other audit procedures are sufficient to enable the auditor to conclude whether mgt.'s use of the going concern assumption in the preparation of the financial statements is appropriate in the circumstances.
- ❖ Evaluation may include:
 - Evaluation of the process management followed to make its assessment.
 - The assumptions on which the assessment is based and management's plans for future action.
 - Whether management's plans are feasible in the circumstances.



Smaller Entities

- ❖ Evaluating Management's assessment of the small entity:
 - Discuss medium and long-term financing of entity with management – *consistent with auditor's understanding*.
 - Assess supporting documentation.
- ❖ Evaluating owner-manager's ability to meet the obligation under support arrangement.

SA 570(R)

Period beyond Management's Assessment

- ❖ Inquire of management as to its knowledge of events/ conditions beyond the period of management's assessment:
 - If events/conditions identified request management to evaluate potential significance.
 - No responsibility to perform any other audit procedure except inquiry.

SA 570(R)



Additional Audit Procedures - I

- ❖ Request mgmt to make GC assessment if not yet performed.
- ❖ Evaluate mgmt's plans for future actions (*e.g., restructuring, expenditure reduction*):
 - outcome likely to improve situation.
 - feasible in the circumstances.
- ❖ Consider whether any additional facts/information available since date of mgmt assessment.

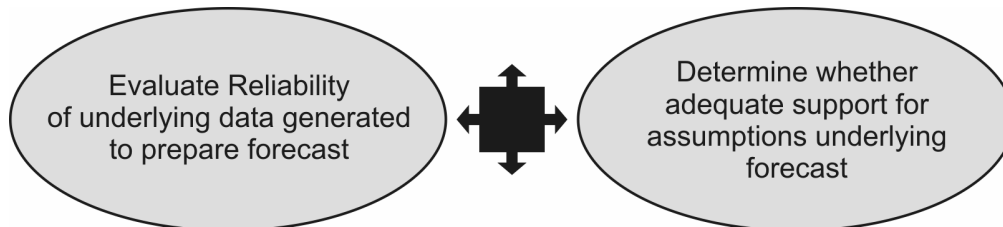
SA 570(R)

- ❖ **Audit procedures may include the following:**
 - Analysing and discussing cash flow, profit and other relevant forecasts with management.
 - Analysing and discussing the entity's latest available interim financial statements.
 - Reading the terms of debentures and loan agreements and determining whether any have been breached.
 - Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
 - Inquiring of the entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
 - Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.
 - Evaluating the entity's plans to deal with unfilled customer orders.
 - Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.
 - Confirming the existence, terms and adequacy of borrowing facilities.
 - Obtaining and reviewing reports of regulatory actions.
 - Determining the adequacy of support for any planned disposals of assets.



Additional Audit Procedures - II

- ❖ Analysis of cash flow forecast prepared by the entity.



- ❖ Request Written Representations from mgt. or, where appropriate, TCWG regarding plans for future action and their feasibility.

SA 570(R)

- ❖ **The Period of Management's Assessment :**

- In addition to the procedures required to evaluate mgt's plans for future actions, the auditor may compare :
 - The prospective financial information for recent prior periods with historical results; and
 - The prospective financial information for the current period with results achieved to date.
- Where management's assumptions include continued support by third parties and such support is important to an entity's ability to continue as a GC, the auditor may need to :
 - consider requesting written confirmation from those third parties; and
 - obtain evidence of their ability to provide such support.

Audit Conclusions and Reporting

- ❖ To conclude whether in Auditor's judgment *material uncertainty* exists which individually/ collectively casts significant doubt on GC assumption.
 - Material uncertainty – Magnitude of potential impact & likelihood of occurrence is such that, in auditor's judgment, appropriate disclosure of nature and implications of uncertainty is necessary for disclosure of true and fair view.

SA 570(R)

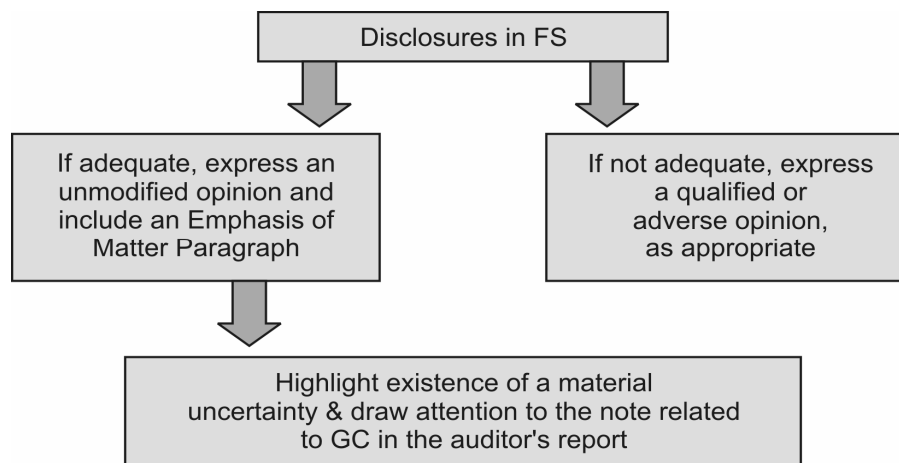


Use of GC assumption appropriate but material uncertainty exists-I

- ❖ Determine whether FS:
 - Adequately describe principal events/conditions that cast significant doubt on entity's ability to continue as GC & Mgt's plans to deal with these events.
 - Disclose clearly that there is material uncertainty.
 - Entity may be unable to realise its assets and discharge its liabilities in the normal course of business.

SA 570(R)

Use of GC assumption appropriate but material uncertainty exists-II



SA 570(R)

- ❖ In situations involving multiple material uncertainties that are significant to the financial statements as a whole, the auditor may consider it appropriate in extremely rare cases to express a disclaimer of opinion instead of adding an Emphasis of Matter paragraph.



Use of GC Assumption Inappropriate

- ❖ If FS prepared on a GC basis but, in auditor's judgment use of GC assumption in FS is inappropriate:
 - Express an adverse opinion.
- ❖ If mgmt required/elects to prepare FS then may be prepared on liquidation basis:
 - Express unmodified opinion along with emphasis of matter paragraph highlighting alternative basis provide disclosure is adequate.

SA 570(R)

Extend Assessment period

- ❖ Failure to obtain SAAE.
- ❖ Management unwilling to extend assessment of entity's ability to continue as GC:
 - Consider implication's for the auditor's report:
 - Qualified opinion or a Disclaimer of opinion.

SA 570(R)

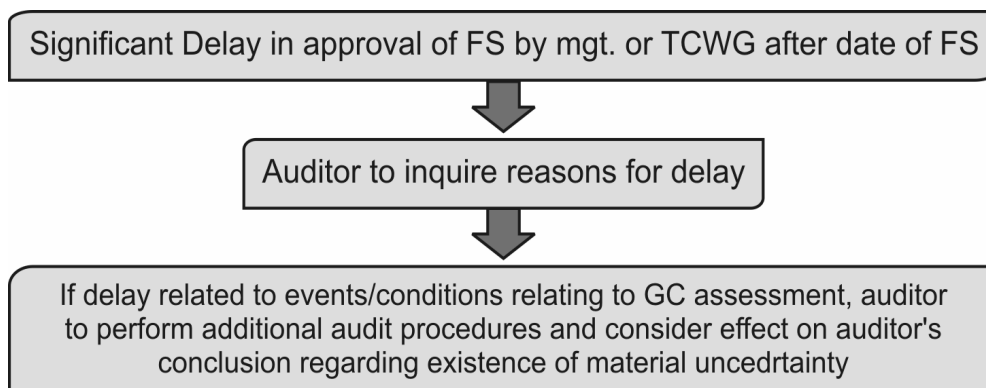


Communication with Those Charged with Governance

- ❖ Unless all TCWG involved in managing entity, communicate with TCWG events/conditions that cast significant doubt on GC assumption:
 - Whether events/ conditions constitute material uncertainty.
 - Whether use of GC assumption appropriate in preparation and presentation of FS.
 - Adequacy of related disclosures in FS.

SA 570(R)

Significant Delay in Approval of FS



SA 570(R)



Revised SA 580

Written Representations

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

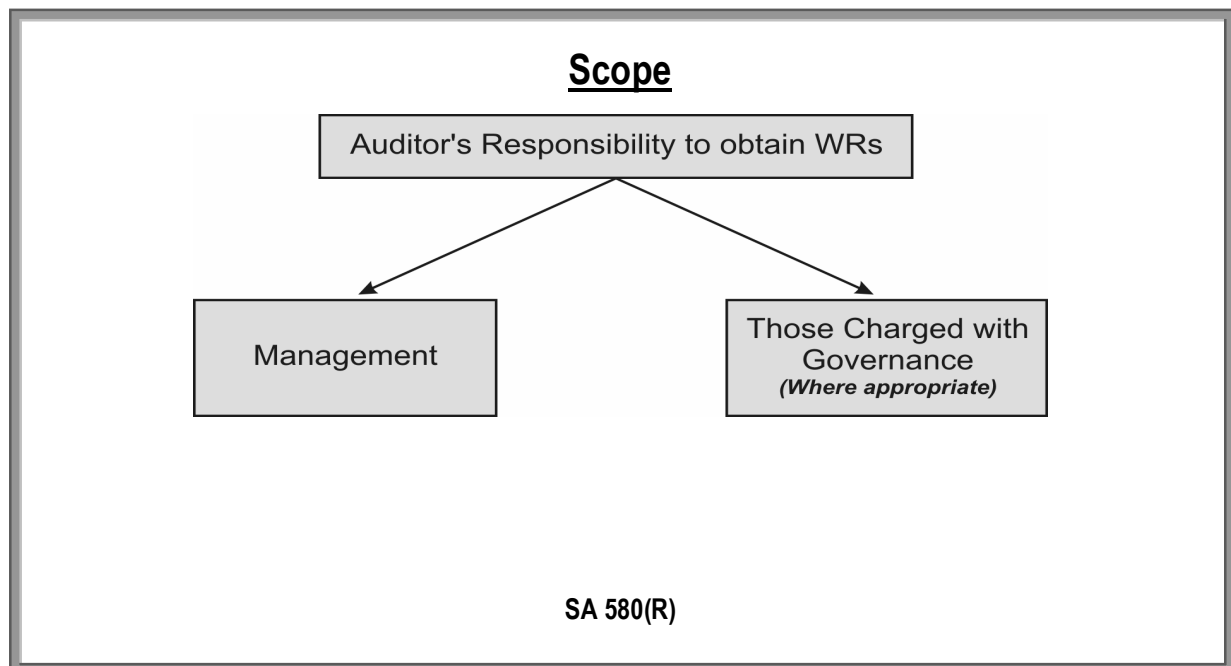
- ❖ Replaces SA 580 (AAS 11), "Representations by Management", issued in February 1996.

Overview of SA 580

- ❖ Introduction
 - Scope
 - Written Representations (WRs) as Audit Evidence
 - Effective Date
- ❖ Objectives
- ❖ Definitions
- ❖ Requirements
 - Management from whom WRs Requested
 - WRs about Management's Responsibilities
 - Other WRs
 - Date of and Period(s) Covered by WRs
 - Form of WRs
 - Doubt as to the Reliability of WRs and Requested WRs Not Provided
- ❖ Application & Other Explanatory Material on these Aspects

SA 580(R)

- ❖ 'R' Stands for Revised.



WRs as Audit Evidence

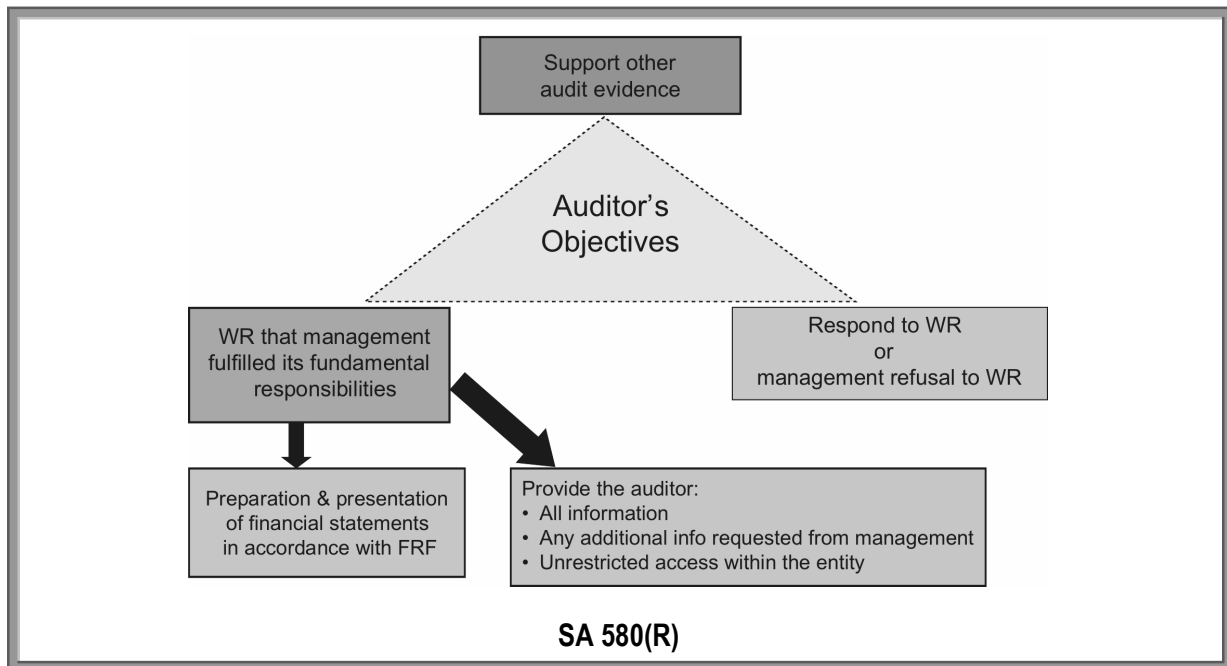
- ❖ WR are audit evidence:
 - but not sufficient appropriate audit evidence.
- ❖ WR do not dilute auditor's responsibility to obtain other audit evidence for matter covered by WR.
- ❖ Management *modifies* or *does not* provide the requested WR => possibility of existence of one or more significant issues.

SA 580(R)

- ❖ WR are necessary information that the auditor requires in connection with the audit of the entity's financial statements.
- ❖ WR will enhance the quality of the representation.



Training Manual on Engagement and Quality Control Standards



- ❖ 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 by him.

Definitions

❖ **Written Representations:**

- written statement by management.
- provided to the auditor.
- to confirm certain matters or to support other audit evidence.
- do not include:
 - financial statements.
 - the assertions therein.
 - supporting books and records.

SA 580(R)



Management from Whom Written Representations Requested-I

Management with:

- ❖ Appropriate responsibilities for the financial statements; **AND**
- ❖ Knowledge of the matters concerned.

(RESPONSIBLE PARTY)

- Depending on the governance structure of the entity and relevant law and regulation.
- Sufficient knowledge of financial reporting process.
- Those charged with governance may also be responsible for the preparation and presentation of the FS.
- Management may approach relevant experts – actuaries, internal counsel, staff engineers.

SA 580(R)

- ❖ Mgt. (rather than TCWG) is often the responsible party, WR may therefore be requested from the entity's chief executive officer and chief financial officer, or other equivalent persons in entities that do not use such titles. In some circumstances, however, other parties, such as TCWG, are also responsible for the preparation and presentation of the FS.

Management from whom Written Representations Requested-II

- ❖ Management's use of "To the best of knowledge & belief" in WR is acceptable.
- ❖ Auditor may request mgt to include in the WR, confirmation that it has made such inquiries as it considered appropriate.

SA 580(R)

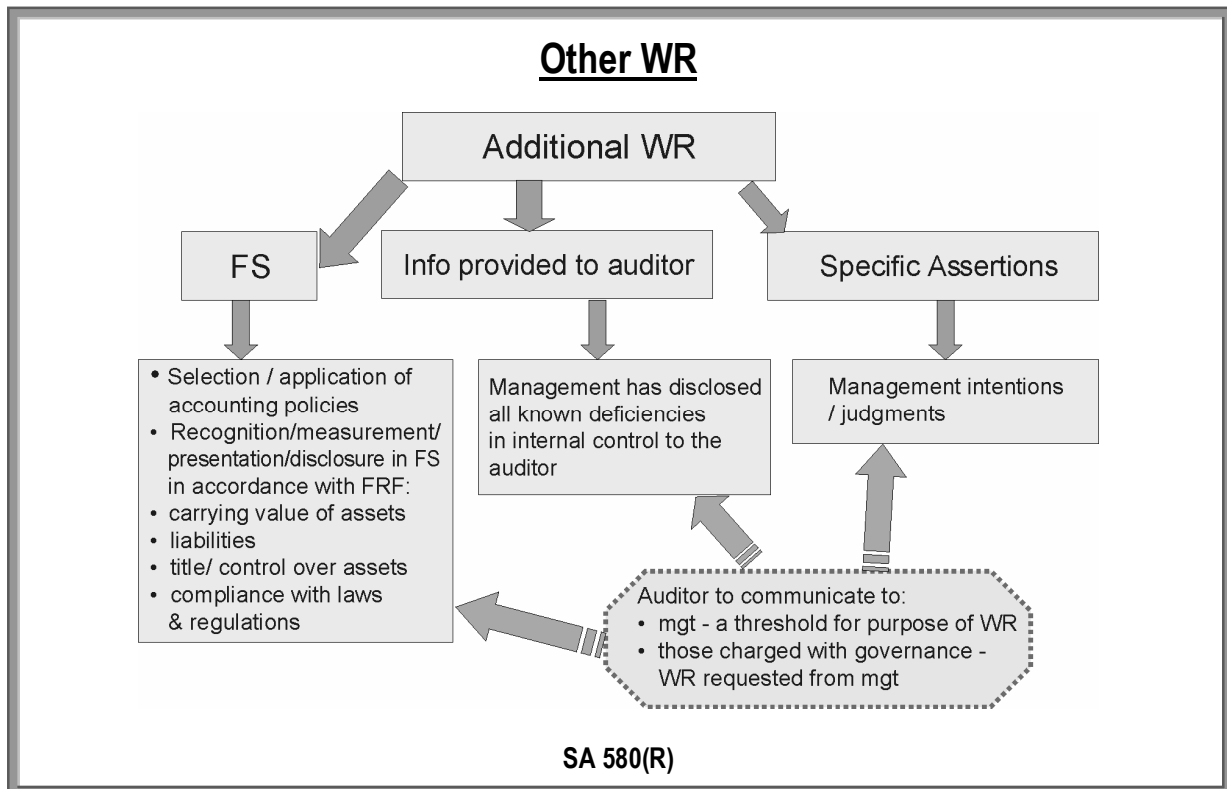


WR about Management's Responsibilities

- ❖ **Preparation & Presentation of FS:**
 - Compliance with applicable FRF.
 - Mention of management responsibility in Audit Engagement Letter not enough.
- ❖ **Information Provided to the Auditor:**
 - Has provided all relevant information agreed in terms of Audit Engagement.
 - All transactions records & reflected in FS.
- ❖ **Description of mgt.'s responsibilities in WR.**

SA 580(R)

- ❖ 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; or
 - The terms of the audit engagement were prepared in a previous year;; or
 - There is any indication that management misunderstands those responsibilities; or
 - Changes in circumstances make it appropriate to do so.



- ❖ **WR about Specific Assertions.**
- ❖ When obtaining evidence about, or evaluating, judgments and intentions, the auditor may consider one or more of the following:
 - The entity's past history in carrying out its stated intentions.
 - The entity's reasons for choosing a particular course of action.
 - The entity's ability to pursue a specific course of action.
 - The existence or lack of any other information that might have been obtained during the course of the audit that may be inconsistent with management's judgment or intent.



Training Manual on Engagement and Quality Control Standards

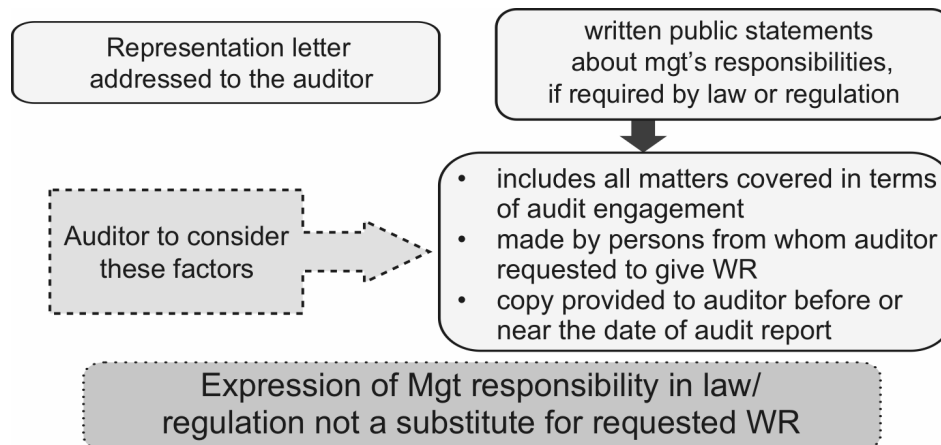
Date of and Period(s) Covered by WR

- ❖ As near as practicable to, **but not after the date** of the auditor's report.
- ❖ For all FS and **period(s)** referred to in the **auditor's report**.
- ❖ Change in management does not diminish their responsibilities for the FS as a whole and the auditor can request from new management a WR that cover the whole of the relevant period(s).

SA 580(R)

- ❖ If WR obtained about a specific assertion in the FS during the course of the audit, request for an updated WR.
- ❖ WR are for all periods referred to in the auditor's report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate.

Form of WR

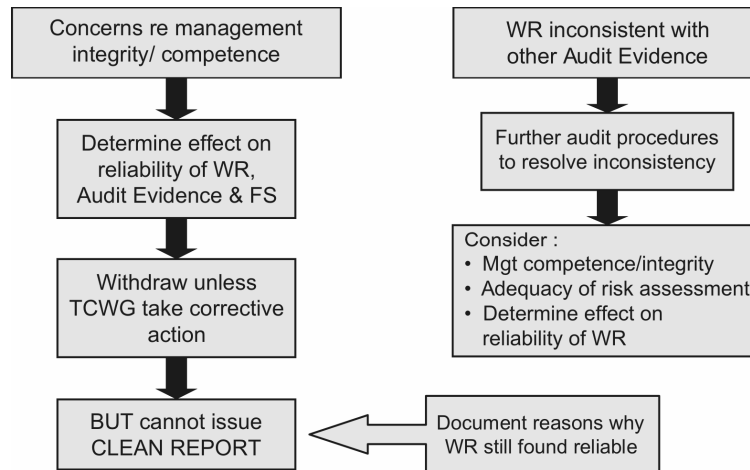


SA 580(R)

- ❖ Matters covered by public statement need not to be covered by the WR.



Doubt on Reliability of WR



SA 580(R)

Requested WR not Provided

- ❖ Discuss matter with management.
- ❖ Re-evaluate integrity of management.
- ❖ Evaluate effect on reliability of representations & audit evidence.
- ❖ Take appropriate actions.

SA 580(R)



WR About Management Responsibility

Disclaimer of an opinion if :

- ❖ Sufficient doubt about the integrity of mgt such that the WR are not reliable:
 - Preparation & presentation of FS.
 - Info to be provided to auditor.
- ❖ Mgt does not provide WR for above aspects.

SA 580(R)

600 – 699: Using Work of Others

- ❖ SA 600 – Using the Work of Another Auditor.
- ❖ SA 610 – Relying Upon the Work of an Internal Auditor.
- ❖ SA 620 – Using the Work of an Expert.



SA 600

Using the Work of Another Auditor

*Effective for all audits relating to accounting periods beginning on or after
April 1, 2002*

❖ Issued in September, 2002.



Training Manual on Engagement and Quality Control Standards

Introduction

- ❖ Genesis SA 200 (para 9).
- ❖ Establishes standards for application in situations where uses the work of another auditor.
- ❖ Does not cover:
 - Joint audits.
 - Relationship with predecessor auditor.
- ❖ Consider how other auditor's work affects the audit.

SA 600

- ❖ SA 200 states as follow :

"When the auditor delegates work to assistants or uses work performed by other auditors and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. In the case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, such as in the case of the work of branch auditors appointed under the Companies Act, 1956 the auditor's report should expressly state the fact of such reliance".
- ❖ Work of the other auditor may relate to financial information of one or more components included in the financial information of the entity.
- ❖ SA 600 not applicable if principal auditor concludes that financial information of the component is immaterial.



Definitions

- ❖ *Principal Auditor (PA)*: Auditor responsible for financial information (FI) of an entity when it includes FI of one or more components audited by another auditor.
- ❖ *Other Auditor (OA)*: Auditor, other than PA, who is responsible for reporting on FI of a component which is included in FI audited by the PA.
- ❖ *Component* : Division, branch, subsidiary, joint venture, associated enterprise or any other entity whose FI is included in FI audited by PA.

SA 600



PA's Procedures

- ❖ Consider the professional competence of OA, if OA is not a member of ICAI.
- ❖ Visit to component and examine books of account, if essential.
- ❖ Obtain sufficient appropriate evidence, that work of OA is adequate for PA's purposes.
- ❖ Discuss audit procedures applied by OA.
- ❖ Review a written summary of OA's procedure and findings through questionnaires/ checklist.
- ❖ Consider significant findings of OA:
 - to discuss audit findings with OA.
 - supplemental tests if necessary.
 - in case OA is not a professionally qualified auditor-for instance, where a component is situated in foreign country.

SA 600

- ❖ Normally PA entitled to rely on the work of OA unless special circumstances make it essential to visit the component and examine the books of accounts. In certain situations, the right to visit a component may be conferred by the statute governing the entity.
- ❖ Areas requiring special consideration include:
 - identification of inter-component transactions.
 - time-table for completion of audit.
- ❖ Sufficient appropriate audit evidence:
 - inform OA about the use of work.
 - coordination of efforts at planning stage.
 - advise OA of significant accounting, auditing and reporting requirements, obtain representation as to compliance with them.



Documentation

- ❖ Components whose FS are audited by OA.
- ❖ Significance to the financial information of the entity as a whole.
- ❖ Names of the other auditors.
- ❖ Any conclusions reached that individual components are not material.
- ❖ Procedures performed regarding that component.
- ❖ Conclusions reached.
- ❖ Manner of dealing with Modified Report while finalising PA's Report.

SA 600

Co-ordination Between Auditors

- ❖ Sufficient liaison/co-ordination between PA and OA.
- ❖ PA may require OA to answer a detailed questionnaire.
- ❖ OA should coordinate with PA:
 - adhering to time-table.
 - any significant finding by bringing it to the attention of PA.
 - compliance with relevant statutory requirements.
 - respond to detailed questionnaire.

SA 600



Reporting Considerations

- ❖ Express a qualified/disclaimer of opinion because of scope limitation:
 - if PA concludes that he cannot use the work of OA; and
 - PA unable to perform sufficient additional procedures regarding FI of the component audited by OA.
- ❖ Report should state clearly division of responsibility between PA and OA.

SA 600

- ❖ The division of responsibility should be stated by indicating extent to which FI of components audited by OA have been included in FI of the entity.



SA 610

Relying upon the Work of an Internal Auditor

*Effective for all audits relating to accounting periods beginning on or after
April 1, 1989*

- ❖ Issued in January, 1989.

Introduction

- ❖ Internal audit is an integral part of internal controls.
- ❖ Establishes standards as to the procedures to be applied by the external auditor in assessing the work of the internal auditor for the purpose of placing reliance upon that work.

SA 610

- ❖ The Companies (Auditor's Report) Order, 2003 requires the external auditor to report as follows:
 - *In the case of listed companies and/or other companies having a paid up capital and reserves exceeding Rs.50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crores rupees for a period of three consecutive financial years immediately preceding the financial year concerned, whether the company has an internal audit system commensurate with its size and nature of its business. [Paragraph 4(vii)].*
- ❖ External Auditor (EA) has sole responsibility for his report and determination of nature, timing and extent of audit procedures, much of the work of internal audit function may be useful to him.



Scope & Objectives of IA Function

- ❖ Dependent upon size, structure of entity and requirements of management.
- ❖ Normal scope of internal audit:
 - review of accounting system and related internal controls.
 - examination for management of financial and operating information.
 - examination of economy, effectiveness and efficiency of operations including non-financial controls of an organisation.
 - physical examination and verification.

SA 610

- ❖ The management is responsible for the establishment and review of an adequate accounting and internal control system which need proper attention on continuous basis.

Relationship Between IA & EA

- ❖ IA's:
 - role determined by management.
 - prime objective differs from EA.
 - cannot be expected to have same degree of independence.
- ❖ EA should evaluate the internal audit function.
- ❖ Report of EA is his sole responsibility.

SA 610

- ❖ Evaluation of the internal audit function by EA may be useful in determining the nature, timing and extent of his compliance and substantive procedures.
- ❖ Responsibility of the external auditor is not reduced by any means because of the reliance he places on IA's work.



General Evaluation of IA Function

- ❖ Important aspects:
 - Organisational status – performed by inside or outside agency, reporting to highest level of management, freedom of communication with EA.
 - Scope of function – nature and coverage of assignment, action by management on recommendations of IA.
 - Technical competence – performed by persons having adequate training and proficiency.
 - Due professional care – properly planned, supervised, reviewed and documented.

SA 610

Coordination with IA

- ❖ Discuss with IA his tentative plan for the year to determine the areas on which EA can place reliance upon his work.
- ❖ Where IA's work is a factor in determining EA's audit procedures then plan in advance:
 - timing of, extent of audit coverage, test levels, documentation of work performed, review and reporting procedures.
- ❖ Develop effective co-ordination by:
 - holding meetings at appropriate intervals.
 - inform any significant matter that comes to attention and which may affect work of the other auditor.

SA 610



Evaluating Specific Internal Audit Work

- ❖ Factors:
 - IA's scope of work and related audit programme.
 - proper planning, supervision, review of work.
 - sufficiency and appropriateness of evidence reports prepared consistent with results of work performed.
 - any exceptions or unusual matters disclosed by IA.
- ❖ EA should test the work of IA on which he intends to rely:
 - materiality of area concerned to FS taken as whole.
 - results of evaluation of internal audit function and of specific internal audit work.

SA 610

SA 620

Using the Work of an Expert

*Effective for all audits relating to accounting periods beginning on or after
April 1, 1991*

- ❖ Issued in December, 1991.



Introduction

- ❖ Deals with the auditor's responsibility in relation to, using the work of an expert.
- ❖ **Expert** – Person, firm, etc. possessing special skill, knowledge & experience other than in accounting and auditing:
 - engaged/employed by client.
 - engaged/employed by auditor.
- ❖ Employee Expert – Expert, not Assistant.

SA 620

- ❖ Use of expert, examples:
 - Valuation of certain types of assets.
 - Determination of quantities/physical condition of assets.
 - Specialised techniques for determining amounts, e.g., Actuarial valuation.
 - Measurement of contract performance.
 - Legal opinions concerning interpretation of statutes, agreements, notifications, etc.

Considerations

- ❖ When to use expert's work:
 - materiality of item.
 - nature and complexity of item.
 - other audit evidence available.
- ❖ Consider expert's skill and competence.
- ❖ Consider objectivity of expert.

SA 620

- ❖ There is no need to assess the skills & competence of the expert if the expert is an employee of the auditor.
- ❖ The auditor should consider the objectivity of the expert. The risk increases when expert is:
 - employed by the client.
 - related in some other manner to the client.



Evaluation of Expert's Work - I

- ❖ Examine evidence to gain knowledge regarding terms of the expert's engagement and other matters as:
 - objective and scope of expert's work.
 - outline of specific items in expert's report.
 - confidentiality of expert's work/client's information used.
 - relationship between expert and client.

SA 620

Evaluation of Expert's Work - II

- ❖ Appropriateness of source data:
 - discussions with expert as to sufficiency, relevance, reliability of the source data.
 - audit tests of data.
- ❖ Appropriateness of assumptions and methods:
 - expert's responsibility.
 - understand the assumptions and methods used by an expert and assess the reasonableness of those assumptions.
- ❖ Inconsistency of expert's work:
 - discuss with the client and expert and also apply additional procedures, if necessary.

SA 620



Reporting Responsibilities

- ❖ Express qualified/adverse or disclaimer of opinion:
 - if inconsistency with information in financial statements or does not constitute sufficient appropriate audit evidence.
- ❖ Reference to Expert's work in Report:
 - don't make if opinion unqualified.
 - in other cases, consider reference but obtain permission.

SA 620

700 – 799: Audit Conclusions & Reporting

- ❖ SA 700 – The Auditor's Report on Financial Statements
- ❖ SA 710 – Comparatives



SA 700

The Auditor's Report on Financial Statements

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

- ❖ Issued in January, 2003.

Introduction

- ❖ Establishes standards on form & content of auditor's report on financial statements.
- ❖ Review & assess conclusions drawn from the audit evidence.
- ❖ Auditor's report to contain a clear written expression of opinion on FS taken as a whole.

SA 700



Basic Elements of Auditor's Report

- ❖ Title.
- ❖ Addressee.
- ❖ Opening or Introductory paragraph.
- ❖ Scope paragraph.
- ❖ Opinion paragraph.
- ❖ Date of the report.
- ❖ Place of signature.
- ❖ Auditor's signature.

SA 700

- ❖ Auditor's Report should have appropriate title to distinguish it from any other report(s) issued by the auditor, officers of the entity, board of directors or others.
- ❖ Addressee – report should be appropriately addressed as required by the circumstances of the engagement and applicable laws and regulations. Ordinarily the report is addressed to the appointing authority.

Opening Paragraph

- ❖ Identify FS been audited:
 - date and period covered.
- ❖ Statement that FS are responsibility of management and auditor expresses an opinion based on the audit.

SA 700



Scope Paragraph

- ❖ Statement that audit conducted in accordance with GAAS in India.
- ❖ Statement that audit was planned and performed to obtain reasonable assurance that FS are free of material misstatements.
- ❖ Describe the audit as including:
 - examining, on test basis, evidence to support amounts and disclosures in FS.
 - assessing accounting principles used in the preparation of the FS.
 - assessing significant estimates made by management.
 - evaluating overall FS presentation.
- ❖ Statement that audit provides a reasonable basis for auditor's opinion.

SA 700

- ❖ Scope refers to the auditor's ability to perform audit procedures deemed necessary in the circumstances.
- ❖ Scope of an audit of FS normally determined by auditor having regards to terms of the engagement, requirements of relevant legislation and pronouncement of ICAI.

Opinion Paragraph

- ❖ Indicate financial reporting framework used.
- ❖ State whether FS give a true and fair view in accordance with the financial reporting framework:
 - Accounting Standards (AS)–ICAI.
 - Recognised accounting principles, practices & guidance notes by ICAI.
- ❖ FS comply with statutory requirements:
 - Companies Act 1956 & other applicable laws.

SA 700



Date and Signature

- ❖ Date of auditor's report is date on which auditor signs report expressing an opinion.
- ❖ Auditor should not date the report earlier than the date on which FS are signed or approved by the management.
- ❖ Report should name city where report is signed.
- ❖ Signed by the auditor in personal name.
- ❖ If firm appointed then also in the name of the firm.
- ❖ Membership number of auditor.

SA 700



Types of Reports

- ❖ Unmodified Report.
- ❖ Modified Report.
 - considered modified when includes:
 - matters that do not affect auditor's opinion.
 - matters that do affect auditor's opinion:
 - ✓ qualified opinion.
 - ✓ disclaimer of opinion.
 - ✓ adverse opinion.

SA 700

Unqualified opinion

- ❖ Concludes that the FS gives a true and fair view in accordance with the financial reporting framework. It indicates that:
 - FS prepared in accordance with GAAP.
 - FS comply with statutory requirements and regulations.
 - FS disclose all material matters relevant to proper presentation.
 - FS meet all applicable statutory requirements.

SA 700



Modified Reports

- ❖ Considered modified when includes:
 - matters that do not affect auditor's opinion:
 - emphasis of matter.
 - matters that do affect auditor's opinion:
 - qualified opinion.
 - disclaimer of opinion.
 - adverse opinion.
- ❖ Uniformity in form and content of each type of modified report for understandability.
- ❖ AAS includes suggested wordings and examples of modifying phrases for use.

SA 700

Matters that Do Not Affect Opinion

- ❖ Emphasis of matter paragraph to highlight a matter included in note to FS.
- ❖ Modify report to highlight matters:
 - if going concern question not resolved and adequate disclosures have been made in FS.
 - significant uncertainty the resolution of which depends upon future events, i.e., matter whose outcome depends on future actions/events not under direct control of entity, but which may affect FS.

SA 700



Matters that Do Affect Opinion

- ❖ Not able to express an unqualified opinion if following circumstances exist & in auditor's judgment the effect is material on FS:
 - limitation on scope (qualified/ disclaimer of opinion).
 - disagreement with management on:
 - acceptability of accounting policies and method of their application.
 - adequacy of financial statement disclosures (qualified/adverse opinion).

SA 700

Affect on Auditor's Opinion - I

- ❖ Qualified opinion:
 - unqualified opinion cannot be expressed but effect of any disagreement with management is not so material and pervasive.
 - should be expressed as being 'subject to' or 'except for'.
- ❖ Disclaimer of opinion:
 - possible effect of a limitation on scope so material and pervasive that auditor has not been able to obtain sufficient appropriate audit evidence, accordingly, unable to express an opinion.

SA 700



Affect on Auditor's Opinion - II

- ❖ Adverse opinion:
 - effect of disagreement so material and pervasive to F/S that auditor concludes that a qualification is not adequate to disclose misleading/incomplete nature of F/S.
- ❖ In all cases of opinion that is other than unqualified:
 - clear description of all substantive reasons to be included in report.
 - quantification of the possible effects, individually and in aggregate on FS. If not possible to quantify accurately then on the basis of estimates by management.

SA 700

Scope limitation

- ❖ If limitation on scope that requires qualified/disclaimer of opinion then:
 - describe the limitation.
 - indicate possible adjustments to FS that might have been determined to be necessary had the limitation not existed.
- ❖ If disagreements with management material:
 - pertaining to selection/application of accounting policies or adequacy of disclosures.
 - express a qualified or an adverse opinion.

SA 700



SA 710

Comparatives

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

❖ Issued in September, 2002.

Introduction

- ❖ Establishes standards on the auditor's responsibilities regarding comparatives.
- ❖ Auditor should determine whether the comparatives comply, in all material respects, with the relevant financial reporting framework.
- ❖ Does not deal with situations where summarised FS or data are presented with audited FS.

SA 710



F/S Presentation Methods

Corresponding figures	Comparative F/S
➤ Where figures are part of current F/S but not as stand alone. ➤ Integral part of current period F/S. ➤ Auditor's report only refers to F/S of current period. ➤ Covered in AAS 25.	➤ Presented for comparison, not part of current period F/S. ➤ Auditor's report refers to each period that F/S are presented. ➤ Not covered in AAS 25.

SA 710

- ❖ This SA establishes standard on the auditor's responsibilities for comparatives and for reporting for 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 present in India. Appendix 1 to this SA discusses these different reporting frameworks.

Auditor's Responsibilities

- ❖ Obtain sufficient appropriate audit evidence that corresponding figures meet requirement of the relevant Financial Reporting Framework (FRF).
- ❖ Limited to ensuring that corresponding figures have been correctly reported and appropriately classified.
- ❖ Possible material misstatement in corresponding figures, perform additional procedures.

SA 710

- ❖ Auditor should assess whether:
 - Consistent application of accounting policies has been made.
 - Corresponding figures agree with amounts and other disclosures presented in prior period.
 - Appropriate adjustments and/or disclosures have been made.



Reporting - I

- ❖ Report not to specifically identify comparatives because opinion on the current period FS as a whole, including the corresponding figures.
- ❖ If a matter that caused prior period report to be qualified/adverse or disclaimer, is unresolved:
 - and results in modification of current period report, current period report should also be modified regarding corresponding figures.
 - but does not result in modification of current period report, current period report should only be modified regarding corresponding figures.

SA 710

- ❖ Illustrative audit reports for the above mentioned situations are given in Appendix II to SA 710.

Reporting - II

- ❖ Material misstatement in prior period FS, examine that:
 - appropriate disclosures have been made.
 - if not, issue modified report on current period financials modified with respect to corresponding figures included therein.
 - if prior period FS not audited, state in report that corresponding figures are unaudited.
- ❖ Incoming auditor may include the emphasis on the prior period resolved modification if material to the current period.

SA 710

- ❖ When the prior period FS are not audited, the incoming auditor should state in his report that corresponding figures are unaudited, but it does not relieve auditor of the requirement to perform appropriate procedures regarding opening balances of the current period.



Standards on Review Engagements (SREs)



SRE 2400

Engagements to Review Financial Statements

Effective for all review engagements relating to accounting periods beginning on or after April 1, 2005.

- ❖ Issued in March, 2005.

Introduction

- ❖ Establishes standards on:
 - professional responsibilities when engagement to review FS undertaken.
 - form and content of report.
- ❖ Applicable to engagements to review financial or other related information also like interim financial statements pursuant to AS 25.
- ❖ Opinion in the form of negative assurance.

SRE 2400

- ❖ Negative assurance – 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.



General Principles

- ❖ Comply with the *Code of Ethics* issued by ICAI.
- ❖ Conduct a review in accordance with this AAS.
- ❖ Attitude of professional skepticism.
- ❖ Obtain sufficient appropriate evidence primarily through inquiry and analytical procedures for expression of negative assurance.

- ❖ Ethical Principles are:
 - independence;
 - integrity;
 - professional competence and due care;
 - confidentiality;
 - objectivity;
 - professional conduct; and
 - technical standards.



Scope of a Review

- ❖ Procedures determined by:
 - requirements of this AAS.
 - relevant legislation and regulation.
 - terms of review engagement.
 - reporting requirements.
- ❖ Provides moderate level of assurance that information subject to review free of material misstatement.
- ❖ Scope substantially narrower as compared to audit.

SRE 2400

Terms of Engagement

- ❖ Auditor and client should agree on terms of engagement.
- ❖ Contents of engagement letter:
 - objective of service.
 - management's responsibility for FS.
 - scope of review, including reference to SRE 2400.
 - unrestricted access to records/ documentation/ other information requested.
 - engagement cannot be relied upon to disclose errors, violation of laws or other irregularities.
 - audit is not being performed and audit opinion will not be expressed.

SRE 2400



Planning & Documentation

- ❖ Plan work:
 - obtain or update knowledge of the business including consideration of entity's organisation.
 - accounting systems, Operating characteristics.
 - nature of assets, liabilities, revenues, expenses.
- ❖ Satisfy that work performed by others is adequate for the purpose of review.
- ❖ Document matters providing evidence to support review report and that review was carried out in accordance with SRE 2400.

SRE 2400

Procedures-I

- ❖ Apply judgement in determining specific nature, timing, extent of review procedures.
- ❖ Apply same materiality considerations as would be applied if an opinion on FS is given.
- ❖ Procedures ordinarily include:
 - inquiries concerning the entity's accounting principles, policies and practices.
 - inquiries concerning the entity's procedures for recording, classifying, etc.
 - inquiries concerning all material assertions.
 - analytical procedures designed to identify relationships, individual items that appear unusual.

SRE 2400

- ❖ Reference may be made to Appendix 2 of SRE 2400, on "Illustrative Detailed Procedures that may be performed in an Engagement to Review Financial Statements".



Procedures-II

- ❖ Inquire about events subsequent to the balance sheet date that may require adjustment/disclosure in FS.
- ❖ If information materially misstated, carry out necessary additional or more extensive procedures.

SRE 2400

- ❖ In applying procedures consider matters requiring adjustments in prior periods:
 - inquiries concerning actions taken at meetings.
 - reading FS to conform basis of accounting.
 - obtaining reports from other auditors.
 - inquiries of persons having responsibility for financial and accounting matters.
 - obtaining written representations.

Conclusions and Reporting

- ❖ Clear written expression of negative assurance.
- ❖ Elements of review report:
 - title, addressee.
 - opening or introductory paragraph.
 - scope paragraph.
 - statement of negative assurance.
 - date of report, place.
 - auditor's signature and membership number.

SRE 2400

- ❖ Opening or introductory paragraph of review report - Identification of FS under review, Statement of the responsibility of the entity's management and also of the auditor.
- ❖ Scope Paragraph of review report:
 - reference to this AAS and other relevant laws or regulations.
 - statement that review limited primarily to inquiries and analytical procedures.
 - statement that an audit has not been performed, procedures undertaken provide less assurance.
- ❖ Reference may be made to Appendix I of SRE 2400 for the example of an Engagement Letter for a Review of Financial Statements.



Review Report Contents

- ❖ Express negative assurance if matters have come to attention; describe those matters that impair a true and fair view and either:
 - express a qualification of the negative assurance provided, or
 - express adverse opinion when the effect of the matter is material and pervasive to FS.
- ❖ If a material scopes limitation then either:
 - qualification of the negative assurance; or
 - possible effect of limitation is so significant and pervasive that auditor concludes that no assurance can be provided.
- ❖ Date of review report – Not earlier than the date when FS are signed or approved by management.

SRE 2400

- ❖ Date the review report as of date review completed, i.e., date of signing of report.
- ❖ Should not agree to a change of engagement if there is no reasonable justification. If change not agreeable and not permitted to continue original engagement then:
 - Withdraw from the engagement, and
 - Consider obligation to report circumstances to other parties, such as the board of directors or shareholders.
- ❖ Reference may be made to Appendix 3 of SRE 2400 for form of Unqualified Review Report.
- ❖ Reference may be made to Appendix 4 for the illustrative examples of Review Reports other than Unqualified.



Standards on Assurance Engagements (SAEs)



SAE 3400

The Examination of Prospective Financial Information (PFI)

*Effective in relation to reports on projections / forecasts issued on
or after April 1, 2007.*

❖ Issued in February, 2007.



Training Manual on Engagement and Quality Control Standards

SAE 3400

- ❖ Establishes standards on engagements to examine and report on:
 - PFI.
 - examination procedures for best estimate and hypothetical assumptions.
- ❖ PFI can be in the form of forecast or projection or combination of both.
- ❖ Not applicable to examination of PFI expressed in general or narrative terms.

SAE 3400

- ❖ Effective in relation to reports on projections/forecasts, issued on or after April 1, 2007.
- ❖ Reference may be made to Clause (3) of Part I of the Second Schedule to the Chartered Accountants Act, 1949. A Chartered Accountant can participate and review the financial forecasts/projections, provided the report clearly mention:
 - source of the information.
 - basis of forecasts.
 - major assumption made.
 - does not vouch for accuracy.
- ❖ A "*forecast*" means prospective financial information prepared on the basis of assumptions as to future events which management expects to take place and the actions management expects to take as of the date the information is prepared (best-estimate assumptions).
- ❖ A "*projection*" means prospective financial information prepared on the basis of:
 - hypothetical assumptions about future events and management actions which are not necessarily expected to take place, such as when some entities are in a start-up phase or are considering a major change in the nature of operations; or
 - a mixture of best-estimate and hypothetical assumptions.
- ❖ PFI can include FS or one or more element of FS and may be prepared as:
 - internal management tool.
 - distribution and submission to third party.
 - potential investors, shareholders, lenders.



PFI Audit Evidence

- ❖ Obtain sufficient appropriate evidence on:
 - reasonableness of management's best-estimate assumptions.
 - hypothetical assumptions are consistent with the purposes of information.
 - PFI prepared properly on basis of assumptions.
 - properly presented and adequate disclosure of all material assumptions.
 - consistent with historical financial statements.

SAE 3400

Acceptance of Engagement

- ❖ Before accepting engagement consider:
 - the intended use of the information.
 - information - general or limited distribution.
 - the nature of the assumptions, i.e. best-estimates or hypothetical assumptions.
 - the elements to be included in information.
 - the period covered by information.
- ❖ Not accept or withdraw from engagement if:
 - assumptions are clearly unrealistic.
 - believes that the PFI will be inappropriate for its intended use.

SAE 3400

- ❖ 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.



Knowledge of Business

- ❖ Obtain sufficient level of knowledge of business to evaluate all significant assumptions:
 - internal controls over the system.
 - documentation supporting management's assumptions.
 - extent to which statistical, mathematical and computer-assisted techniques used.
 - methods used to develop and apply assumptions.
 - accuracy of PFI prepared in prior periods.
- ❖ Consider the extent to which reliance on the entity's historical financial information is justified.

SAE 3400

Period Covered

- ❖ Consider the period of time covered:
 - more Length- Assumptions More Speculative.
 - not extend beyond the time for which management has reasonable basis for assumption.
- ❖ Relevant Factors:
 - operating cycle.
 - degree of reliability of assumptions.
 - needs of users like, prepared in connection with application for loan or for issue of securities.

SAE 3400



Examination Procedures-I

- ❖ Factor in determination of nature, timing, extent of examination procedures:
 - knowledge obtained during previous engagements.
 - management's competence.
 - likelihood of material misstatement.
 - extent to which PFI is affected by the management's judgment.
 - sources of information.
 - stability of entity's business.
 - engagement team's experience.

SAE 3400

Examination Procedures-II

- ❖ When hypothetical assumptions used:
 - all significant assumptions taken into consideration.
 - consistent with purpose and realistic.
- ❖ Focus on areas sensitive to variation and material.
- ❖ If engagement for individual component, consider interrelationship of other components.
- ❖ Obtain written management representations regarding intended use of PFI/
Completeness of assumptions/responsibility for PFI.

SAE 3400

- ❖ Examples of external sources are government publications, industry publications, economic forecast, existing or proposed legislation, and reports of changing technology.
- ❖ Examples of internal sources are budgets, the economic substance and viability of the entity and/or transaction or project of the entity, reputation of management responsible for assumptions underlying the prospective financial information, wage agreements, patents, royalty agreements and records, sales backlog records, debt agreements, and actions of the board of directors involving entity plans, etc.



Presentation and Disclosure

- ❖ Requirements of statutes, regulations and professional pronouncements and other factors:
 - presentation is informative and not misleading.
 - accounting policies and assumptions are clearly disclosed in the notes.
 - date of preparation is properly disclosed.
 - basis of establishing points in a range is clearly indicated.
 - adequacy of disclosure if any change in the accounting policy.

SAE 3400

Documentation

- ❖ Document matters important in providing evidence that such examination was carried out in accordance with this AAS.

SAE 3400

- ❖ Working papers includes:
 - sources of information.
 - basis of forecasts and assumptions made in arriving forecasts.
 - hypothetical assumptions and supporting evidence.
 - management representations and acceptance of its responsibility.
 - audit plan and nature, timing and extent of examination procedures performed.
 - in case auditor expresses a modified opinion or withdraws, reasons of such decision.



Reporting-I

- ❖ The report of the Auditor should contain the following:
 - title and Addressee.
 - identification of the prospective financial information.
 - reference to applicable AAS.
 - management responsibilities.
 - when applicable, a reference to purpose and/or restricted distribution.
 - statement that examination procedures included examination, on a test basis.
 - statement of negative assurance.
 - properly prepared on basis of assumptions and presented in accordance with relevant financial reporting framework.
 - appropriate caveats concerning achievability of results.
 - date/place and signature.

SAE 3400

Reporting-II

- ❖ Qualified/Adverse opinion or withdraw from the engagement, if the auditor believes that:
 - presentation and disclosure is not adequate.
 - one or more significant assumptions do not provide a reasonable basis:
 - prepared on the basis of best-estimate, or
 - given the hypothetical assumptions.
- ❖ Disclaimer of opinion or withdraw from the engagement, when:
 - examination is affected by conditions that preclude application of one or more procedures considered necessary in the circumstances.

SAE 3400

- ❖ Reference may be made to Appendix I of SAE 3400 for the illustrative format of an Unqualified Review Report.
- ❖ Reference may be made to Appendix II of SAE 3400 for the examples of Review Reports other than Unqualified.



Standards on Related Services (SRSs)



SRS 4400

Engagements to Perform Agreed- upon Procedures regarding Financial Information

Effective for all agreed upon procedures engagements beginning on or after April 1, 2004.

❖ Issued in April, 2004.

Introduction

- ❖ Establishes standards on the auditor's professional responsibilities with regard to:
 - perform AUP on FI.
 - form & Content of report of AUP engagements.
- ❖ Report of factual findings based on:
 - specified procedures performed on specified subject matter of special elements, accounts or items of FS.

SRS 4400

❖ May provide guidance for engagements to perform AUP regarding non FI.



Training Manual on Engagement and Quality Control Standards

Objectives

- ❖ To carry out procedures of audit nature to which the auditor, the entity and any appropriate third parties have agreed.
- ❖ To report on factual findings.
- ❖ Restricted circulation may be made available to wider range of entities/individuals.

SRS 4400

- ❖ No assurance is expressed in the report of the auditor and hence users assess for themselves the procedures and findings and draw their own conclusions from the work done by the auditor.

General Principles

- ❖ Comply with *Code of Ethics* issued by ICAI.
- ❖ Where the auditor is not independent, a statement to that effect should be made in the report of factual findings.
- ❖ Conduct AUP engagement in accordance with this AAS and terms of engagement.

SRS 4400

- ❖ Ethical principles:
 - Integrity, Objectivity;
 - Professional competence and due care;
 - Confidentiality;
 - Professional conduct; and
 - Technical standards.



Defining Terms of Engagement-I

- ❖ Ensure that there is clear understanding of agreed procedures, conditions of engagement with:
 - representatives of entity.
 - other specified parties who will receive copies of report of factual findings.
- ❖ Matters agreed includes:
 - nature of engagement.
 - stated purpose for engagement.
 - identification of FI to which AUP applied.
 - nature, timing and extent of the specific procedures to be applied.
 - limitations on distribution of report.

SRS 4400

Defining Terms of Engagement-II

- ❖ Send engagement letter:
 - listing of procedures to be performed.
 - restrictions on distribution of report.
- ❖ If procedures agreed between regulator/industry representatives then auditor may not be able to discuss procedures with all parties who will receive report.

SRS 4400

- ❖ Refer to Appendix I of SRS 4400 for an example of an engagement letter.



Planning and Documentation

- ❖ Plan the work so that an effective engagement will be performed.
- ❖ Document matters which are important in providing evidence:
 - to support the report of factual findings.
 - that engagement was carried out in accordance with this AAS and terms of engagement.

SRS 4400

Procedures and Evidence

- ❖ Perform AUP and use the evidence obtained as basis for report of factual findings.
- ❖ Procedures applied include:
 - inquiry and analysis.
 - recomputation, comparison and other clerical accuracy checks.
 - observation.
 - inspection.
 - obtaining confirmations.

SRS 4400

- ❖ Refer to Appendix II of SRS 4400 for an illustrative list of procedures which may be used as one part of a typical AUP procedures engagement.



Reporting-I

- ❖ Describe the purpose and agreed-upon procedures of engagement.
- ❖ Report of factual findings should contain:
 - title and Addressee.
 - identification of specific FI/ non-FI to which AUP have been applied.
 - statement that procedures performed were those agreed upon with recipient.
 - statement that engagement performed in accordance with AAS applicable to AUP engagements.

SRS 4400

- ❖ The report on agreed-upon procedures needs to describe the purpose and agreed-upon procedures of engagement in sufficient detail to enable reader to understand nature and extent of work performed, and it should be clearly mentioned that no audit/review has been performed.

Reporting-II

- ❖ Identification of the purpose of AUP.
- ❖ Listing of specific AUP performed.
- ❖ Description of factual findings including sufficient details of errors and exceptions found.
- ❖ Statements that procedures performed do not constitute either an audit or a review and as such, no assurance is expressed.
- ❖ Statement that had the auditor performed additional procedures, audit or review, other matters might have come to light.
- ❖ Statement that report restricted to specified parties.
- ❖ Does not extend to entity's FS taken as a whole.
- ❖ Date of report, Place of signature.
- ❖ Auditor's signature- by accountant in his personal name.

SRS 4400

- ❖ Auditor's Signature:
 - where firm is appointed, report should be signed in the personal name of accountant and in name of firm.
 - the partner/proprietor signing report should also mention membership number assigned by the Institute of Chartered Accountants of India.
- ❖ Refer to Appendix II of SRS 4400 for an example of a report of actual findings issued in connection with an engagement to perform AUP regarding financial information.



SRS 4410

Engagements To Compile Financial Information

*Effective for all compilation engagements beginning on or after
April 1, 2004*

- ❖ Issued in April, 2004.

Introduction

- ❖ Establishes standards on professional responsibilities of an accountant engagement for compiling FS or FI.
- ❖ To establish form and content of the Compilation Report.
- ❖ Applicable to the extent practicable, to engagements to compile non-financial information.

SRS 4410



Objective of Compilation Engagement

- ❖ To use accounting expertises, as opposed to auditing expertise, to collect, classify and summaries FI.
- ❖ Procedures not designed to enable accountant to express any assurance on FI.

SRS 4410

- ❖ Ordinarily entails reducing detailed data to manageable and understandable form without requirement to test the assertions.
- ❖ Ordinarily include preparation of FS (which may or may not be a complete set of FS) but may also include collection, classification and summarisation of other FI.

General Principles

- ❖ Comply with the Code of Ethics.
- ❖ Where the accountant is not independent, include a statement to that effect in report.
- ❖ Accountant to issue a report in all circumstances, when accountant's name associated with FI compilation.

SRS 4410

- ❖ Ethical principles governing professional responsibilities for this type of engagement are:
 - integrity, Objectivity.
 - professional competence and due care.
 - confidentiality, Professional conduct.
 - technical standards.



Responsibility of Management

- ❖ Prevent and detect errors, frauds and other irregularities.
- ❖ Management's responsibility for appropriate preparation and presentation of FS or FI.
- ❖ A compilation engagement carried out by accountant does not relieve management of these responsibilities.

SRS 4410

- ❖ Auditor to obtain an acknowledgement from the management of its responsibilities:
 - preparation and presentation.
 - approval of information compiled.
 - accuracy and completeness of accounting date.
 - complete disclosure of material and relevant information.
- ❖ Management's responsibilities:
 - Accuracy and completeness of information.
 - Preparation and presentation of the financial statements of the entity.
 - Safeguarding the assets of the entity.
 - Appropriate controls designed to prevent and detect fraud and other irregularities.
 - Ensuring that the activities of the entity are carried in accordance with the applicable laws and regulations.
 - Ensuring complete disclosure of all material information to the accountant.
- ❖ Appendix I to SRS 4410 gives an example of an engagement letter for a compilation engagement.



Defining Terms of Engagement

- ❖ Confirms accountant's acceptance of engagement and ensures clear understanding.
- ❖ Scope normally defined by client but in some cases form and content might be laid down under a statute.

SRS 4410

- ❖ Contents of engagement letter:
 - nature of engagement including fact that neither audit nor review will be carried out.
 - nature of information supplied by the client.
 - management's responsibilities.
 - use and distribution of information compiled.
 - basis of accounting on which FI compiled.
 - unrestricted access to records, documents.

Planning and Documentation

- ❖ Plan work so that an effective engagement will be performed.
- ❖ Document matters which are important in providing evidence that the engagement was carried out in accordance with:
 - SRS 4410.
 - Terms of engagement.

SRS 4410



Training Manual on Engagement and Quality Control Standards

Procedures - I

- ❖ Obtain General understanding of:
 - business and operations of entity.
 - accounting principles and practices of industry in which entity operates.
 - form and content of FS/other FI.
- ❖ Request management representation.

SRS 4410

- ❖ Normally reliance is placed on management for most of information needed to compile FS or other FI, including accounting estimates.
- ❖ Accountant is not, ordinarily, required to do:
 - inquires of management to assess the reliability and completeness of information.
 - assess internal controls.
 - verification of any matters or explanations.

Procedures - II

- ❖ Incorrect, incomplete, unsatisfactory information from management:
 - consider performing additional procedures.
 - request management to provide additional information.
- ❖ Management refusal to provide additional information:
 - withdraw from engagement.
 - inform entity of the reasons for withdrawal.
- ❖ Compiled information appears to be appropriate in form and free from obvious material misstatements.

SRS 4410

- ❖ Material misstatements include:
 - mistakes in application of identified financial reporting framework.
 - non-disclosure of financial reporting framework and any known departures therefrom.
 - non-disclosure of any other significant matters of which accountant has become aware.
- ❖ The identified financial reporting framework and any known departures therefrom should be disclosed within FI, though their effects need not be quantified.



Special Considerations – I Financial Reporting Framework (FRF)

- ❖ Clients having identified FRF:
 - ensure FS or FI comply with requirements.
 - disclosure of any material departure.
- ❖ Clients having no identified FRF:
 - that compliant with generally accepted accounting practices.
 - different basis of compilation should be set out in Notes to Accounts/ other Financial Information and in Accountant's report.

SRS 4410

Special Considerations-II Accounting Standards and Accounting Estimates

- ❖ Material non compliance with Accounting Standards:
 - communicate to management.
 - if the same is not rectified, disclose in notes to accounts and accountant's report.
- ❖ Draw attention of management for reconsideration in case certain estimates are unreasonable.
- ❖ Awareness of material misstatements:
 - persuade management to carry out amendments.
 - if amendments not made and FS still misleading then withdraw from engagement.

SRS 4410



Training Manual on Engagement and Quality Control Standards

Special Consideration –III Others

- ❖ Compiled information should be approved by client before compilation report is signed by accountant.
- ❖ Client should be asked to sign a statement on face of accounts retained by accountant.
- ❖ Ensure that users are aware of the extent of his involvement so that they do not derive unwarranted assurance.
- ❖ Words like audit, auditor's fees should not be used in correspondence, documents.
- ❖ Letterhead of accountant not to be used as liable to be misinterpreted.

SRS 4410

Reporting - I

- ❖ Accountant should clearly bring out nature of association with FS and nature of work performed:
 - title.
 - addressee.
 - identification of FI.
 - when relevant, statement that accountant is not independent of the entity.
 - performed in accordance with AAS 31.
 - statement that review/audit has not been done.

SRS 4410

- ❖ The title of the Accountant's Report should be "Accountant's Report on Compilation of Unaudited Financial Statements".
- ❖ The Addressee should, Normally, be appointing authority.
- ❖ Identification of FI and also noting that it is based on information provided by management.
- ❖ Appendix II to this Standard contains examples of compilation reports.



Reporting - II

- ❖ if necessary, disclosure of material departures from identified financial reporting framework.
- ❖ statement of management responsibility.
- ❖ date, place of signature.
- ❖ accountant's signature & membership number.
- ❖ each page of FI or front of complete set of FS should contain a reference "Unaudited", "Compiled without audit or review" and also "Refer to Compilation Report".

SRS 4410



PART – III

Documentation Requirements in the Standards on Auditing



Documentation Requirements in the Standards on Auditing

Audit Documentation

“The skills of an accountant can always be ascertained by an inspection of his working papers”.

– Robert H Montgomery, *Montgomery’s Auditing*, 1912

What the noted authority on auditing said about the relationship between an accountant (read “auditor”) and his working papers almost 85 years back is true even today and then no wonder that “audit documentation” is the buzz word among the professional accountants today. The fact that “audit documentation” has remained as one of the top priorities in the professional circles, importantly, the standard setters, and that messing with the same has cost one of the oldest accounting firms its very existing drives home the point how important is documentation for the auditors. Audit documentation normally includes, in sufficient details, record of the following aspects of an audit:

- audit programme and other planning documents, including documents relating to assessment of the acceptance or continuance of the client.
- copies of significant client documents.
- checklists and questionnaires.
- notes of discussions with the client and/ or within the audit team on various aspects of the audit.
- management representation letters, third party confirmations and other important communications.
- details of tests performed, documents examined, analyses undertaken and results thereof. Though it is neither necessary nor practicable to document all the aspects of an audit, it needs to be adequate and appropriate enough to provide evidence that:
 - ⇒ the auditor’s basis for a conclusion about the achievement of the overall objective of the auditor; and
 - ⇒ the audit was planned and performed in accordance with Standards on Auditing and the applicable legal and regulatory requirements.

In addition, audit documentation serves a number of other purposes including:

- Assisting the engagement team to plan and perform the audit.
- Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with Proposed SA 220 (Revised).
- Enabling the engagement team to be accountable for its work.



Training Manual on Engagement and Quality Control Standards

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

Thus, the objectives to be met by the auditor when preparing audit documentation are:

- A sufficient and appropriate record of the basis for the auditor's report; and
- Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Strong audit documentation, therefore, also comes handy in cases of professional negligence against the auditor. Appropriate and adequate audit documentation, containing proper linkages, is virtually infallible evidence to the fact that the auditor has performed his work in accordance with the requirements of the professional Standards. One of the leading contemporary authorities working for an international auditing standards setter recently noted at a workshop organized by the Institute that the normal human psychology is that one documents/ records what one does. And going by that, the third parties, especially, the regulators and the law enforcers, normally, whatever be the facts, *prima facie* drew an analogy that what has not been documented has not been done. He also noted that there was a general perception among the professionals that bigger/ leading auditing firms were normally able to smooth sail such cases whereas the smaller audit firms/ practitioners found their defense difficult even though they had committed no such negligence. The main reason for this, he felt, was probably the fact that the larger auditing firms normally had stronger and well organized audit documentation which helped them in providing evidence of the work performed by them, whereas their smaller counterparts, were normally found to be lacking on the audit documentation aspects and therefore, unable to provide sufficient appropriate evidence of the work done by them. Therefore, notwithstanding the depth of knowledge that a practitioner has about his client, it is essential that the same is appropriately documented.

Further, the Standard on Quality Control (SQC) 1, issued by the Institute, which lays down the fundamental principles for maintenance of quality by the firms/ practitioners in the assurance engagements provided by them, draws its strength from the documentation skills and techniques of the practitioners. The Standard envisages that the audit documentation would be adequate enough to enable an "experienced auditor" (term which has been defined in the Standard) to follow the audit progress, basis of the decisions taken by the audit team, etc.

Audit documentation has also gained ground due to the process of peer review initiated by the Institute. The peer reviewer examines adequacy and appropriateness of the audit documentation of the reviewer. At its initial stages, peer review has been propagated as a learning exercise for the practice units rather than being a fault finding one.

Above all, strong documentation repository in an audit firm, comprising information about the clients is vital for building up the knowledge bank for the future use of the firm/ practitioner – a legacy of the firm/ practitioner. Working papers containing the history of the client over the years would help the audit staff to enrich their knowledge of not only what the client has been but also what they can expect the client to be. The knowledge bank would also come handy in



Documentation Requirements in the Standards on Auditing

helping the audit staff to understand the audit methodology, charting the reasons necessitating changes thereto as also understanding how the firm/ practitioner deal with various types of situations using the knowledge bank as the precedence.

To help the auditors in preparing sufficient appropriate audit documentation, the Institute had issued the Standard on Auditing (SA) 230, *Documentation*, in 1985. The Institute, in 2008, issued the Revised Standard on Auditing (SA) 230, *Audit Documentation*, providing detailed guidelines on important issues such as timely preparation of audit documentation, documentation of audit procedures performed and audit evidence obtained, assembly of the final audit file, ownership of audit documentation, etc.

DISCLAIMER : *These documentation requirements have been extracted from the requirements given in the individual Standards on Auditing under the specific head of documentation and are illustrative only. These documentation requirements may have been abridged or reworded in the following. Accordingly, the readers are cautioned to refer to the text of the SAs for complete documentation requirements. Further, a mere compliance with these documentation requirements in this document does not imply compliance with the respective Standard on Auditing (SA). The members and other interested readers are also requested to peruse the respective SA to identify the various documentation requirements arising therein. Further, this document does not include all the SAs since, some of the SAs, for example, SA 200, Basic Principles Governing an Audit, are purely conceptual and per se contain no documentation requirements.*

SAs included:

SA #	SA Title
240R ⁷	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
250R	Consideration of Laws and Regulations in an Audit of Financial Statements
260R	Communication with Those Charged with Governance
300R	Planning an Audit of Financial Statements
315	Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment ⁸
330	The Auditor's Responses to Assessed Risks
505	External Confirmations
540R	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
550R	Related Parties
600	Using the Work of Another Auditor
610	Relying Upon the Work of an Internal Auditor

⁷ "R" stands for Revised

⁸ Effective for audits of financial statements for periods beginning on or after 1st April, 2008.



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

Para Ref.	Issue	Documentation Needed
44	- Understanding the entity & its environment - Assessment of risks of material misstatements	- The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and - The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.
45	Responses to assessed risks	- The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and - The results of the audit procedures, including those designed to address the risk of management override of controls.
46	Communications	Communications about fraud made to management, those charged with governance, regulators and others.
47	Fraud in revenue recognition	Reasons for concluding the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is not applicable in the circumstances of the engagement,



Documentation Requirements in the Standards on Auditing

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

Para Ref	Issue	Documentation Needed
21	• Non - compliance • Discussions	• Identified or suspected non-compliance with laws and regulations. • Results of discussions with : ▪ Management; ▪ those charged with governance (where applicable); and ▪ other parties outside the entity.
A21	Non compliance	• Documentation may include: ▪ Copies of records or documents. ▪ Minutes of discussions held with management, those charged with governance or parties outside the entity.

SA 260R: Communication with Those Charged with Governance

Para Ref	Issue	Documentation Needed
19	Oral & written communications to those charged with governance	• Matters required by SA 260R to be communicated are communicated orally, document: ▪ The matter; ▪ When communication was made; and ▪ To whom communication was made. • Matters required by SA 260R to be communicated are communicated in writing, retain a copy.
A49	Oral communication	May include a copy of minutes prepared by client retained as part of audit documentation where those minutes are an appropriate record of the communication.



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SA 300R: Planning an Audit of Financial Statements

Para Ref	Issue	Documentation Needed
11	Planning	• The overall audit strategy; • The audit plan; and • Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.
A17-A20		• In respect of overall audit strategy, document: ▪ the key decisions considered necessary to properly plan the audit – scope, timing, conduct of audit; and ▪ communicate significant matters communicated to the engagement team. • May summarize the overall audit strategy in the form of a memorandum. • Documentation of the audit plan is record of planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. • May use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances. • A record of the significant changes to the overall audit strategy and the audit plan should document: ▪ resulting changes to the planned nature, timing and extent of audit procedures. ▪ reasons for significant changes were made. ▪ overall strategy and audit plan finally adopted for the audit. ▪ Response to the significant changes occurring during the audit. • In smaller entities a suitable, brief memorandum may serve as the documented strategy for the audit of a smaller entity.



Documentation Requirements in the Standards on Auditing

SA 315: Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment

Para Ref	Issue	Documentation Needed
33	Discussion	• The discussion among the engagement team where required by paragraph 10 of SA 315, and the significant decisions reached: ▪ 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.
	Understanding of each of the aspects of the entity and its environment specified in paragraph 11	• Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. • The nature of the entity, including: ▪ its operations; ▪ its ownership and governance structures; ▪ the types of investments that the entity is making and plans to make; and ▪ the way that the entity is structured and how it is financed. • Accounting policies selection and application of accounting policies, including the reasons for changes thereto. • Auditor's evaluation of whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. • The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. • The measurement and review of the entity's financial performance.
	Understanding of each of the internal control components specified in paragraphs 14-23	• Control environment – Auditor's evaluation of whether: ▪ Management, with the oversight of those



Training Manual on Engagement and Quality Control Standards

		charged with governance, has created and maintained a culture of honesty and ethical behavior. ▪ 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. • Entity's risk assessment process for : ▪ Identifying business risks relevant to financial reporting objectives; ▪ Estimating the significance of the risks; ▪ Assessing the likelihood of their occurrence; and ▪ Deciding about actions to address those risks. • Management's failure to identify a risk otherwise expected to have been identified: ▪ Why that process failed to identify it; and ▪ Evaluation of whether the process is appropriate to its circumstances or if there is a material weakness in the entity's risk assessment process. • If the entity has not established such a process or has an <i>ad hoc</i> process: ▪ Discussion with management regarding whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. ▪ The information system, including the related business processes, relevant to financial reporting, and communication. • Information system, including the related business processes, relevant to financial reporting, including the following areas: ▪ The classes of transactions in the entity's operations that are significant to the financial statements; ▪ The procedures, within both information



Documentation Requirements in the Standards on Auditing

		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; ▪ 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; ▪ How the information system captures events and conditions, other than transactions, that are significant to the financial statements; ▪ The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures; and ▪ Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. • Entity's communication of financial reporting roles and responsibilities and significant matters relating to financial reporting, including: ▪ Communications between management and those charged with governance; and ▪ External communications, such as those with regulatory authorities. • Control activities relevant to the audit: ▪ Understanding of control activities relevant to the audit; and ▪ Entity's response IT risks. • Monitoring of controls: ▪ Entity's major activities to monitor internal control over financial reporting; and ▪ How the entity initiates corrective actions to its controls.



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	Sources of information from which the understanding was obtained	- Sources of the information used in the entity's monitoring activities. - Basis upon which management considers the information to be sufficiently reliable for the purpose.
	Risk assessment procedures performed	
	Risks (in terms of para 24 of the standard)	- Risks of material misstatement identified and assessed: - at the financial statement level; and - at the assertion level.
	Risks requiring special audit considerations	The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 26-29 of the Standard.

SA 330: The Auditor's Responses to Assessed Risks

Para Ref	Issue	Documentation Needed
29	Overall responses	Overall responses to address the assessed risks of material misstatement at the financial statement level, and the nature, timing and extent of the further audit procedures performed.
	Linkages	Linkage of those procedures with the assessed risks at the assertion level.
	Results	The results of the audit procedures, including the conclusions where these are not otherwise clear.



Documentation Requirements in the Standards on Auditing

SA 505: External Confirmations

<i>Para Ref</i>	<i>Issue</i>	<i>Documentation Needed</i>
35	Oral external confirmations	Oral external confirmations should be documented.
40	Auditor accepts management's request not to seek confirmations	Reasons for acceding to the management's request.
41	Auditor does not accede to management's request not to seek confirmations	• Request made by the management. • Reasons given by the management therefore. • Auditor's own reasons for not acceding to the management's request.

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

<i>Para Ref</i>	<i>Issue</i>	<i>Documentation Needed</i>
23.	Auditor's conclusion	• The basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks.
	Management bias	• Indicators of possible management bias, if any.

SA 550R: Related Parties

<i>Para Ref</i>	<i>Issue</i>	<i>Documentation Needed</i>
28	Related parties	• Names of the identified related parties. • Nature of the related party relationships.



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SA 600: Using the Work of Another Auditor

Para Ref	Issue	Documentation Needed
18	Components and component auditors	• Components whose financial information was audited by other auditors. • Such components' significance to the financial information of the entity as a whole. • Names of the other auditors. • Any conclusions reached that individual components are not material. • Procedures performed and the conclusions reached. • Where component auditor's report is other than unmodified⁹, document how principal auditor has dealt with the qualifications or adverse remarks contained in the other auditor's report in framing his own report.

SA 610: Relying Upon the Work of an Internal Auditor

Para Ref	Issue	Documentation Needed
10	Extent of reliance on internal audit	• General evaluation of the internal audit function to determine the extent of reliance that can be placed upon the work of the internal auditor and conclusions in this regard. For example, ▪ Organizational status ▪ Scope of function ▪ Technical competence ▪ Due professional care
13	Evaluation of specific work of internal auditor	Conclusions in respect of the specific work of the internal auditor which external auditor has reviewed.

⁹ 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.



PART - IV

Case Studies and Technical Posers

This part is a collection of scenarios in practical implementation of Standards on Auditing. The objective of the case studies is to initiate the reader's mind to find solutions to the problems presented in the case studies relating to implementation of the requirements enunciated in the applicable Standard(s) on Auditing and to, accordingly, encourage brainstorming among the participants at the training session.



Case Studies

CASE STUDY – 1

M/s. JKN & Co.

Client Acceptance Considerations*

Mr. John is a partner with M/s. JKN & Co., a firm of Chartered Accountants, which has been invited by the Board of Directors of Trinca Ltd. to accept appointment as external auditors. Trinca Ltd. operates a number of car dealerships and has grown rapidly over the past three years through an aggressive take-over strategy. Mr. Johns is aware that the company's existing auditors, a much smaller firm, qualified their last auditor's report. During discussions, the CFO of Trinca Ltd. Mentioned that their existing auditors could not cope with audit of a company of their size and, in particular, were not equipped to audit the recently installed sophisticated accounting software. He communicated that their company needed a firm of reputation and caliber like M/s. JKN & Co., in order to reassure the market as they intend to seek a public listing within two years.

A background check on the prospective client by M/s. JKN & Co revealed as follows:

- Management gives insufficient consideration to developing an accounting system adequate and appropriate to the expanding business. In particular, there is a lack of concern as to control. A number of petty employee frauds as a result of control weaknesses have been reported. However, no action is taken against the employees identified as engaged in fraud. The management attitude seems to be to encourage risk taking employees, who, in turn, make money on the side, whilst securing good deals for the company.
- The newly installed accounting software is unreasonably complicated though Trinca Ltd. claims this is necessary because of the need to maintain records to justify the company's claims for volume rebates, and bonuses under the complex incentive schemes by which car manufacturers reward dealers.

On an enquiry from the existing auditors, the former have advised M/s. JKN & Co. against accepting the engagement on grounds, including, that though they have no evidence of deliberate misrepresentation by the directors of Trinca Ltd. but the audit staff was hindered in their audit work by a less than helpful attitude by senior management who adopted an aggressive stance whenever a query was raised. The CFO of Trinca Ltd. was constantly on the phone to the partner claiming the audit staff was incompetent and accusing them of wasting his time asking unnecessary questions.

Queries to the Readers

- i) What factors should partners of M/s. JKN & Co. should considered for and against accepting the appointment?
- ii) In the case of acceptance of appointment, what matters should be taken into consideration in obtaining the required knowledge of the business and in developing the audit plan?

* Adapted from a Case Study published in Modern Auditing, Grahan W. Cosserrat (Second Edition), John Wiley & Sons pg. 206.



CASE STUDY – 2

Mr. Vallabh

Audit of Inventories[#]

Mr. Vallabh is a senior auditor assigned to the Seasons Electronics audit. This is the first year his firm is conducting the audit for this particular client. In fact, although Seasons Electronics has previously engaged audit firms to perform limited-review services for the purpose of obtaining bank loans, this is the first year Seasons Electronics has contracted for a full-scale audit of its financial statements. The company is planning an initial public offering (IPO) of its stock in the next two or three years and has hired Mr. Vallabh's firm to conduct its first financial statement audit in preparation for the upcoming IPO.

Seasons Electronics is a medium sized company that buys copper rod and plastics materials used to make insulated copper wirings. Seasons Electronics operates from a single location totaling 600,000 square feet, which includes office space (4%), production area (56%), shipping and receiving (18%), and finished goods and raw materials inventory warehousing (22%). Seasons Electronics supplies insulated copper wiring in the southern parts of the country. The company has a good reputation for quality products and has had a good working relationship with its past audit firms over the past years. Mr. Vallabh has been assigned responsibility for auditing Seasons Electronics' inventories. He is in the planning stages of the audit and he is preparing to conduct some analytical procedures to help identify risk areas that may require further attention.

Mr. Vallabh's staff assistant assembled information relating inventories and other items, including a brief description of Seasons Electronics production and inventory areas. The information provided by the assistant is listed below :

(Amount in Rs.)

Particulars	2005	2004
Sales	94,50,000	91,50,000
Cost of Sales	72,62,500	69,60,000
Finished Goods Inventory	27,58,500	21,72,500
Copper Rod Inventory	36,25,000	27,50,000
Plastics Inventory	5,50,000	5,25,000
Days purchase in Account Payables	45.8 Days	47 Days

[#] Adapted from a Case Study published in Auditing Cases Buckless, Beasley, Glower, Prawitt (2000 edition), Prentice Hall, pg. 130.



Case Studies

Days sales in Account Receivables	57.6 days	48.9 days
Market Price of Insulated wire (per foot)	Rs. 0.008	Rs. 0.009
Market Price of Copper Rod (Per Kg.)	Rs. 0.510	Rs. 0.510
Market Price of Plastics (Per Kg.)	Rs. 0.125	Rs. 0.185

Seasons Electronics makes several different gauges and types of insulates copper wire for use in applications ranging from residential telephones and electrical wiring to industrial grade, high-voltage power cables. The production area is divided into three areas, with each area specialising in a particular product group, including residential products, industrial products, and special-order products. Production is done in batches according to orders placed with the firm. For each batch, machinery is adjusted and calibrated according to the type and size of products to be manufactured, and the size of the batch depends on the amount of product needed. Average machine setup time from start to finish is approximately six hours, which is slightly below the industry average.

The different types of products Seasons Electronics manufacturers all use similar raw material, so raw material inventory is stored in a single location, divided only into copper and plastics materials. Finished insulated copper wire is stored on large, stackable spools of various sizes, with approximately 500,000 feet of wire spool. Copper rod inventory is stored on pallets, which are not stackable. Each pallet measures 6 feet by 6 feet, stands 5 feet tall, and holds 1,500 tons of copper rod. Plastics inventory is stored in 4-foot-diameter stackable barrels, with approximately 350 kg of plastic per barrel. The raw material inventory storage area is located near the shipping and receiving area for convenience. Inbound and outbound shipments of inventory are trucked to the nearest rail yard, from which they are distributed around the southern region of the country. A single 18-wheeler can carry up to 15 pallets of copper rod, 40 barrels of plastics, or 24 spools of finished wire.

Seasons Electronics production process is semi-automated, but it still requires a relatively large amount of labour. Thus, conversion costs are fairly evenly divided between direct labour and factory overhead. Overhead consists primarily of the costs of production facilities and depreciation and maintenance on the machinery. Seasons Electronics uses a hybrid product costing system (i.e., a system that combines characteristics of both job-order and process-costing systems) to accommodate both the continuous and homogenous nature of the manufacturing process and the fact that production runs are performed in separately identifiable batches. In accordance with the relatively homogenous nature of Season's products, overhead is allocated from a single cost pool bases on a combination of machine and direct labour hours.

As wire product is completed, it is rolled onto large spools of various sizes, usually in lengths of about 500,000 linear feet. These spools of finished inventory are stored next to the raw materials inventory near the facility's eight loading and unloading docks. In many cases the



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inventory is produced in response to specific customer orders received, in which case the spools are tagged for shipment to customers according to date requested. Inventory that has been produced without a customer order to provide a “cushion” for rush orders is stored toward the far end of the finished goods storage area, away from the shipping area.

The inventory and production areas are well organised and seem to flow smoothly. Machines appear to be well maintained. A cursory visual examination of inventories reveal no problems. Two spools in the finished goods area were tagged as being of the type of residential wiring recently banned by government safety guidelines. These spools are clearly marked, and the inventories supervisor indicated that they are to be destroyed within the next week. Procedures and records for tracking materials upon arrival, through the production process, and into finished goods and shipping, appear to be well designed.

Queries to the Readers

What analytical procedures should Mr. Vallabh perform to help him identify risks or issues that indicate the need for further attention, if any, in case of the following management assertions:

- i) existence of occurrence.
- ii) Completeness.
- iii) valuation of allocation.
- iv) rights and obligations.
- v) presentation and disclosure.



CASE STUDY – 3

M/s. S.K. Lal & Co.

Auditing in a CIS Environment^β

Millennium Stores, is a first-year audit client of M/s. S.K. Lal & Co. The audit partner, Mr. Raj obtained background information about the sales system after recently meeting with client personnel at the corporate office. The company's sales system is computer-based & with computerised cash registers on the floors of all of its stores. At the point of sale, the company's sales personnel enter product number, quantity per product, and indication of whether it is a cash sale or credit sale. Additionally for credit sales, the sales personnel must enter customer credit card agency approving the credit sale. Millennium Stores only accepts Master or Citibank cards and a copy of the credit charge slip is maintained in the cash drawer. The computerised cash register performs the following tasks:

- Identifies correct price based on product number.
- Notifies clerk if product number is invalid.
- Calculates total price of purchase (price* quantity).
- Extends totals, calculates sales taxes, and determines final transaction amount.
- Generates a customer receipt and a duplicate record of the transaction on a cash register tape that is locked inside the register. Cash register tapes indicate all inputted information. Only accounting department personnel have access to the tapes.

Stores clerks are allowed to operate any machine on the floor. If a cash register is not currently being used, all the clerk has to do is turn the machine on, and once the system is booted, the clerk begins by entering the product number. Generally, operation of the each register is self-explanatory although some problems have occurred previously. Millennium Stores has no formal training for cash register operation because management believes "on the job experience" is more effective.

At the end of each day, sales personnel count the cash in the drawer and list the total cash count on the Daily Deposit Sheet (a pre-printed blank form). In addition, the sales personnel summarize total credit sales on the Daily Deposit Sheet by listing total amounts from the credit sales slips in the register. The sales personnel takes the cash drawer, which includes credit slips, to the store cashier. The cashier verifies the Daily Deposit Sheet and initials the total cash and credit sales columns listed on the Daily Deposit Sheet. The cashier leaves Rs. 20,000 in each cash drawer to begin the following days. Cash drawers are stored overnight in the store's vault. The store cashier takes the cash plus credit charge slips to the bank at the end of each day. The bank immediately credits the store's cash account for all cash and credit and receipts presented. An independent person in accounting verifies that the sum of the cash and credit

^β Adapted from a Case Study published in Auditing Cases : Buckless, Beasley, Glover, Prawitt (2000 edition), Prentice Hall, pg. 134.



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card slip totals on all Daily Deposit Sheets for the prior day reconcile to the validated deposit slip. After performing the reconciliation, the accounting clerk attaches the Daily Deposit Sheets to the validated deposit slip and files them together by date.

Accounting personnel close out the machines each night. As a part of this procedure, the machine prints subtotals of cash and credit sales for the day at the end of the cash register tape. Accounting personnel remove the cash register tapes from the machines each night, and the tapes are stored in the accounting department.

Overnight, the computer system processes all transactions for each cash register and summarizes this information on a Daily Sales Report. The Daily Sales Report is generated for each store nightly. It summarizes total stores sales, as well as subtotals of cash and credit sales, by store cash register. These reports are filed by date at each store. In addition, the computer updates perpetual inventory records daily, which are stored on magnetic disk. No reports of this interface are generated daily by the computer.

At month's end, the computer generates a detailed Inventory Listing, which provides quantity information by product number. Also, the computer generates a Monthly Sales Report for each store. This report shows daily sales totals for the store for each day of the month. The computer also prepares and prints a consolidated General Ledger, which summarizes the postings of monthly sales totals from each store to the consolidated sales account.

Queries to the Readers

- i) Describe the audit trail from the point of the sale to the general ledger posting of the consolidated sales and cash accounts and also emphasise whether the audit trail is in paper or electronics form.
- ii) Develop a proposed strategy for auditing the existence of sales. Is there a sufficient appropriate audit trail to be able to audit that assertion without relying on IT specialists?
- iii) What source should be used to select a sample of sales transactions to test the existence of sales at one store? Why this source is better than the other available sources?
- iv) Develop a proposed strategy for auditing the valuation of the sales account. Is there a sufficient paper trail to be able to audit that assertion without relying on IT audit specialists?
- v) What portion, if any, of the sales system will likely require the assistance of an IT systems auditor, who evaluates evidence existing only in electronic form?
- vi) What control weaknesses are there in the existing sales system?



CASE STUDY – 4

M/s. Krishnan Menon & Co.

Audit Quality Control^λ

The senior partner of Krishnan Menon & Co., L. Krishnan, glanced at the newspaper in disbelief. “This can’t be true,” he muttered. “How did we ever manage to remain unaware of this?” he asked R.K. Menon. With him was a small news item adorning the front page of a leading financial newspaper. It concerned their new client an upcoming textile manufacturer, the Rs. 220 crore Nataraj Ltd. The announcement stated in bold letters that Nataraj had violated provisions of the Foreign Exchange Management Act (FEMA), and had been booked by the Reserve Bank of India. It went on to say that of the Rs. 70 crore worth of yarn imported during the year, the company was found to have over-invoiced imports by Rs. 33 crore.

Menon, who was also a founder partner, looked equally nonplussed. “Let us call a meeting day after tomorrow,” he suggested. “The other partners can also fly down.” That evening, Krishnan settled in his plush room and let his thoughts go back some 35 years...

Krishnan Menon & Co., chartered accountants, was established in 1970 in Coimbatore. During the initial years, the audit work was closely monitored and supervised by its two partners. The list of clients included small scale industrialist and partnership firms of professional and traders. Most of these clients shared as associated with the city that went back several generations. They were men of repute well-known for their integrity, and their business dealings were straightforward. As a matter of fact, the perceived audit risk factor was quite low. Even then, each time before finalising an audit report, Krishnan & Menon would sit down and discuss the issues raised during the audit. This was regardless of who acted as the principal auditor. They kept up a lively interest in professional issues and kept track of all new developments.

This was not all. Once every week, Krishnan would hold a meeting in the office. The discussions would centre around the day-to-day queries and issues specific to each audit client. In addition, there were exchanges on the current developments affecting the accounting profession. Articles appearing in professional journals were dissected and debated. Taxation and corporate law issues, in particular, were subjects of some extremely painstaking analysis.

With the passage of time, the firm witnessed steady growth and the annual gross billings swelled. The client portfolio too registered an impressive horizontal and vertical expansion. Their operations now ranged across industries and, of course, their numbers also puffed up. By 1990, the firm had three partners and eight qualified employees, and a branch at Trichur. During all these years of practice, all the partners were well-acquainted with each other, and the staff kept track of all clients. In the next decade, the growth of practice was exponential. The firm’s gross billings increased by more than five times. Two more branches (at Visakhapatnam and Bangalore) were opened. By 2001, with nine partners and all of 36 qualified chartered accountants, Krishnan and Menon had a formidable reputation to live up to.

^λ Adapted from Case Study contributed by Vijay Kapur published in The Chartered Accountant, April 1997, pg. 82-83.



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The sound of the phone ringing shook Krishnan out of his reverie. It was his secretary with the message that all the partners had confirmed they would attend the meeting. Krishnan now braced himself for the meeting on Wednesday. The meeting was attended by all the partners. They shared Krishnan's concern and were unanimous on initiating an action plan. One of the significant conclusions that emerged was that the firm had no formal policies and procedures for assigning personnel to undertake audit assignments, or for hiring staff members. The situation called for a thorough investigation. Accordingly, Menon was assigned the task of identifying instances, if any, that could be potentially embarrassing to the firm. A schedule was drawn up for his visit to all the branch offices, and they all agreed to meet again in a fortnight.

The report that was submitted two weeks later was a revelation. It was a replete with interesting findings. (See Menon's Report : Executive Summary) The founder partners were appalled. All this time, their constant effort had been to instill a work culture that would encourage professionalism and continuous learning. This was, after all, a pre-requisite for the growth of the firm. Obviously, the cracks were now beginning to show. What exactly were the implications of all this? We must do something fast, they concurred but what?

MENON'S REPORT: EXECUTIVE SUMMARY

- The Swamy Group of Industries accounts for about 28 per cent of gross audit billings for the year 1995-96.
- In 1995, three traders paid audit fees less than Rs. 5,000.
- The EDP in-charge of a branch was suspended for fraudulent transfer of funds to his saving accounts. The partner in-charge of the concurrent audit of the branch has admitted to lack of EDP knowledge.
- An audit manager accepted an expensive gift from an officer in the client company.
- Documentation was found to be woefully inadequate in the case of certain audits.
- One of the partners purchased a car, the finance for which was arranged by a finance company which is audited by the firm. Terms of credit extended are normal.
- A partner was assigned an engagement where a close relative was an officer in the company concerned.
- During the last two to three years, only 10 staff members attended seminars and workshops organized by professional accounting bodies.

Queries to the Readers

Views of the readers are invited on the shortcomings in the audit quality control system in Krishnan Menon & Co., and remedial measures.



CASE STUDY – 5

M/s. Verifiers & Co.

Audit Documentation⁷

Vikram Seth, audit manager of M/s Verifiers & Co., chartered accountants, was all set for a week-long vacation in Bangalore the following morning when the telephone rang. It was Vishnu Gopal, senior partner in his firm, on the line. The tone itself conveyed the message. Seth was to change the venue of his visit. Instead of Bangalore, he would have to report to office the following morning. It was an emergency.

Seth reached office around 9.30 a.m. the next morning his disgust at the turn of events having abated considerably and headed straight for Gopal's cabin. Sonali, a senior articled trainee, was already closeted with him. It began with apologies. Gopal was sorry that Seth had to cancel his visit but the matter was urgent it was to do with the issue of audit report of Krashers Ltd. (Krashers). The previous evening, before leaving office, Seth had informed Gopal that he had reviewed the audit working papers of Krashers thoroughly and that there was nothing wrong in them. Seth had said a clean report could be issued to Krashers.

But Gopal had spent a couple of late hours in the office examining the audit working papers and had come round to the opinion that certain auditing procedures had not been followed, or even if they had been followed, the fact was not reflected in the documentation. Moreover, there was no evidence that Seth had really reviewed the working papers since he had not initialed at many places.

Gopal suggested that Seth must have forgotten to put his initials since he would have been pre-occupied with the Bangalore trip. But such slips could get the firm into trouble, he reminded the audit manager. And, more importantly, Gopal said, the working papers for quite a few significant transactions were not available in the file. The lapses were as follows:

- Bank reconciliations for two months had not been prepared and cash balances shown in the ledgers did not tally with confirmation received from the bank.
- No evidence was available to prove the authenticity of a transaction involving the sale of certain raw materials at a throwaway price to a sister concern of which the managing director of Krashers was a board member.
- A branch office of Krashers had been closed and let out to another company on lease for five years, and the property had been classified as investment property.
- Krashers had purchased explosives for which the company could have no conceivable use.

Further, it was not clear whether the internal control system, particularly for inventories and debtors, had been reviewed since there was no documentation for such review. Moreover, in the case of investments, there were no records of third party confirmations, and apparently, no

⁷ Adapted from Case Study contributed by Vijay Kapur published in The Chartered Accountant, June 1997.



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follow-up had been carried out on non-responses to confirmations regarding inventories held by third parties and debtors.

“Look Vikram,” Gopal said, “I have always relied on your opinion on various audit assignments. But I do not understand how this time the documentation fails to reflect the work you have performed. You should have taken particular care in this case since you knew fully well that Krashers is a new client.” Seth’s reply was firm. He emphasized that a fairly good job had been done and all standard audit procedures of the firm had been followed meticulously. There was no compromise on this aspect, he re-iterated. The extent of documentation required was a matter of professional judgement, Seth said, adding that it was neither necessary nor practical to have every observation, consideration, or conclusion documented by the auditor in his working papers. However it was quite possible that the working papers were not adequate, he said, and explained that he had relied on verbal assurances offered by the management of Krashers.

Seth said that Chakresh, the managing director of Krashers, had assured him on more than one occasion that there was no problem in this regard and that all relevant papers would be handed over to the audit firm. Seth said even Sonali would confirm that two such meetings had taken place with the chief accounts officer of krashers.

“You would also recall that Chakresh has been pestering us to submit an early audit report since the date of the annual general meeting has been fixed and Krashers is planning for its first public issue,” Seth explained to Gopal.

Seth went on to say that the audit had been planned properly so that sufficient appropriate audit evidence could be obtained. The internal control was also reviewed and tested properly using a standard questionnaire. Further, lot of extra book-keeping work was done since the records of Krashers were not exactly up-to-date. As far as the issue of cash not being reconciled was concerned, Seth said that would not pose much of a problem since he did not suspect any fraud. “In any case, just because some prospective investors rely on financial statements audited by us, we need not be overly concerned. And we can always prove that the audit was conducted exercising reasonable care and skill, and following the standards of auditing procedures,” Seth asserted. He added that he had spent a good number of days on the job, and nothing had come to his attention to arouse the suspicion that the accounts did not provide a true and fair view. “Your point that I had not reviewed the working papers is not correct,” Seth told Gopal. Sonali agreed with Seth but felt that before issuing the audit report, it would be better to spend some more time on the assignment.

Meanwhile, the telephone rang. It was Gopal’s secretary. He was holding a call from Chakresh. Chakresh reminded Gopal that the audit report, though promised, has not been delivered yet. He said the Board was meeting that evening and he needed the report by that time.

Gopal politely informed Chakresh of the problem with the report. But Chakresh insisted on getting the report and assured Gopal that in case there was any inadequacy in the working papers, Krashers would take care of it. Gopal was in dilemma and stared at Seth and Sonali. He asked his secretary to connect him to his legal adviser.

Queries to the Readers

What should Gopal do?



CASE STUDY – 6

M/s. Sparkle Limited

Going Concern[¶]

Mr. Chris Xavier's entire schedule had suddenly gone awry. The Managing Director of Sparkle Limited, a Rs. 143 crore company engaged in the business of mining and processing of precious and semi-precious stones, was in the middle of a grueling series of meetings to finalise the bid documents for a new mining venture. Absorbed in putting the final touches to his presentation to the state government, He had not glanced at the lengthy fax message that he had received in the morning from Mr. R. Krishnan, audit manager, M/s. Tickers & Co., statutory auditors of the company. Finally able to grab a few minutes between meetings, Xavier retrieved the fax from under a pile of slides. The Initial cursory scan, however, was soon transformed to an intent scrutiny as Xavier read the fax with mounting alarm. At stake was the future of a company he had devoted over 30 years to.

Noted the fax, "During the course of audit of your company, it was observed that the company had acquired a tract of land in Zozila (Madhya Pradesh) and invested about Rs. 25 crore (representing about 30 per cent of total assets). Further, another Rs. 50 lakh was spent by the company in acquiring the mining licence and other sundry work preparatory to the mining of the mineral zelota form which the rare metal zinesium can be extracted. The viability of the investment is solely dependent on quantity and quality of ore. The audit staff observed that the investment was made on the basis of report submitted by Mr. M. Venkatesh, a fairly senior employee of your company known for his expertise in evaluation of precious and semi-precious metals/stones, and a subsequent report obtained from the General Manager (Analysis) of reputed mining consultancy firm. As was apparent from the internal audit report, the management itself is not very comfortable with the report of Mr. Venkatesh probably because of his lack of adequate experience in the field of geological surveys. On the recommendation of MR. K. Kumar, Chief Internal Auditor, the matter was referred to the General Manager (Analysis). The sample obtained by Mr. Venkatesh from the site was also sent for analysis.

We have been given to understand that the final report submitted by the General Manager (Analysis) indicates a high proportion of the metal zinesium in the sample. However, the complete report detailing the methodology followed, the data relating to geographical features, the estimated quantity of ore, etc., and other assumptions have not been made available to us. Under the circumstances, we have no option but to issue an audit report indicating doubt about the going concern status of the company, since we are of the opinion that such a substantial investment made by the company is nothing but a pure gamble. However, we would like to verify the detailed report including credentials of the General Manager (Analysis) for the purchase of land in Zozila before we issue our audit report."

Xavier immediately buzzed his secretary and ordered her to cancel all remaining appointments. He then summoned Mr. S. Singh, Director, (Finance) and Mr. K. Kumar Sparkle Ltd.'s Chief Internal Auditor for an emergency meeting. In the stormy session that ensued, a clearly worried

[¶] Adapted from Case Study contributed by Vijay Kapur, published in The Chartered Accountant, February, 1997.



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Xavier demanded an explanation. Kumar clarified that though Venkatesh had a wealth of practical experience, he did not possess a professional qualification. So, at the insistence of the internal audit department, the General Manager (Analysis) were called in to evaluate technical feasibility of the project.

Mr. Singh pointed out that though there was no harm in submitting the complete report to statutory auditors, there were unfortunately certain remarks appearing on the report which could prove to be damaging. For instance, the report expressed doubts about the safety of the mine after five years. Nor did it clearly spell out the cost of operations. When presented with this explanation, Xavier's initial reaction was to send the complete report (including supporting documents) for examination by the auditors. But both Singh and Kumar expressed their reservations about submitting the complete report. It would unnecessarily reopen the entire issue and could even raise fresh questions about viability of the project. Moreover, not only had the auditors grossly exaggerated the situation, they had overstepped their bounds in demanding the full report.

Xavier was in a dilemma. If he provided the full report to the auditors, it could still create a controversy that could adversely affect Sparkle Ltd.'s negotiations with the State Government for a mining lease, which were at a particularly delicate state. On the other hand, not submitting the detailed report could have serious consequences. After all, casting doubt on the going concern status of the company is the single most serious objection an audit report can raise. Just what are the rights of the auditor in such a situation, wondered Xavier.

Queries to the Readers

Readers are invited to offer their comments on the situation.



CASE STUDY – 7

M/s. Steel Krafts Private Limited

Illegal Acts of Clients^Ω

Mr. Arshad, a chartered accountant and senior employee of the auditing firm M/s. SAS & Associates, was in the process of finalising the audit report for Steel Krafts Private Limited for the year ended March, 31, 2006. Steel Krafts was in the business of manufacturing precision steel instruments since 1996, when it started off as a partnership firm. In the first year of its operations, the firm picked up a small turnover of Rs. 25 lakh. In 2002, it converted itself into a private limited company. The Steel Krafts had always focused on developing a captive market for its products, and supplied to various ancillary units both in the public and private sectors. In the financial year 2005-06, Steel Krafts' turnover jumped to Rs. 10 crore. About 30 per cent of this figure was accounted for by exports to Russia, Belgium, and Yugoslavia. Steel Krafts appointed M/s. SAS & Associates as statutory auditors for the first time in the financial year 2005-06.

While going through the working papers, Arshad felt that an unqualified opinion could be issued to Steel Krafts for the year ended March 31, 2006. But as he prepared himself for the meeting back in his own office with Mr. K. Kumar, partner in-charge of the audit, he noticed a flurry of activity in the cabin of Steel Kraft's managing director (MD). A few minutes later, he saw two police officials coming out of the cabin. Arshad felt curious. He enquired Girish, a senior audit assistant, about the commotion. Girish informed that in February (2006), the MD's driver had run over a person and the visit of the police officials, in all probability, had something to do with that accident. But then, Girish added, the matter had already been settled out of court and the company had cleared all legal claims.

Arshad was not fully satisfied with Girish's explanation and went on to check the date of the accident and the relevant accounting records. While scrutinizing the entertainment expenses, Arshad stumbled upon some figures booked around the date of the accident. He called for Mukesh, the accounts manager of Steel Krafts. Arshad had seen from the accounting records that Kumar had started off with a monthly salary of Rs. 15,000 but was now drawing a gross salary of Rs. 350,000 a month (inclusive of car allowance.) During the last one year, there had been a noticeable change in Mukesh's lifestyle.

On persistent queries by Arshad about the car accident, Mukesh revealed that around Rs. 25,000 had been paid to the relevant authorities to hush up the case. The amount was camouflaged as an entertainment expense. "However, the two police officials visiting the Steel Krafts MD that day had nothing to do with the case", Mukesh said. "In fact, they were not from the police but from the Customs department. And, this time, it is a stickier case than the previous one", the accounts manager confided.

Arshad's curiosity had been raised again, and he would not let go without an explanation. After some persuasion, Mukesh gave in. He said the two customs officials had come in demanding a

^Ω Adapted from Case Study contributed by Vijay Kapur published in The Chartered Accountant, April, 1997.



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hefty sum since the boxes being air-freighted to Belgium actually contained rags instead of export material. “These things had to be done if one were to stay in business”, he explained to Arshad. “In fact, no business could be run without greasing the palms of the officials”, Mukesh said, adding that such payoffs, to a large extent, were responsible for Steel Krafts’ rise in fortunes.

Seeing Arshad’s bewilderment, Mukesh said that too much importance should not be attached to the payments since they were routine and the amounts involved were not material. He confided that, initially, even he was not comfortable dealing with such situations, but now he was reconciled to reality. He said the MD’s family which held about 70 per cent equity in Steel Krafts considered him as one of the most trusted employees and, in fact almost all deals were routed through him. “Normally, these transactions were disguised as publicity or advertising expenditure”, Mukesh said. He was also quick to remind Arshad that as a professional accountant he should not share the information given to him with anyone else.

Arshad was confounded at the revelations. After much thought, he called up Kumar requesting him to postpone the meeting by at least two days in view of the new developments. The next day, he began a thorough scrutiny of the expenditure under various heads. He was astonished to note that Steel Krafts had paid for the air tickets of certain government officials and their families who visited two international trade fairs in which Steel Krafts had participated. The more Arshad thought of the information he had stumbled upon, the more his dilemma grew. He kept wondering as to how he should go about the entire matter. Equally disturbing for him were the instances in which Steel Krafts had violated the various provisions of the law. “These could well have an impact on the financial statements and above all, the going concern of the company”, he thought. Unable to decide the course of action that he should take, Arshad decided to place all the facts before Kumar and seek his advice. But Kumar, after going through the entire matter, was equally perplexed.

Queries to the Readers

Readers are invited to offer their views on the scenario.



CASE STUDY – 8

M/s. Great Champs

Using Analytical Procedures as Substantive Tests^Ψ

Great Champs, an independent, minor football team, competes in the Southern zone. The team finished in second place in 2006 with a good record. The Great Champs cumulative season attendance of 5,45,459 spectators set a new record high for the team, up from 4,90,000 in 2005. Bank-loan agreements require the Great Champs to submit audited financial statements annually to the bank. M/s. ABC & Co. has been the Great Champs' auditors for the past five years.

One of the major audit areas involved audit of ticket revenues. Those revenues reached nearly Rs. 10,88,0000 in 2005. In the prior years, the audit plan called for detailed testing of revenue accounts to gain assurance that reported ticket revenues were fairly stated.

Mr. Abhi, a new audit manager, just received the assignment to be manager on the 2006 audit. He had worked previously on the Great Champs prior-year audits as a staff auditor. When he learned that he would be managing the current-year engagement, he immediately thought back to all the hours of detailed testing of ticket sales he had performed in earlier years. One some of his other clients Mr. Abhi had been successful at redesigning the audit plans to make better use of analytical procedures as substantive tests. He is beginning to wonder if there was a more efficient way to gather substantive evidence related to ticket revenues on this audit engagement also.

In his first meeting with the management of Great Champs for the 2006 audit, Mr. Abhi learned that the Great Champs now use an outside company, M/s. Chicklets, to operate ticket gates for home games. The terms of the contract required M/s. Chicklets to collect ticket stubs so that they could later report total tickets collected per game. Although M/s. Chicklets did not break down the total ticket sales into the various price categories, Mr. Abhi thought there might be a way to develop an analytical procedure using the independently generated total ticket numbers and data from prior audits. To investigate this possibility, he asked a staff person to gather some information related to reported sales. The information that the staff person gathered from the records of the client, M/s. Chicklets and prior-year working papers is as follows :

2006 Park Attendance	
Total park attendance	5,45,459
2006 Number of Games	
Weekday games	44
Weekend games	29

Information from prior-year audit working papers indicate that average per-game attendance for weekend games was 27% higher than average per-game attendance for weekday games.

^Ψ Adapted from a case study published in Auditing Cases : Buckless, Beasley, Glover, Prawitt (2000 edition), Prentice Hall, pg. 133.



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2006 Per-Game Ticket Prices

Club seats	Rs. 300
Box seats	Rs. 200
General seats : Adult :	Rs. 150
Child :	Rs. 75

Sales Mix	Weekday	Weekend
Club seats	30%	25%
Box seats	40%	30%
General Seats		
Adults	15%	25%
Child	15%	20%

Comparison of 2005 ticket prices to 2006 ticket prices reveals an average increase of 12% between the two years.

Information from prior-year audit working papers shows that sales mix has remained fairly constant over the past several years.

2006 Promotion : Number of Games

Weekday	7
Weekend	10

Information from prior-year audit working papers shows that attendance generally increases by 10 percent when there is a promotion (e.g., free football cap, poster, or special entertainment).

Queries to the Readers

- i) Using the information provided, what expectation for ticket revenue for the year 2006 fiscal year should be developed by Mr. Abhi?
- ii) How close would the Great Champs reported ticket revenue have to be to your expectation for you to consider reported ticket revenue reasonable or fairly stated?
- iii) If reported ticket revenues are outside the “reasonable range” what could explain the difference?
- iv) If the engagement team decides to use analytical procedures for the Great Champs audit then how will the audit plan differ from prior years?



CASE STUDY – 9

M/s. Eduk IT International Ltd.

Accounting Systems and Internal Controls[∞]

EdukIT International Ltd. runs four private colleges which provide education and training for people in the information technology industry. Its two-year course includes training in data processing, multimedia, animation, etc. M/s. Tick Tack & Co. are conducting the interim audit for the year ended 30th June 2005. The tangible fixed assets of each college are recorded in an asset register which is maintained at each college location by the respective college manager. The system operates as described below:

- In order to obtain new assets, a purchase requisition form is completed and approved by the manager at each college.
- The requisition is sent to the head office, where the purchases officer checks the requisition for approval and completes the purchase order for the new asset.
- Assets costing more than Rs. 50,000, are approved by the head of the Accounts Department. All assets over Rs. 2,00,000 require Board of Directors' approval.
- The purchase order is then sent to the supplier and a copy is sent to the central store at the location of the head office.
- The asset is received by the central store where the receiving clerk checks that all the asset details agree with those on the goods received note and the copy of the purchase order. The receiving clerk then issues the asset with its computer-generated sequential barcode number. This barcode is fixed to the asset and written on the goods received note and the supplier invoice.
- The relevant college manager inputs the new asset details into the asset register using a copy of the purchase order, the original requisition and the asset's barcode.
- For disposal or write-off of an asset, an asset disposal write-off form is completed by the relevant college manager, signed and sent to the head office. Disposals and write-offs are approved by the head of the Accounts Department. A copy of the form is filed at the head office and the approved original returned to the college manager for action. The college manager then updates the fixed asset register for the subsequent disposals/write-off.
- The asset register is maintained on tailored fixed assets accounting software systems, known as FAST and reconciled to the general ledger by each college manager monthly.
- The FAST system calculates depreciation automatically each month using the rate input by the college manager at the time the asset was added to the register.

[∞] Adapted from the case study published in *Modern Auditing*, Graham W Cosserat, (second edition), John Wiley & Sons, pg. 252.



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Queries to the Readers

- i) Identify five internal control strengths in the above case on which the auditor can place reliance.
- ii) What tests of control should be designed to evaluate the effectiveness of each of the controls identified.



CASE STUDY – 10

M/s. Fluffy Fresh & Co.

Auditing in an IT Driven Environment³

Fluffy Fresh & Co. is a one-location bakery whose focus is specialty cookies with unique flavorings and ingredients for holidays and special occasions. The bakery only ships cookies that have been baked within the last 24 hours. In 2005, approximately 75% of the market for the Company's product was local and 25% national. The owner, Ms. Baker, noted that local market demand was relatively stable, and she expected demand from the national market to increase exponentially. Her goal for 2006 was to increase national market share. The company's order entry system consists of national and local customers placing order using the bakery's toll-free or local number and providing credit card, address, and other relevant order information. To ensure accuracy, the operator repeats the order to the customer, who has the option of receiving a fax confirmation. Orders are sequentially numbered and entered into personal computers by 12 data-entry operators. The personal computers are connected to a local area network (LAN).

After an order is entered, the computer system generates a production request for the 15 bakers working in three shifts and a mailing label. Four packers per shift pick and package the appropriate cookies and place mailing labels on decorative boxes, which are shipped by carriers that guarantee a maximum three-day delivery. The company accepts order 24 hours a day, seven days a week. Each mailing label contains a bar code that is scanned to update the outstanding orders file. Information on filled orders is automatically deleted from the system. For quality control, an inspector periodically compares the packed goods with the order. In 2005, Ms. Baker hired a consultant and developed an electronic storefront on the Internet. The website provides a catalogue of available cookie shapes, flavors, and styles and allows customers to place orders online as well as by telephone. The online customer completes an order form and provides the same information requested in a telephone order. The company sends the customer an e-mail confirmation when the order is filled that provides information on the expected delivery date. Orders received at the electronic storefront are captured on a file that is used as input to the existing order-entry system. Ms. Baker hired Mr. Shaw, a local college student majoring in information technology, to help develop the website.

By the end of 2006, national sales had increased beyond expectations and approximately 80% of all sales (national and local) were received *via* the Internet. The business experienced overall cost efficiencies, with no increase in the number of order-takers. Mr. Shaw was working four hours each weekday and was responsible for maintaining the LAN and all of the programming for processing customer orders, preparing production requests, printing mailing labels, and transmitting credit card charges to the company's bank. He also served as the weekend computer operator for nightly updating of files, printing reports and preparing backup. A LAN supervisor was also appointed who performed these duties during the week. Each weekend, Mr.

³ Adapted from the CPA Journal, April 2000, AICPA.



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Shaw would take the backup disk home with him so the company always had a current copy of its files off-site.

After some customer complaints about not receiving shipments, the packers started recording the number of shipments made during each shift on a summary sheet. The bookkeeper was responsible for comparing the number of shipments with the weekly sales summary report and investigating any differences. However, Mr. Shaw found that the bookkeeper frequently forgot to make the comparison, so he did it himself. Once Mr. Shaw completed his graduation, Ms. Baker hired him full time to write programs for an inventory control system and a system to automatically reconcile the credit card settlement report from the bank with the company's sales records. After these projects were done, the owner had him develop programs to order supplies automatically by sending electronic data interchange records to the three baking ingredients suppliers and the decorative box supplier.

Ms. Baker believed that, due to the implementation of the electronic storefront and the increasing international exposure provided by the company's website, sales would increase significantly in the ensuing years. She wanted to construct new and larger production facilities to accommodate the expected demand. Ms. Baker contacted a local community bank that agreed to fund the expansion if the company could provide audited financial statements. She engaged M/s. KJ & Associates, a firm which had been performing tax services for the company for several years, to conduct an audit. The audit manager assigned the task noted that Fluffy Fresh & Co. sales system had evolved into one in which significant information was transmitted, processed, maintained, and accessed electronically.

Queries to the Readers

In this situation, what audit planning should be done and how the internal control environment should be evaluated for assessing risks arising due to IT driven environment?



CASTE STUDY – 11

M/s. Excel Electronics Technologies Ltd.

Inflated Inventories[⊕]

Excel Electronics Technologies Ltd. (EET) is operating 25 electronics outlets in different parts in India. The company has reported significant increase in sales and overall profit earnings since it became public limited company in 2002. The company raised Rs. 50 crores through its first public issue which was oversubscribed about 60 times. According to Bhaskaran, the company's founder and chairman and one of the principal shareholders, EET's success may be attributed to rapid expansion of its retail showrooms combines with media blitz through sponsoring tele-serials. Bhaskaran always pointed out this fact with pride that though the EET has been operating in high tech area faced with a strong threat of product obsolescence and severe competition but it faced these challenges very boldly by entering into tie-ups with leaders in the electronics field and marketing the latest technology. EET reported consistent performance during last five years and earned profits of Rs. 10-12 crores every year. The share price also touched an high of Rs. 450 last year which plummeted back to Rs. 225 during the current year. In a takeover bid, Sloans Instruments International Inc. successfully took charge of EET. Shortly thereafter, in early 2007, the new management discovered that prior financial statements were incorrect and perhaps fraudulent.

In conducting fresh audit of EET, Pixley & Co., Chartered Accountants, discovered that instead of Rs. 12 crores profit during 2006-07 the company had actually incurred a loss of Rs. 15 crores during the same period. The auditors noted that the loss included certain items which should have been charged to prior years but it could not be reasonably ascertained the years to which specific charges could have been applied. The audit also revealed that inventories were inflated by Rs. 12 crore and sundry creditors were understand by approximately Rs. 2 crores.

The value of inventories was overstated by fabricating inventory stock sheets for non-existent inventory. This was done by (1) including goods in inventories which had already been recorded as purchase returns and were awaiting dispatch to vendors; and (2) by including unrecorded inventories in stores prior to physical inventory counts and auditor's observation of such counts. Thus, in fact the purchases had not been recorded but the goods were included in the closing stock. Sales were also inflated by including in a given outlet's sale those goods that were dispatched to other outlets. Even the manner of valuation of inventories was also a contributing factor on account of variation in selling prices at different points of time in the year as also substantial difference between export selling prices and domestic selling prices.

A study of internal control procedures in this area reveled that, as a matter of general policy, all the outlets located in different regions were dispatched goods from a central warehouse but, in exceptional cases, goods could be dispatched from an outlet having surplus stocks to an outlet in the same region. Sales at different outlets are made for payment by cash, by cheque or on hire-purchase term. Receipts are banked by Branch Manager of each outlet. A weekly statement is prepared by Branch Manager showing sales by cash and cheque and against hire-

[⊕] Adapted from Case Study contributed by Vijay Kapur published in The Chartered Accountant, January 1998, page 64



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purchase including installments received and payments made for wages, etc. The procedure also envisages stock-taking by personnel from head-office on a yearly basis and reconciliation with the data held at the head-office. Seasonal discounts are offered by all outlets as per the uniform policy laid down by the head-office. The valuation of stocks at outlets is done at current selling prices but at the head-office level, it is reduced by normal profit margin. EET is also required to meet an export obligation to the extent of 25% of its production during the year.

A detailed report submitted by the auditors to the management also noted that the sales growth at new outlets was a key success indicator emphasized during public issue.

Queries to the Readers

- i) What were the specific weaknesses in the internal control procedures to be overcome to improve the procedure?
- ii) Whether the method of valuation of stocks is proper, particularly in view of the fact that prices of certain electronic items varied greatly from month to month?
- iii) What procedures might the auditors have applied that would have enabled them to detect the fraud?
- iv) What should be auditor's responsibility for detecting the EET's fraud?



CASE STUDY – 12

M/s Heritage Export Ltd.

Detecting Fraud^y

A late evening news item on a TV network. Reported that the Central Bureau of Investigation, (CBI) had unearthed a rich haul of selected art works of renowned artists. This caused great anxiety to Navroz, a Chartered Accountant and Senior Partner in M&N Associates. According to the show, some of the biggest international art dealers in India, acting in close connivance with a gang of smugglers, had been smuggling original artworks abroad. The next morning, the newspapers carried elaborate details of art dealers conspiring with smugglers. A list of such artworks, some of them going back to the 19th Century, which had been smuggled out of the country, was also given. The report also made it clear that there was a possibility that the original paintings missing from the stocks of these dealers might have been substituted by forgeries. Navroz felt even more disturbed on learning this, since his firm's list of clients included a good number of art dealers and antique exporters. In particular, Heritage Export Ltd. (HEL) is a fairly big international art dealer of repute, which specialised in impressionistic paintings.

As soon as Navroz reached his office, he noticed that the atmosphere was rather tense. Natasha, his private secretary, informed him that Sudhakaran has been anxiously waiting to see him for the last one hour. Sudhakaran is a qualified chartered accountant who had been working with M&N Associate for about five years and had developed an expertise in conducting the audit of art dealers and exporters apart from rendering investment advice to clients in procuring antique items and paintings. He closely followed the trends in the international market for such items, and was a frequent visitor to art exhibitions and auctions. He also subscribed to catalogues and specialist art magazines. Sudhakaran had been the principal audit supervisor of the annual audit of HEL for the last two years.

Sudhakaran informed Navroz that early in the morning, he received information that Paul Christopher, managing director, HEL, has been questioned by the CBI in connection with the smuggling. After going through the various press reports, it seemed probable that some of the classic works belonging to HEL had been missing for quite some time. But a perusal of audit files for the previous year showed that they were still in the possession of HEL and had been so shown in the financial statements. The situations seemed to be quite serious. In case the value of stocks reflected in HEL's financial statements was not backed by original paintings in their possession, the continuance of HEL as a going concern would be in doubt. Navroz told Sudhakaran to go to HEL's corporate office and acquire a complete schedule of paintings, giving all details including title of the works, artist's name, period, location, distinctive features, cost, value and other sundry information. Any representations made by the management in the past should also be scrutinised carefully once again. Sudhakaran left for HEL's office accompanied by two assistants.

Two days later, Sudhakaran reported to Navroz that the total stock of impressionistic paintings would have been valued at Rs. 60 crore. The total turnover of HEL for the current year was

^y Adapted from Case Study contributed by Vijay Kapur published in The Chartered Accountant, February 1998, pages 30-31.



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around Rs. 150 crore. During the previous accounting years, the value of the paintings had been included in the financial statements on the basis of a certificate given by the management. In addition, the assessment of value was certified by Murtaza Ali, an eminent artist and consultant to HEL. Despite persistent enquiries expressing grave doubt about the originality of such paintings, the HEL management maintained that all paintings in their possession were the originals and the same had also been certified by a highly-respected person in the world of art. After discussing the matter at some length, Navroz decided that it would be appropriate to commission an independent specialist to determine the authenticity of the paintings. Accordingly, it was decided to approach Wilson & Christ (W&C), a firm of international fame, to take up this special assignment. Navroz got in touch with Christopher to work out the details of scope of work and consultancy fees. But to his surprise, there was lot of resistance to the appointment of W&C. Christopher argued incessantly that the situation was not alarming, since this aspect has been verified and certified by renowned experts in the field, and moreover, the fees of W&C were likely to be very high. Despite this, Navroz decided to go ahead with the appointment of W&C on his own. W&C informed M&N Associates that their charges would be worked out on the basis of a percentage of the value of the stocks and audit fees, subject to the fact that the total fees would not be less than 50 per cent of audit fees. Traveling expenses would be charged on an actual basis.

W&C were informed about their scope of work and the fact that their findings would have significant support for verification and valuation of paintings being shown in the financial statements. The report of W&C revealed that it was almost certain that Rs. 10 crore worth of stock was definitely authentic, about Rs. 15 crore worth of stock was definitely forged, and there was considerable doubt about the remaining stock. In their report, W&C explained the objective and scope of their work. A complete description of material and assumptions used in arriving at such conclusions were also given. They also clarified that on certain stocks it was difficult for them to comment since they could not physically verify them.

W&C's report was quite disturbing. Both Navroz and Sudhakaran debated the issue at length but could not reach a consensus on how to deal with the situation.

Queries to the Readers

- i) Should M&N Associates accept at face value the report issued by Wilson & Christ?
- ii) Whether M&N Associates should refer to Wilson & Christ's report in their audit report?
- iii) What course of action should be taken with regard to the nature of the doubts which had been expressed by Wilson & Christ?
- iv) Whether another specialist be appointed or what further additional procedures should be performed by M&N Associates under the circumstances?
- v) Who should bear the consultancy fees charges by W&C and in what proportion? In case HEL refuses to pay, would sharing a part of audit fees with W&C be in order?



CASE STUDY – 13

Konark Pvt. Ltd.

The Expectation Gap[√]

It was a fine morning when S.K. Parnami, managing director of Konark Pvt. Ltd. met Arun Dale, senior partner of his company's auditors Dale & Associates (DA), at the Royal Golf Club. As conversation picked up, Parnami told Dale about his plans to expand Konark's ceramic and melamine potteries business, and about the way he would raise money for that. He would raise a term loan from a financial institution and negotiate with his bankers for renewal of overdraft facilities. But while all this was fine, what worried Parnami was the fall in net profits for the current year over the previous year, despite both turnover and gross profits increasing considerably.

Parnami, while expressing his general displeasure over the state of affairs in his company, said that, in his view, appointment of "independent auditors" during the last three years would have solved much of his problems. That would have ensured the company's resources were utilised efficiently, and no manipulation or misappropriations were possible in the management of financial affairs. In Parnami's opinion, one of the primary tasks of auditors was to ensure minimisation of tax liability, but in Konark's case, its tax liability had gone up over the period. Parnami also felt that the audit fees were quite high and disproportionate to the benefits derived from having the financial statements audited. Further, he said the auditors had not even bothered to look at the stocks in the 10 depots of the company.

A little astonished, Dale explained to Parnami the objectives of audit and the professional responsibilities of auditors. He also emphasised that it was the responsibility of the management to prevent and detect frauds and errors by maintaining an adequate and efficient system of internal control in the company. However, before leaving, Dale told Parnami that he would like to make a presentation to him on auditor's duties and responsibilities sometime the following week.

Later in the afternoon, Dale reached his office and began skimming the papers on Konark. He noted that Konark was initially established as a partnership firm about 10 years back. It was incorporated as a private limited company after about seven years, and since then DA had been its auditors. Konark, with two manufacturing units at Mirzapur and Bulandshahar in Uttar Pradesh, had a workforce of 225. While physical distribution of finished products was handled by 10 retail depots mainly in the northern and central areas of the country, each of the depots was headed by a storekeeper-cum-accountant. On an average, 80 or 90 daily-wage workers were employed at the manufacturing locations, while contract labour was engaged at the depots.

Since conversion to a company, Konark's turnover had gone up from an initial Rs. 1.5 crore to about Rs. 6 crore in 1996-97. Its net profits had also risen consistently throughout (from Rs. 20 lakh to Rs. 1 crore) until the previous year. In 1996-97, however, the net profits fell, while sundry

[√] Adapted from Case Study contributed by Vijay Kapur published in The Chartered Accountant, October 1997, pages 30-31.



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debtors went up considerably. Looking at the papers, Dale did feel that there was something amiss somewhere. He summoned K. Sundreshan, partner-in-charge of the audit, to understand first-hand the affairs of Konark. During the course of discussion, Sundreshan made the following submission:

- While Konark's major shareholder was S.K. Parnami, the company was controlled mainly by R.K. Singh, chief accountant, who was married to Parnami's eldest daughter.
- During preliminary audit, Konark's internal control was found to be very weak in respect of salaries at both the manufacturing units, but no major errors had been detected.
- Sale of wood from plantations in the periphery of certain depots was booked through petty cash.
- No proper explanation was given for certain expenses booked as entertainment expenses. While no proper receipts were available, Singh had said the auditors should not bother about the entertainment expenses since Konark was a private limited company, and it was, more or less, a family affair.
- No reconciliation had ever been done with reference to the total quantity of items manufactured, items sold, and stock-in-hand. The explanation given was that reconciliation was not possible since there were too many items with different colours and designs. Moreover, it was not possible to count and value the stocks at the end of the year since staff was limited.
- One of the audit clerks had overheard a customer telling the accountant that he had already made the payment in cash to Singh. It was suspected that Singh had not deposited the amount subsequently.

After considering Sundreshan's submission, Dale felt some frauds may have been perpetrated by a few officials at Konark in collusion with the accountant. This would have ultimately led to the fall in net profits. Subsequently, as he had promised, Dale made a presentation to Parnami on the roles and responsibilities of auditors and those of the management. He also indicated the possible impact of Sundreshan's revelations on the accounts of the company.

At the end of the presentation, Parnami simply nodded his head, almost in disbelief. Apparently, he was still not quite convinced about the whole affair.

Queries to the Readers

- i) What are the role and responsibility of the auditors in detecting frauds and errors, and the contribution of audit to the efficient management of the business affairs of a company?



CASE STUDY – 14

Gamma Surgical Equipment

Planning the Audit↔

Gamma Surgical Equipment (GSE), a New Delhi-based company, is a distributor of surgical equipment. It is the principal distributor for British Laboratories in the northern region where it has a market-share of 30 per cent. For the accounting year 2006-07, the annual sales of GSE were about Rs. 20 crore, and its net income Rs. 1.80 crore. GSE's income figure also included a substantial income of about Rs. 50 lakh from investments, both long-term as well as current. R. Krish and Co., Chartered Accountants, have been auditing the financial statements of GSE for the past three years. As a matter of policy, the firm has a well-established practice of rotating the partner-in-charge of audit every three years so that the quality of audit is maintained. Pursuant to this policy, V.S. Narayan, CA, a partner of the firm was given the charge of GSE audit for the current accounting period for the first time. While going through the previous year's audit working papers, Narayan noted that the overall performance of GSE had been quite impressive and its markets share had gone up steadily over a period of time.

A close review of the organization chart showed that marketing was the dominant activity of the company, and a major part of the workforce comprised sales personnel in all, there are eight sales executives representing different territories in the region headed by a sales manager who are responsible not only for booking orders and ensuring delivery of goods to hospitals in far-flung villages and remote areas, but also for follow-up of incollectible amount. As against this, Narayan felt that a host of functions were being performed by a single individual and, practically, there was no adequate segregation of duties as far as staff functions were concerned. There was also no separate dispatch department, and the mail including cheques was distributed directly to the officer to whom it was addressed.

The following day, Narayan reached GSE's corporate office to commence the audit for the year. Since debtors constituted a significant aspect of the business. Narayan decided to concentrate on the sales cycle. He observed that there were three persons working in the accounts section whose duties had been allocated. S.K. Pai, accounts officer and overall in-charge of the accounts section, dealt with sales from the receipt of orders to the collection and recording of cash from debtors. Sonam, accounts executive, dealt with all purchases and expected payments including entries in the cashbook. Prachi, accounts clerk, maintained the petty cashbook and dealt with preparation and payment of wages. The preliminary review revealed that the total debtors outstanding at the end of the year as per the ageing schedule were as follows:

- i) Outstanding debts for over six months:
 - Considered good Rs. 6 crore
 - Considered doubtful Rs. 2 lakh
- ii) Other debts considered good Rs. 17 crore
(Outstanding for less than six months)

↔ Adapted from Case Study contributed by Vijay Kapur published in The Chartered Accountant, December 1997, pages 26-27.



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Narayan was perplexed as to how the debtors considered good could exceed the annual turnover by about Rs. 3 crore. He wondered that even if sales of the last six months were counted on an average basis, the excess of debtors over sales would be about Rs. 8 crore. As per analysis of the past trends in debtors expressed as percentage of total sales, no cyclical fluctuations were noticeable and GSE did not belong to the category of a seasonal industry.

Further, while reviewing investment operations, Narayan noted that R.V. Manan had been working as manager (investments) for the last five years. The company had authorized Manan to open accounts with various brokers in his own name. To provide maximum flexibility, all purchases and sales investments were authorised by Manan. Broker's advices and other correspondence from brokers, including cheques for sale proceeds, were directly mailed to Manan. The cheques were drawn in favour of R.V. Manan C/o GSE A/c. The investment ledger was maintained by Manan but the general ledger was maintained by Pai.

Narayan noted, to his dismay, that the procedure offered considerable scope for defalcation of sums received from brokers, particularly in view of the fact that cheques were received directly by Manan. It was quite likely that he might not have passed on broker's advices to Pai for recording in the general ledger. During his two day stay at GSE, Narayan felt that both Manan and Pai had been maintaining quite a luxurious lifestyle that did not quite match their monthly salary and perks. He was stunned to learn that both had been planning their next vacation abroad and planned to spend about Rs. 5 lakh. Narayan brought all these facts to the notice of the managing director (MD). However, there was lukewarm response from the MD since he felt that given the number of persons working in the accounts section, he was able to supervise the activities more closely.

With regard to the above, Narayan concluded that the internal control system was quite weak and, thus, called for detailed substantive audit procedures and periodic surprise checks. He was, however, unable to lay down a concrete plan of action on certain issues regarding the course of action to be followed under the circumstances.

Queries to the Readers

- i) Whether to inform the board of directors about the weaknesses in the internal control system on an immediate basis.
- ii) How the division of duties should be restructured, given the number of employees working in the company, with regard to cost-benefit analysis, and whether the same should be carried out by the auditors themselves.
- iii) The type of substantive audit procedures that should be performed to assess that sundry debtors and investments are reflected properly in all respects.
- iv) Whether auditors can be held liable for not detecting defalcation, if any, perpetrated and concealed by the top management.



CASE STUDY – 15

ABC Limited

Relying Upon The Work of an Internal Auditor

ABC Limited, a listed company with a turnover of over Rs. 100 crore. It is mainly involved in manufacture / trading of office automation products. The manufacturing facility and corporate office are based in the same location. It has sales / branch offices across the country. The company has an internal audit department comprising of three personnel including the IA head who is professionally qualified and has a number of years experience in the industry / company. The other members of the team are graduates with a number of years in the company. The IA head reports independently to the Managing Director and is also present in the audit committees.

The company is facing high blockage of funds in current assets mainly certain category of stock, certain debtors and certain loans and advances (to group companies).

The above balances from the statutory auditors' perspective are high risk and involve judgement regarding reliability, analysis of contractual terms etc. The company may have high exposure in them in terms of sticky balances which may be overstated.

The internal auditor's have covered the following areas as part of their annual audit programme- cash and bank balances, payroll, purchase-payable cycle. However it is seen that the specific balances which are considered risky by the statutory auditors have not been covered by the internal audit team although they are material also from the company's perspective.

In view of the above what implications are there in the statutory auditor's scope of reliance of the internal audit work, evaluation of internal audit work. What implications are there in CARO reporting?

Source : Anonymous



Technical Posers

Technical Poser – 1

The client had provided Rs. 10 lakhs as provision for doubtful receivables. The auditor challenged this because as per his estimate, it should have been at least Rs. 60 lakhs. After many meetings and arguments, both parties agreed that a provision of Rs. 40 lakhs was appropriate. The audit working papers do not have any record of how the provision was determined. The auditor says that once he was satisfied about the adequacy of provision, he is not required to keep any record on his file.

Is the auditor's argument valid?

Technical Posers – 2

When testing cash and bank balances, the cashier provided the auditor a bank confirmation of Rs. 2,50,00,000 on the official letterhead of the Bank. This was duly tallied with the bank statement and filed among the audit working papers. Next year it was discovered that both, the bank statement and the confirmation, were forged and the actual bank balance was only Rs. 1,50,000.

Is there any failure on the part of the auditor in carrying out the audit?

Technical Poser – 3

The statutory auditor of a nationalised bank held discussion with the internal auditor and obtained a program of internal audit coverage made during the year. Based on this, the statutory auditor decided not to include areas covered by internal audit in his own audit program, as he relied on the work of the internal auditor.

Is the statutory auditor justified in his action?

Technical Poser – 4

When asked for planning documentation for the audit of a listed company, the auditor produces two-page document called "Audit Plan". This contains a table giving the various account balances to be tested, the randomly selected months for which vouching is to be done, and some details of finalisation work like stock-take.

Would you consider document appropriate?

Technical posers – 5

For determining the liability for gratuity, the client produces a report obtained from a reputed independent actuary. On examination of the assumptions made in the actuary's report, the auditor notices that the rate of return on gratuity trust investments assumed is 10%. The auditor knows that the current return on it is no more than 6%.

Can the auditor challenge the actuary's report?



Technical Posers

Technical Poser – 6

Audit of a distillery is being done at the head office in Mumbai. The company has a sales outlet for army personnel on the Indo-Pak border in Kashmir. The auditor relied on the written representation of the company's management that stock worth Rs. 2 crores lying at the godown near Srinagar was physically verified by the local storekeeper, without performing any other audit procedures. It was later found that no such godown existed.

On what counts would the auditor be lacking in this case?

Technical Poser – 7

A number of material account receivable balances from certain related parties are outstanding for more than five years. The parties do not respond to balance confirmation requests. The management assures the auditor that all the parties are sound and the money will be recovered. Audited financial statements of one of the parties are shown to the auditor as proof of its solvency. Taking these financial statements on record as evidence, the auditor agrees that no provision for doubtful debts need be made.

Is the auditor's decision appropriate?

Technical Poser – 8

Provision was made in the books on account of translation loss in respect of a foreign subsidiary that was consolidated. Prior to signing the financial statements, the exchange rate became favourable. The management urged the auditor to reverse the charge to income in view of evidence of rate correction provided by the subsequent event.

Should the auditor agree?

Technical Poser - 9

Newspaper reports allege that the promoter-managing director of a company had committed an excise duty fraud in that company's subsidiary. The company's auditor checked excise duty workings of the holding company that he audited and concluded that no such fraud appeared to have been committed in the auditee company.

Were the auditor's procedures adequate?

Technical Poser – 10

Last year's auditor's report was qualified as regards short provision for receivables. This year, the provision is adequate. The auditor, therefore, dropped the qualification altogether from his current year's auditor's report.

Is the auditor justified in dropping the qualification from the current year's audit report?



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Technical Poser - 11

A private limited company has a board of directors but no audit committee. The auditor, by and large, deals with the company's financial controller. All audit issues were discussed with the controller, the financial statements finalised, and the auditor's report issued.

Would this be a violation of Standards on Auditing?

Technical Poser – 12

The auditor was told by the financial controller that arrangement for him to attend the annual stock-take of the company at an outstation location, carrying significant value of stock, could not be made consequently, the auditor did not attend the stock-take.

What would be the impact of the inability of the auditor to attend the stock take on the audit opinion.

Technical Poser – 13

When the audit team visited the client to perform substantive audit of debtors the client produced ledger accounts of customers and debtor's confirmation letters in respect of the ten largest debtors. One of the debtors was more than five years old, but had confirmed his balance. The audit manager verified the confirmations with the ledger balances and found them to be in order.

Did the manager perform adequate work to obtain sufficient appropriate audit evidence?

Technical Poser – 14

Mr. CA is provided free-of-cost office premises in a property belonging to XYZ Co., in addition to a monthly retainership fee. The Company asks him to issue a report on the valuation of its subsidiary's business. Mr. CA. provides such a report to the Company the nature of his business relationship with the Company.

Would this be a violation of any Standards on Auditing



PART – V

**Text of the Standards on Auditing issued
under the Clarity Project
Applicable from April 1, 2010**



SA 210 (REVISED)

AGREEING THE TERMS OF AUDIT ENGAGEMENTS

(Effective for all audits relating to
accounting periods beginning on or after April 1, 2010)

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Appendix 2: Determining the Acceptability of General Purpose Frameworks



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Standard on Auditing (SA) 210 (Revised), “Agreeing the Terms of Audit Engagements” should be read in the context of the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services¹,” which sets out the authority of SAs and proposed SA 200(Revised), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”².

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

² Presently, SA 200, “Basic Principles Governing an Audit” and SA 200A, “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). Post revision, the principles covered by SA 200 (AAS 1) and SA 200A (AAS 2) will be merged into one Standard, i.e., SA 200.



Agreeing the Terms of Audit Engagements

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management and, where appropriate, those charged with governance. This includes establishing that certain preconditions for an audit, responsibility for which rests with management and, where appropriate, those charged with governance, are present. Proposed SA 220 (Revised)³ deals with those aspects of engagement acceptance that are within the control of the auditor. (Ref: Para. A1)

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

3. The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:

- (a) Establishing whether the preconditions for an audit are present; and
- (b) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.

Definitions

4. For purposes of the SAs, the following term has the meaning attributed below:

Preconditions for an audit – The use by management of an acceptable financial reporting framework⁴ in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise⁵ on which an audit is conducted.

³ Currently, SA 220 (AAS 17), "Quality Control for Audit Work", issued in July 1999 by the Institute of Chartered Accountants of India (ICAI) is in force. The Standard is being revised in the light of the corresponding Revised International Standard on Auditing (ISA) 220, "Quality Control for an Audit of Financial Statements".

⁴ 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 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 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".

Presently, SA 200, "Basic Principles Governing an Audit", issued in April 1985 and SA 200A, "Objective and Scope of an Audit of Financial Statements", issued in April 1985, correspond to the 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 revision, the principles covered by SA 200 (AAS 1) and SA 200A (AAS 2) will be merged into one Standard, i.e., SA 200 (Revised).

⁵ Paragraph 13 (j) of ISA 200 defines the Premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted as follows:

"That management and, where appropriate, those charged with governance have the following responsibilities that are fundamental to the conduct of an audit in accordance with ISAs. That is, responsibility:



Training Manual on Engagement and Quality Control Standards

5. For the purposes of this SA, references to “management” should be read hereafter as “management and, where appropriate, those charged with governance”.

Requirements

Preconditions for an Audit

6. In order to establish whether the preconditions for an audit are present, the auditor shall:
- (a) Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable; and (Ref: Para. A2-A9)
 - (b) Obtain the agreement of management that it acknowledges and understands its responsibility: (Ref: Para A10-A13, A19)
 - (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation; (Ref: Para. A14)
 - (ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and (Ref: Para. A15-A18)
 - (iii) To provide the auditor with:
 - a. Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
 - b. Additional information that the auditor may request from management for the purpose of the audit; and
 - c. Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Limitation on Scope Prior to Audit Engagement Acceptance

7. If management or those charged with governance impose a limitation on the scope of the auditor’s work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

-
- (i) 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
 - (ii) To provide the auditor with:
 - (a) All information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements;
 - (b) Any additional information that the auditor may request from management and, where appropriate, those charged with governance; and
 - (c) Unrestricted access to those within the entity from whom the auditor determines it necessary to obtain audit evidence.

In the case of a fair presentation framework, the responsibility is 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. This applies to all references to “preparation and presentation of the financial statements” in the ISAs.

The “premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted” may also be referred to as the “premise”.



Agreeing the Terms of Audit Engagements

Other Factors Affecting Audit Engagement Acceptance

8. If the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement:

- (a) If the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable, except as provided in paragraph 19; or
- (b) If the agreement referred to in paragraph 6(b) has not been obtained.

Agreement on Audit Engagement Terms

9. The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. (Ref: Para. A20)

10. Subject to paragraph 11, the agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include: (Ref: Para. A21-A24)

- (a) The objective and scope of the audit of the financial statements;
- (b) The responsibilities of the auditor;
- (c) The responsibilities of management;
- (d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and
- (e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

11. If law or regulation prescribes in sufficient detail the terms of the audit engagement referred to in paragraph 10, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities as set out in paragraph 6(b). (Ref: Para. A21, A25-A26)

12. If law or regulation prescribes responsibilities of management similar to those described in paragraph 6(b), the auditor may determine that the law or regulation includes responsibilities that, in the auditor's judgment, are equivalent in effect to those set out in that paragraph. For such responsibilities that are equivalent, the auditor may use the wording of the law or regulation to describe them in the written agreement. For those responsibilities that are not prescribed by law or regulation such that their effect is equivalent, the written agreement shall use the description in paragraph 6(b). (Ref: Para. A25)

Recurring Audits

13. On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. (Ref: Para. A27)



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Acceptance of a Change in the Terms of the Audit Engagement

14. The auditor shall not agree to a change in the terms of the audit engagement where there is no reasonable justification for doing so. (Ref: Para. A28-A30)
15. If, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement that conveys a lower level of assurance, the auditor shall determine whether there is reasonable justification for doing so. (Ref: Para. A31-A32)
16. If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.
17. If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:
- (a) Withdraw from the audit engagement where possible under applicable law or regulation; and
 - (b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

Additional Considerations in Engagement Acceptance

Financial Reporting Standards⁶ Supplemented by Law or Regulation

18. If financial reporting standards established by an authorised or recognised standards setting organization are supplemented by law or regulation, the auditor shall determine whether there are any conflicts between the financial reporting standards and the additional requirements. If such conflicts exist, the auditor shall discuss with management the nature of the additional requirements and shall agree whether:
- (a) The additional requirements can be met through additional disclosures in the financial statements; or
 - (b) The description of the applicable financial reporting framework in the financial statements can be amended accordingly.

If neither of the above actions is possible, the auditor shall determine whether it will be necessary to modify the auditor's opinion in accordance with SA 705 (Revised)⁷. (Ref: Para. A33)

Financial Reporting Framework Prescribed by Law or Regulation—Other Matters Affecting Acceptance

19. If the auditor has determined that the financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation, the auditor shall accept the audit engagement only if the following conditions are present: (Ref: Para. A34)
- (a) Management agrees to provide additional disclosures in the financial statements required to avoid the financial statements being misleading; and

⁶ Accounting Standards promulgated by Accounting Standards Board (ASB) of the ICAI or Accounting Standards, notified by the Central Government by publishing the same as the Companies (Accounting Standards) Rules, 2006, or the Accounting Standards for Local Bodies promulgated by the Committee on Accounting Standards for Local Bodies (CASLB) of the ICAI, as may be applicable.

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". However, the concept of modified audit report has been discussed in SA 700, "The Auditor's Report on Financial Statements", issued by ICAI in January 2003. The Auditing and Assurance Standards Board (AASB) has issued the Exposure Drafts of Revised SA 700, "Forming an Opinion and Reporting on Financial Statements"; SA 705, "Modifications to the Opinion in the Independent Auditor's Report"; and SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", corresponding to the ISA 700, ISA 705 and ISA 706. These Exposure Drafts are published in the June, 2009 issue of the Journal and are also hosted on the website of ICAI.



Agreeing the Terms of Audit Engagements

- (b) It is recognised in the terms of the audit engagement that:
- (i) The auditor's report on the financial statements will incorporate an Emphasis of Matter paragraph, drawing users' attention to the additional disclosures, in accordance with SA 706 (Revised)⁸; and
 - (ii) Unless the auditor is required by law or regulation to express the auditor's opinion on the financial statements by using the phrases "present fairly, in all material respects", or "give a true and fair view" in accordance with the applicable financial reporting framework, the auditor's opinion on the financial statements will not include such phrases.

20. If the conditions outlined in paragraph 19 are not present and the auditor is required by law or regulation to undertake the audit engagement, the auditor shall:

- (a) Evaluate the effect of the misleading nature of the financial statements on the auditor's report; and
- (b) Include appropriate reference to this matter in the terms of the audit engagement.

Auditor's Report Prescribed by Law or Regulation

21. In some cases, the law or regulation applicable to the entity prescribes the layout or wording of the auditor's report in a form or in terms that are significantly different from the requirements of SAs. In these circumstances, the auditor shall evaluate:

- (a) Whether users might misunderstand the assurance obtained from the audit of the financial statements and, if so,
- (b) Whether additional explanation in the auditor's report can mitigate possible misunderstanding⁹.

If the auditor concludes that additional explanation in the auditor's report cannot mitigate possible misunderstanding, the auditor shall not accept the audit engagement, unless required by law or regulation to do so. An audit conducted in accordance with such law or regulation does not comply with SAs. Accordingly, the auditor shall not include any reference within the auditor's report to the audit having been conducted in accordance with SAs¹⁰. (Ref: Para. A35-A36)

Application and Other Explanatory Material

Scope of this SA (Ref: Para. 1)

A1. Assurance engagements, which include audit engagements, may only be accepted when the practitioner considers that relevant ethical requirements such as independence and professional competence will be satisfied, and when the engagement exhibits certain characteristics¹¹. The auditor's responsibilities in respect of ethical

⁸ At present, there is no separate Standard on Auditing (SA) corresponding to International Standard on Auditing (ISA) 706, "Emphasis of Matter Paragraphs and Other Matter 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", issued by ICAI in January 2003. The Auditing and Assurance Standards Board (AASB) has issued the Exposure Drafts of Revised SA 700, "Forming an Opinion and Reporting on Financial Statements"; SA 705, "Modifications to the Opinion in the Independent Auditor's Report"; and SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", corresponding to the ISA 700, ISA 705 and ISA 706. These Exposure Drafts are published in the June, 2009 issue of the Journal and are also hosted on the website of ICAI.

⁹ See foot note no. 7.

¹⁰ See paragraph 43 of the Exposure Draft of Revised SA 700, "Forming an Opinion and Reporting on Financial Statements". The Exposure Draft has been published in June, 2009 issue of the Journal of ICAI.

¹¹ "Framework for Assurance Engagements," paragraph 16.



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requirements in the context of the acceptance of an audit engagement and in so far as they are within the control of the auditor are dealt with in proposed SA 220 (Revised)¹². This SA deals with those matters (or preconditions) that are within the control of the entity and upon which it is necessary for the auditor and the entity's management to agree.

Preconditions for an Audit

The Financial Reporting Framework (Ref: Para. 6(a))

A2. A condition for acceptance of an assurance engagement is that the criteria referred to in the definition of an assurance engagement are suitable and available to intended users¹³. Criteria are the benchmarks used to evaluate or measure the subject matter including, where relevant, benchmarks for presentation and disclosure. Suitable criteria enable reasonably consistent evaluation or measurement of a subject matter within the context of professional judgment. For purposes of the SAs, the applicable financial reporting framework provides the criteria the auditor uses to audit the financial statements, including where relevant their fair presentation.

A3. Without an acceptable financial reporting framework, management does not have an appropriate basis for the preparation of the financial statements and the auditor does not have suitable criteria for auditing the financial statements. In many cases the auditor may presume that the applicable financial reporting framework is acceptable, as described in paragraphs A8-A9.

Determining the Acceptability of the Financial Reporting Framework

A4. Factors that are relevant to the auditor's determination of the acceptability of the financial reporting framework to be applied in the preparation of the financial statements include:

- The nature of the entity (for example, whether it is a business enterprise, or a not for profit organization);
- The purpose of the financial statements (for example, whether they are prepared to meet the common financial information needs of a wide range of users or the financial information needs of specific users);
- The nature of the financial statements (for example, whether the financial statements are a complete set of financial statements or a single financial statement); and
- Whether law or regulation prescribes the applicable financial reporting framework.

A5. Many users of financial statements are not in a position to demand financial statements tailored to meet their specific information needs. While all the information needs of specific users cannot be met, there are financial information needs that are common to a wide range of users. Financial statements prepared in accordance with a financial reporting framework designed to meet the common financial information needs of a wide range of users are referred to as general purpose financial statements.

A6. In some cases, the financial statements will be prepared in accordance with a financial reporting framework designed to meet the financial information needs of specific users. Such financial statements are referred to as special purpose financial statements. The financial information needs of the intended users will determine the applicable financial reporting framework in these circumstances. Proposed SA 800 discusses the acceptability of financial reporting frameworks designed to meet the financial information needs of specific users.¹⁴

¹² See foot note no. 3.

¹³ "Framework for Assurance Engagements," paragraph 16(b)(ii).

¹⁴ At present, there is no corresponding SA issued by ICAI on the subject. The AASB has, however, already initiated a project on formulation of SA corresponding to International Standard on Auditing (ISA) 800, "Special Considerations-Audits of Financial Statements Prepared in



Agreeing the Terms of Audit Engagements

A7. Deficiencies in the applicable financial reporting framework that indicate that the framework is not acceptable may be encountered after the audit engagement has been accepted. When use of that framework is prescribed by law or regulation, the requirements of paragraphs 19-20 apply. When use of that framework is not prescribed by law or regulation, management may decide to adopt another framework that is acceptable. When management does so, as required by paragraph 16, new terms of the audit engagement are agreed to reflect the change in the framework as the previously agreed terms will no longer be accurate.

General purpose frameworks

A8. At present, there is no objective and authoritative basis that has been generally recognised globally for judging the acceptability of general purpose frameworks. In the absence of such a basis, financial reporting standards established by organizations that are authorised or recognised to promulgate standards to be used by certain types of entities are presumed to be acceptable for general purpose financial statements prepared by such entities, provided the organizations follow an established and transparent process involving deliberation and consideration of the views of a wide range of stakeholders. Examples of such financial reporting standards include:

- Accounting Standards promulgated by Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (ICAI) and/ or Accounting Standards, notified by the Central Government by publishing the same as the Companies (Accounting Standards) Rules, 2006, as may be applicable;
- Accounting Standards for Local Bodies promulgated by Committee on Accounting Standards for Local Bodies (CASLB) of the Institute of Chartered Accountants of India (ICAI);
- International Financial Reporting Standards (IFRSs) promulgated by the International Accounting Standards Board; and
- International Public Sector Accounting Standards (IPSASs) promulgated by the International Public Sector Accounting Standards Board.

These financial reporting standards are often identified as the applicable financial reporting framework in law or regulation governing the preparation of general purpose financial statements.

Financial reporting frameworks prescribed by law or regulation

A9. In accordance with paragraph 6(a), the auditor is required to determine whether the financial reporting framework, to be applied in the preparation of the financial statements, is acceptable. Appendix 2 contains guidance on determining the acceptability of the financial reporting framework. In case of some entities, law or regulation may prescribe the financial reporting framework to be used in the preparation of general purpose financial statements. In the absence of indications to the contrary, such a financial reporting framework is presumed to be acceptable for general purpose financial statements prepared by such entities. In the event that the framework is not considered to be acceptable, paragraphs 19-20 apply.

Agreement of the Responsibilities of Management (Ref: Para. 6(b))

A10. An audit in accordance with SAs is conducted on the premise that management has acknowledged and understands that it has the responsibilities set out in paragraph 6(b)¹⁵. In case of certain entities, such responsibilities

Accordance with Special Purpose Frameworks". Meanwhile, attention of the readers is also drawn to the "Guidance Note on Audit Reports and Certificates for Special Purposes" issued by ICAI in March, 1984.

¹⁵ Paragraph A2 of ISA 200 provides as follows:

"An audit in accordance with ISAs is conducted on the premise that management and, where appropriate, those charged with governance have responsibility:



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may be specified in the applicable law or regulation. In others, there may be little or no legal or regulatory definition of such responsibilities. SAs do not override law or regulation in such matters. However, the concept of an independent audit requires that the auditor's role does not involve taking responsibility for the preparation of the financial statements or for the entity's related internal control, and that the auditor has a reasonable expectation of obtaining the information necessary for the audit in so far as management is able to provide or procure it. Accordingly, the premise is fundamental to the conduct of an independent audit. To avoid misunderstanding, agreement is reached with management that it acknowledges and understands that it has such responsibilities as part of agreeing and recording the terms of the audit engagement in paragraphs 9-12.

A11. The way in which the responsibilities for financial reporting are divided between management and those charged with governance will vary according to the resources and structure of the entity and any relevant law or regulation, and the respective roles of management and those charged with governance within the entity. In most cases, management is responsible for execution while those charged with governance have oversight of management. In some cases, those charged with governance will have, or will assume, responsibility for approving the financial statements or monitoring the entity's internal control related to financial reporting. In larger or public entities, a subgroup of those charged with governance, such as an audit committee, may be charged with certain oversight responsibilities.

A12. SA 580 (Revised) requires the auditor to request management to provide written representations that it has fulfilled certain of its responsibilities¹⁶. It may therefore be appropriate to make management aware that receipt of such written representations will be expected, together with written representations required by other SAs and, where necessary, written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements.

A13. Where management will not acknowledge its responsibilities, or agree to provide the written representations, the auditor will be unable to obtain sufficient appropriate audit evidence¹⁷. In such circumstances, it would not be appropriate for the auditor to accept the audit engagement, unless law or regulation requires the auditor to do so. In cases where the auditor is required to accept the audit engagement, the auditor may need to explain to management the importance of these matters, and the implications for the auditor's report.

Preparation of the Financial Statements (Ref: Para. 6(b)(i))

A14. Most financial reporting frameworks include requirements relating to the presentation of the financial statements; for such frameworks, preparation of the financial statements in accordance with the financial reporting framework includes presentation. In the case of a fair presentation framework the importance of the reporting objective of fair presentation is such that the premise agreed with management includes specific reference to fair presentation, or to the responsibility to ensure that the financial statements will "give a true and fair view" in accordance with the financial reporting framework.

-
- (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, where appropriate, those charged with governance; and
 - (iii) Unrestricted access to those within the entity from whom the auditor determines it necessary to obtain audit evidence."

¹⁶ SA 580 (Revised), "Written Representations," paragraphs 10-11.

¹⁷ SA 580 (Revised), paragraph A28.



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Internal Control (Ref: Para. 6(b)(ii))

A15. Management maintains such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives due to the inherent limitations of internal control¹⁸.

A16. An independent audit conducted in accordance with the SAs does not act as a substitute for the maintenance of internal control necessary for the preparation of financial statements by management. Accordingly, the auditor is required to obtain the agreement of management that it acknowledges and understands its responsibility for internal control. However, the agreement required by paragraph 6(b)(ii) does not imply that the auditor will find that internal control maintained by management has achieved its purpose or will be free of deficiencies.

A17. It is for management to determine what internal control is necessary to enable the preparation of the financial statements. The term "internal control" encompasses a wide range of activities within components that may be described as the control environment; the entity's risk assessment process; the information system, including the related business processes relevant to financial reporting, and communication; control activities; and monitoring of controls. This division, however, does not necessarily reflect how a particular entity may design, implement and maintain its internal control, or how it may classify any particular component.¹⁹ An entity's internal control (in particular, its accounting books and records, or accounting systems) will reflect the needs of management, the complexity of the business, the nature of the risks to which the entity is subject, and relevant laws or regulation.

A18. In some cases, law or regulation may refer to the responsibility of management for the adequacy of accounting books and records, or accounting systems. In some other cases, general practice may assume a distinction between accounting books and records or accounting systems on the one hand, and internal control or controls on the other. As accounting books and records, or accounting systems, are an integral part of internal control as referred to in paragraph A18, no specific reference is made to them in paragraph 6(b)(ii) for the description of the responsibility of management. To avoid misunderstanding, it may be appropriate for the auditor to explain to management the scope of this responsibility.

Considerations Relevant to Smaller Entities (Ref: Para. 6(b))

A19. One of the purposes of agreeing the terms of the audit engagement is to avoid misunderstanding about the respective responsibilities of management and the auditor. For example, when a third party has assisted with the preparation of the financial statements, it may be useful to remind management that the preparation of the financial statements in accordance with the applicable financial reporting framework remains its responsibility.

Agreement on Audit Engagement Terms

Agreeing the Terms of the Audit Engagement (Ref: Para. 9)

A20. The roles of management and those charged with governance in agreeing the terms of the audit engagement for the entity depend on the governance structure of the entity and relevant law or regulation.

¹⁸ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment," paragraph A42.

¹⁹ SA 315 (Revised), paragraph A47 and Appendix 1.



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*Audit Engagement Letter or Other Form of Written Agreement*²⁰ (Ref: Para. 10-11)

A21. It is in the interests of both the entity and the auditor that the auditor sends an audit engagement letter before the commencement of the audit to help avoid misunderstandings with respect to the audit. In some entities, however, the objective and scope of an audit and the responsibilities of management and of the auditor may be sufficiently established by law, that is, they prescribe the matters described in paragraph 10. Although in these circumstances paragraph 11 permits the auditor to include in the engagement letter only reference to the fact that relevant law or regulation applies and that management acknowledges and understands its responsibilities as set out in paragraph 6(b), the auditor may nevertheless consider it appropriate to include the matters described in paragraph 10 in an engagement letter for the information of management.

Form and Content of the Audit Engagement Letter

A22. The form and content of the audit engagement letter may vary for each entity. Information included in the audit engagement letter on the auditor's responsibilities may be based on SA 200 (Revised)²¹. Paragraphs 6(b) and 12 of this SA deal with the description of the responsibilities of management. In addition to including the matters required by paragraph 10, an audit engagement letter may make reference to, for example:

- Elaboration of the scope of the audit, including reference to applicable legislation, regulations, SAs, and ethical and other pronouncements of professional bodies to which the auditor adheres.
- The form of any other communication of results of the audit engagement.
- The fact that because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with SAs.
- Arrangements regarding the planning and performance of the audit, including the composition of the audit team.
- The expectation that management will provide written representations (see also paragraph A13).
- The agreement of management to make available to the auditor draft financial statements and any accompanying other information in time to allow the auditor to complete the audit in accordance with the proposed timetable.
- The agreement of management to inform the auditor of facts that may affect the financial statements, of which management may become aware during the period from the date of the auditor's report to the date the financial statements are issued.
- The basis on which fees are computed and any billing arrangements.
- A request for management to acknowledge receipt of the audit engagement letter and to agree to the terms of the engagement outlined therein.
- The fact that the audit process may be subjected to a peer review under the Chartered Accountants Act, 1949.

A23. When relevant, the following points could also be made in the audit engagement letter:

- Arrangements concerning the involvement of other auditors and experts in some aspects of the audit.

²⁰ In the paragraphs that follow, any reference to an audit engagement letter is to be taken as a reference to an audit engagement letter or other suitable form of written agreement.

²¹ See foot note no. 2.



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- Arrangements concerning the involvement of internal auditors and other staff of the entity.
- Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit.
- Any restriction of the auditor's liability when such possibility exists.
- A reference to any further agreements between the auditor and the entity.
- Any obligations to provide audit working papers to other parties.

An example of an audit engagement letter is set out in Appendix 1.

Audits of Components

A24. When the auditor of a parent entity is also the auditor of a component, the factors that may influence the decision whether to send a separate audit engagement letter to the component include the following:

- Who appoints the component auditor;
- Whether a separate auditor's report is to be issued on the component;
- Legal requirements in relation to audit appointments;
- Degree of ownership by parent; and
- Degree of independence of the component management from the parent entity.

Responsibilities of Management Prescribed by Law or Regulation (Ref: Para. 11-12)

A25. If, in the circumstances described in paragraphs A22 and A27, the auditor concludes that it is not necessary to record certain terms of the audit engagement in an audit engagement letter, the auditor is still required by paragraph 11 to seek the written agreement from management that it acknowledges and understands that it has the responsibilities set out in paragraph 6(b). However, in accordance with paragraph 12, such written agreement may use the wording of the law or regulation if such law or regulation establishes responsibilities for management that are equivalent in effect to those described in paragraph 6(b).

A26. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), law or regulation governing the operations of that entities generally mandate the appointment of the auditor and commonly set out the auditor's responsibilities and powers, including the power to access an entity's records and other information. When law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor may nonetheless consider that there are benefits in issuing a fuller audit engagement letter than permitted by paragraph 11.

Recurring Audits (Ref: Para. 13)

A27. The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

- Any indication that the entity misunderstands the objective and scope of the audit.
- Any revised or special terms of the audit engagement.
- A recent change of senior management.



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- A significant change in ownership.
- A significant change in nature or size of the entity's business.
- A change in legal or regulatory requirements.
- A change in the financial reporting framework adopted in the preparation of the financial statements.
- A change in other reporting requirements.

Acceptance of a Change in the Terms of the Audit Engagement

Request to Change the Terms of the Audit Engagement (Ref: Para. 14)

A28. A request from the entity for the auditor to change the terms of the audit engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit as originally requested or a restriction on the scope of the audit engagement, whether imposed by management or caused by other circumstances. The auditor, as required by paragraph 14, considers the justification given for the request, particularly the implications of a restriction on the scope of the audit engagement.

A29. A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of the service originally requested may be considered a reasonable basis for requesting a change in the audit engagement.

A30. In contrast, a change may not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory. An example might be where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the entity asks for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion.

Request to Change to a Review or a Related Service (Ref: Para. 15)

A31. Before agreeing to change an audit engagement to a review or a related service, an auditor who was engaged to perform an audit in accordance with SAs may need to assess, in addition to the matters referred to in paragraphs A29-A31 above, any legal or contractual implications of the change.

A32. If the auditor concludes that there is reasonable justification to change the audit engagement to a review or a related service, the audit work performed to the date of change may be relevant to the changed engagement; however, the work required to be performed and the report to be issued would be those appropriate to the revised engagement. In order to avoid confusing the reader, the report on the related service would not include reference to:

- (a) The original audit engagement; or
- (b) Any procedures that may have been performed in the original audit engagement, except where the audit engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

Additional Considerations in Engagement Acceptance

Financial Reporting Standards Supplemented by Law or Regulation (Ref: Para. 18)

A33. In case of some entities, law or regulation may supplement the financial reporting standards established by an authorised or recognised standards setting organization with additional requirements relating to the preparation of financial statements. In such cases, the applicable financial reporting framework for the purposes of applying the SAs



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encompasses both the identified financial reporting framework and such additional requirements provided they do not conflict with the identified financial reporting framework. This may, for example, be the case when law or regulation prescribes disclosures in addition to those required by the financial reporting standards or when they narrow the range of acceptable choices that can be made within the financial reporting standards²².

Financial Reporting Framework Prescribed by Law or Regulation—Other Matters Affecting Acceptance (Ref: Para. 19)

A34. Law or regulation may prescribe that the wording of the auditor's opinion use the phrases "present fairly, in all material respects" or "give a true and fair view" in a case where the auditor concludes that the applicable financial reporting framework prescribed by law or regulation would otherwise have been unacceptable. In this case, the terms of the prescribed wording of the auditor's report are significantly different from the requirements of SAs (see paragraph 21).

Auditor's Report Prescribed by Law or Regulation (Ref: Para. 21)

A35. SAs require that the auditor shall not represent compliance with SAs unless the auditor has complied with all of the SAs relevant to the audit²³. When law or regulation prescribes the layout or wording of the auditor's report in a form or in terms that are significantly different from the requirements of SAs and the auditor concludes that additional explanation in the auditor's report cannot mitigate possible misunderstanding, the auditor may consider including a statement in the auditor's report that the audit is not conducted in accordance with SAs. The auditor is, however, encouraged to apply SAs, including the SAs that address the auditor's report, to the extent practicable, notwithstanding that the auditor is not permitted to refer to the audit being conducted in accordance with SAs.

A36. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), specific requirements may exist within the legislation governing the audit mandate; for example, the auditor may be required to report directly to a regulator or the legislative body or the stakeholders if the entity attempts to limit the scope of the audit.

Material Modifications to ISA 210, "Agreeing the Terms of Audit Engagements"

Addition

Paragraph A8 of ISA 210 provides the examples of the financial reporting standards, which can be used for the preparation and presentation of general purpose financial statements. Since in India, financial reporting standards, used for the preparation and presentation of financial statements, can be 'Accounting Standards promulgated by the Accounting Standards Board of the Institute of Chartered Accountants of India or Accounting Standards, notified under Companies (Accounting Standards) Rules, 2006' or 'Accounting Standards for Local Bodies promulgated by Committee on Accounting Standards for Local Bodies (CASLB) of the Institute of Chartered Accountants of India (ICAI)', these have been added in the list of examples of financial reporting standards. References have accordingly been changed.

²² See paragraph 15 of the Exposure Draft of Revised SA 700, "Forming an Opinion and Reporting on Financial Statements", which includes a requirement regarding the evaluation of whether the financial statements adequately refer to or describe the applicable financial reporting framework. The Exposure Draft is published in the June, -2009 issue of the Journal of ICAI.

²³ ISA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing", paragraph 20, states as under:

"The auditor shall not represent compliance with ISAs in the auditor's report unless the auditor has complied with the requirements of this ISA and all other ISAs relevant to the audit".

Presently, SA 200, "Basic Principles Governing an Audit", issued in April 1985 and SA 200A, "Objective and Scope of an Audit of Financial Statements", issued in April 1985, correspond to the 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 revision, the principles covered by SA 200 (AAS 1) and SA 200A (AAS 2) will be merged into one Standard, i.e., SA 200 (Revised).



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Deletions

1. Paragraph A10 of the ISA 210 deals with situations where the entity operates in a jurisdiction that does not have a standard setting organization or a prescribed financial reporting framework. Since in India, this kind of situation does not exist, paragraph A10 has been deleted. However, the reference to Appendix 2, *Determining Acceptability of General Purpose Frameworks*, has been shifted to paragraph A9.
2. Paragraph A27 of ISA 210 deals with the condition where the law or regulation governs the operations of public sector audits, and also prescribes the public sector auditor's responsibilities and powers. Paragraph A37 of ISA 210 deals with the specific reporting requirements within the legislation governing the audit which may mandate; for example, the auditor may be required to report directly to a minister or the legislature or to public if the entity attempts to limit the scope of the audit in case 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. However, since it is also possible that such situations may also exist in case of certain non-public entities pursuant to a requirement under the statute or regulation under which they operate the spirit of erstwhile A27 and A37 has been retained.



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Appendix 1

(Ref: Paras. A22-A23)

Example of an Audit Engagement Letter

The following is an example of an audit engagement letter for an audit of general purpose financial statements prepared in accordance with Financial Reporting Standards²⁴ of a company registered under the Companies Act, 1956. This letter is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this SA. It will need to be varied according to individual requirements and circumstances. It is drafted to refer to the audit of financial statements for a single reporting period and would require adaptation if intended or expected to apply to recurring audits (see paragraph 13 of this SA). It may be appropriate to seek legal advice that any proposed letter is suitable.

To the Board of Directors of ABC Company Limited:²⁵

[The objective and scope of the audit]

You²⁶ have requested that we audit the financial statements of ABC Company Limited, which comprise the Balance Sheet as at March 31, 20X1, and the Statement of Profit & Loss, and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.²⁷

[The responsibilities of the auditor]

We will conduct our audit in accordance with Standards on Auditing (SAs), issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about 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. 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.

²⁴ Refer footnote 6.

²⁵ The addressees and references in the letter would be those that are appropriate in the circumstances of the engagement, including the relevant jurisdiction. It is important to refer to the appropriate persons – see paragraph A21.

²⁶ Throughout this letter, references to “you”, “we”, “us”, “management”, “those charged with governance” and “auditor” would be used or amended as appropriate in the circumstances.

²⁷ Where the financial statements of the entity include financial statements/ information of its component(s) which have been audited by another auditor/ auditors, the engagement letter may be modified as under:

“You have requested that we audit the financial statements of ABC Company Limited, which comprise the Balance Sheet as at March 31, 20X1, and the Statement of Profit & Loss, and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.

Further, as informed by you, the financial statements of the components of ABC Company Limited, viz., PQR Company Limited and XYZ Company Pvt Limited, whose financial information/ financial statements have been included in the financial statements of ABC Company would be/ have been audited by another auditor/ auditors. However, we expect to be furnished the reports of such other auditor(s) before the date of our audit report so as to enable us to deal with such reports in accordance with the principles enunciated in the Standard on Auditing (SA) 600, *Using the Work of Another Auditor*, issued by the Institute of Chartered Accountants of India”.



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Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with SAs.

In making our risk assessments, we consider internal control relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.

[The responsibilities of management and identification of the applicable financial reporting framework (for purposes of this example it is assumed that the auditor has determined that the provisions of the Companies Act, 1956 relating to responsibility of the Board of Directors be supplemented by the descriptions in paragraph 6(b) of this SA).]

Our audit will be conducted on the basis that [management and, where appropriate, those charged with governance]²⁸ acknowledge and understand that they have responsibility:

- (a) For the preparation of financial statements that give a true and fair view in accordance with the Financial Reporting Standards.²⁹ This includes:
 - the responsibility for the preparation of financial statements on a going concern basis.
 - the responsible for selection and consistent application of appropriate accounting policies, including implementation of applicable accounting standards along with proper explanation relating to any material departures from those accounting standards.
 - The responsibility for making judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity at the end of the financial year and of the profit or loss of the entity for that period.
- (b) For such internal control as [management] determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
- (c) To provide us with:
 - (i) Access, at all times, to all information, including the books, account, vouchers and other records and documentation, of the Company, whether kept at the head office of the company or elsewhere, of which [management] is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
 - (ii) Additional information that we may request from [management] for the purpose of the audit; and
 - (iii) Unrestricted access to persons within the entity from whom we determine it necessary to obtain audit evidence. This includes our entitlement to require from the officers of the Company such information and explanations as we may think necessary for the performance of our duties as auditor.

As part of our audit process, we will request from [management and, where appropriate, those charged with governance], written confirmation concerning representations made to us in connection with the audit.

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 to be conducted by an Independent reviewer. The reviewer may inspect, examine or take abstract of our working papers during the course of the peer review.

We look forward to full cooperation from your staff during our audit.

²⁸ Use terminology as appropriate in the circumstances.

²⁹ Or, if appropriate, "For the preparation and fair presentation of the financial statements in accordance with the Financial Reporting Standards".



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[Other relevant information]

[Insert other information, such as fee arrangements, billings³⁰ and other specific terms, as appropriate.]

[Reporting]

[Insert appropriate reference to the expected form and content of the auditor's report.]

The form and content of our report may need to be amended in the light of our audit findings.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.

XYZ

&

Co.

Chartered

Accountants

.....
(Signature)

Date :

(Name of the Member)

Place :

(Designation³¹)

Acknowledged on behalf of ABC Company by

.....

(Signature)

Name and Designation

Date

³⁰ For example, "Our fees will be billed as the work progresses".

³¹ Partner or proprietor, as the case may be.



Determining the Acceptability of General Purpose Frameworks

1. Acceptable financial reporting frameworks normally exhibit the following attributes that result in information provided in financial statements that is useful to the intended users:
 - (a) Relevance, in that the information provided in the financial statements is relevant to the nature of the entity and the purpose of the financial statements. For example, in the case of a business enterprise that prepares general purpose financial statements, relevance is assessed in terms of the information necessary to meet the common financial information needs of a wide range of users in making economic decisions. These needs are ordinarily met by presenting the financial position, financial performance and cash flows of the business enterprise.
 - (b) Completeness, in that transactions and events, account balances and disclosures that could affect conclusions based on the financial statements are not omitted.
 - (c) Reliability, in that the information provided in the financial statements:
 - (i) Where applicable, reflects the economic substance of events and transactions and not merely their legal form; and
 - (ii) Results in reasonably consistent evaluation, measurement, presentation and disclosure, when used in similar circumstances.
 - (d) Neutrality, in that it contributes to information in the financial statements that is free from bias.
 - (e) Understandability, in that the information in the financial statements is clear and comprehensive and not subject to significantly different interpretation.
2. The auditor may decide to compare the accounting conventions to the requirements of an existing financial reporting framework considered to be acceptable. For example, the auditor may compare the accounting conventions to IFRSs. For an audit of a small entity, the auditor may decide to compare the accounting conventions to a financial reporting framework specifically developed for such entities by an authorised or recognised standards setting organization. When the auditor makes such a comparison and differences are identified, the decision as to whether the accounting conventions adopted in the preparation and presentation of the financial statements constitute an acceptable financial reporting framework includes considering the reasons for the differences and whether application of the accounting conventions, or the description of the financial reporting framework in the financial statements, could result in financial statements that are misleading.
3. A conglomeration of accounting conventions devised to suit individual preferences is not an acceptable financial reporting framework for general purpose financial statements. Similarly, a compliance framework will not be an acceptable financial reporting framework, unless it is generally accepted in the industry to which the entity belongs by preparers and users.



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Limited Revision Consequential to issuance of Standard on Auditing (SA) 210 (Revised), “Agreeing the Terms of Audit Engagements”

The amendments to the following Standards on Auditing (SAs) have been shown in track change mode.

SA 580 (Revised), “Written Representations”

[No amendments are proposed to paragraphs 1-4]

Objectives

5. The objectives of the auditor are:

- (a) To obtain written representations from management and, where appropriate, those charged with governance that they management believes that they have it has fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor; 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 and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance does not provide the written representations requested by the auditor.

[No amendments are proposed to paragraph 6.]

Definitions

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 applicable financial reporting framework; or the preparation of financial statements *that give a true and fair view* in accordance with the applicable financial reporting framework.

[No amendments are proposed to paragraphs 8.]

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 in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement³². 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)

³² SA 210 (Revised), “Agreeing the Terms of Audit Engagements”, paragraph 6(b)(i).



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Information Provided and Completeness of Transactions to the Auditor

10. The auditor shall request management to provide a written representation that:

- (a) ~~I~~ it has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement³³, and
- (b) ~~that a~~ 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)~~

[No amendments are proposed to paragraphs 12-19 and A1.]

~~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 evidence³⁴.~~

~~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 engagement³⁵ 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 engagement³⁶.~~

[No amendments are proposed to paragraphs A4 – A8.]

³³ SA 210 (Revised), paragraph 6(b)(iii).

³⁴ SA 200, "Basic Principles Governing an Audit" (earlier known as AAS1), refer paragraphs 18 and 19. The Standard is being revised in the light of the corresponding International Standard.

³⁵ Refer footnote 3.

³⁶ Refer footnote 3.



Agreeing the Terms of Audit Engagements

Written Representations about Management's Responsibilities (Ref: Para. 9-10)

A9. Audit evidence obtained during the audit that management ~~is fulfilling~~ has fulfilled the responsibilities referred to in paragraphs 10 and 11 ~~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 all relevant ~~the information agreed in the terms of the audit engagement described in paragraph A2(b)~~ without asking it whether, and receiving confirmation that, such information has been provided.

[No amendments are proposed to paragraphs A10-A20.]

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 the responsibilities referred to in paragraphs 10 and 11 ~~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).

[No amendments are proposed to paragraphs A22-A27.]

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 fulfilled the responsibilities referred to in paragraphs 10 and 11 ~~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 circumstances³⁷.

[No amendments are proposed to paragraph A29 and Appendix 1.]

³⁷ [Proposed] SA 705, paragraph {12}.



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Appendix 2

(Ref: Para. A23)

Illustrative Representation Letter

The following illustrative letter includes written representations that are required by this and other SAs in effect for audits of financial statements for periods beginning on or after 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)³⁸ 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 March 31, 20XX³⁹ 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):*

Financial Statements

- We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated [insert date], for the preparation and presentation of the financial statements in accordance with Financial Reporting Standards; 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 there with the applicable accounting standards in India.

...

Information Provided

- We have provided you with:
 - Access to all information of which we are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
 - Additional information that you have requested from us for the purpose of the audit; and
 - Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.

...

[No other amendments are proposed to Appendix 2.]

³⁸ Revised SA 570, "Going Concern".

³⁹ 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.



Agreeing the Terms of Audit Engagements

SA 240 (Revised), “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”

39. The auditor shall obtain written representations from management and, where applicable, those charged with governance that:
- (a) ~~They~~ It acknowledges ~~its~~ their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;
 - (b) ~~It has~~ They have disclosed to the auditor the results of ~~its~~ management’s assessment of the risk that the financial statements may be materially misstated as a result of fraud;
 - (c) ~~It has~~ They have disclosed to the auditor ~~its~~ their 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~~ They have disclosed to the auditor ~~its~~ their knowledge of any allegations of fraud, or suspected fraud, affecting the entity’s financial statements communicated by employees, former employees, analysts, regulators or others. (Ref: Para. A57-A58)

...

A12. Management ~~is responsible~~ accepts responsibility for the entity’s internal control and for the preparation of the entity’s 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.

...

A57. SA 580, “Management Representations⁴⁰”, establishes requirements and provides guidance on obtaining appropriate representations from management and, where appropriate, those charged with governance in the audit. In addition to acknowledging ~~its~~ that they have fulfilled their responsibility for the preparation of the financial statements, it is important that, irrespective of the size of the entity, management and, where appropriate, those charged with governance acknowledge ~~its~~ their 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 and, where appropriate, those charged with governance confirming that ~~it has~~ they have 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~~ Their knowledge of actual, suspected or alleged fraud affecting the entity.

⁴⁰ Revised Standard on Auditing (SA) 580, “Written Representations”.



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SA 540 (Revised), “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”

22. The auditor shall obtain written representations from management and, where appropriate, those charged with governance whether they ~~management~~ believes significant assumptions used ~~by it~~ in making accounting estimates are reasonable. (Ref: Para. A126-A127)

SA 550 (Revised), “Related Parties”

A16. The audit is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged and understand that they have responsibility for the preparation ~~and presentation~~ of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, and for such- ~~This includes the design, implementation and maintenance of internal control as management and, where appropriate, those charged with governance, determine is necessary to enable~~ relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error.⁴¹ 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.

SA 560 (Revised), “Subsequent Events”

Management Responsibility Towards Auditor (Ref: Para. 10)

A11. As explained in SA 210 (Revised), agreed in the terms of the audit engagement, include the agreement of management ~~has a responsibility~~ to inform the auditor of relevant facts that may affect the financial statements, of which management it may becomes aware during the period from the date of the auditor’s report to the date the financial statements are issued.

SA 570 (Revised), “Going Concern”

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)

....

(e) Requesting written representations from management and or, where appropriate, those charged with governance, regarding their plans for future action and the feasibility of these plans.

⁴¹ SA 200 [See footnote 2].



SA 265

COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL TO THOSE CHARGED WITH GOVERNANCE AND MANAGEMENT

(Effective for all audits relating to accounting periods beginning on or after April 1, 2010)

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Material Modifications to ISA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management"

Standard on Auditing (SA) 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", which sets out the authority of SAs and proposed SA 200 (Revised), "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing"².

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

² Presently, SA 200, "Basic Principles Governing an Audit" and SA 200A, "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). Post revision, the principles covered by SA 200 (AAS 1) and SA 200A (AAS 2) will be merged into one Standard, i.e., SA 200.



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Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control³ that the auditor has identified in an audit of financial statements. This SA does not impose additional responsibilities on the auditor regarding obtaining an understanding of internal control and designing and performing tests of controls over and above the requirements of SA 315 and SA 330⁴. SA 260 (Revised)⁵ establishes further requirements and provides guidance regarding the auditor's responsibility to communicate with those charged with governance in relation to the audit.
2. The auditor is required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement⁶. In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. The auditor may identify deficiencies in internal control not only during this risk assessment process but also at any other stage of the audit. This SA specifies which identified deficiencies the auditor is required to communicate to those charged with governance and management.
3. Nothing in this SA precludes the auditor from communicating to those charged with governance and management other internal control matters that the auditor has identified during the audit.

Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

5. The objective of the auditor is to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

Definitions

6. For purposes of the SAs, the following terms have the meanings attributed below:
 - (a) Deficiency in internal control – This exists when:
 - (i) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or
 - (ii) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.
 - (b) Significant deficiency in internal control – A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance. (Ref: Para. A5)

Requirements

³ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraphs 4 and 12.

⁴ SA 330, "The Auditor's Responses to Assessed Risks".

⁵ SA 260 (Revised), "Communication with Those Charged with Governance".

⁶ SA 315, paragraph 12. Paragraphs A56-A61 provide guidance on controls relevant to the audit.



Communicating Deficiencies in Internal Control

7. The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control. (Ref: Para. A1-A4)
8. If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies. (Ref: Para. A5-A11)
9. The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. (Ref: Para. A12- A18, A27)
10. The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis: (Ref: Para. A19, A27)
 - (a) In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and (Ref: Para. A14, A20-A21)
 - (b) Other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. (Ref: Para. A22- A26)
11. The auditor shall include in the written communication of significant deficiencies in internal control:
 - (a) A description of the deficiencies and an explanation of their potential effects; and (Ref: Para. A28)
 - (b) Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that: (Ref: Para. A29-A30)
 - (i) The purpose of the audit was for the auditor to express an opinion on the financial statements;
 - (ii) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and
 - (iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

Application and Other Explanatory Material

Determination of Whether Deficiencies in Internal Control Have Been Identified (Ref: Para. 7)

A1. In determining whether the auditor has identified one or more deficiencies in internal control, the auditor may discuss the relevant facts and circumstances of the auditor's findings with the appropriate level of management. This discussion provides an opportunity for the auditor to alert management on a timely basis to the existence of deficiencies of which management may not have been previously aware. The level of management with whom it is appropriate to discuss the findings is one that is familiar with the internal control area concerned and that has the authority to take remedial action on any identified deficiencies in internal control. In some circumstances, it may not be appropriate for the auditor to discuss the auditor's findings directly with management, for example, if the findings appear to call management's integrity or competence into question (see paragraph A20).



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A2. In discussing the facts and circumstances of the auditor's findings with management, the auditor may obtain other relevant information for further consideration, such as:

- Management's understanding of the actual or suspected causes of the deficiencies.
- Exceptions arising from the deficiencies that management may have noted, for example, misstatements that were not prevented by the relevant information technology (IT) controls.
- A preliminary indication from management of its response to the findings.

Considerations Specific to Smaller Entities

A3. While the concepts underlying control activities in smaller entities are likely to be similar to those in larger entities, the formality with which they operate will vary. Further, smaller entities may find that certain types of control activities are not necessary because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide effective control over important account balances and transactions, lessening or removing the need for more detailed control activities.

A4. Also, 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 may be able to exercise more effective oversight than in a larger entity. This higher level of management oversight needs to be balanced against the greater potential for management override of controls.

Significant Deficiencies in Internal Control (Ref: Para. 6(b), 8)

A5. The significance of a deficiency or a combination of deficiencies in internal control depends not only on whether a misstatement has actually occurred, but also on the likelihood that a misstatement could occur and the potential magnitude of the misstatement. Significant deficiencies may therefore exist even though the auditor has not identified misstatements during the audit.

A6. Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency include:

- The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
- The susceptibility to loss or fraud of the related asset or liability.
- The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
- The financial statement amounts exposed to the deficiencies.
- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- The importance of the controls to the financial reporting process; for example:
 - General monitoring controls (such as oversight of management).
 - Controls over the prevention and detection of fraud.
 - Controls over the selection and application of significant accounting policies.
 - Controls over significant transactions with related parties.
 - Controls over significant transactions outside the entity's normal course of business.
 - Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).



Communicating Deficiencies in Internal Control

- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
 - The interaction of the deficiency with other deficiencies in internal control.
- A7. Indicators of significant deficiencies in internal control include, for example:
- Evidence of ineffective aspects of the control environment, such as:
 - Indications that significant transactions in which management is financially interested are not being appropriately scrutinised by those charged with governance.
 - Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.
 - Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.
 - Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.
 - Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.
 - Evidence of an ineffective response to identified significant risks (e.g., absence of controls over such a risk).
 - Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.
 - Disclosure of a material misstatement due to error or fraud as prior period items in the current year's Statement of Profit and Loss⁷.
 - Evidence of management's inability to oversee the preparation of the financial statements.

A8. Controls may be designed to operate individually or in combination to effectively prevent, or detect and correct, misstatements⁸. For example, controls over accounts receivable may consist of both automated and manual controls designed to operate together to prevent, or detect and correct, misstatements in the account balance. A deficiency in internal control on its own may not be sufficiently important to constitute a significant deficiency. However, a combination of deficiencies affecting the same account balance or disclosure, relevant assertion, or component of internal control may increase the risks of misstatement to such an extent as to give rise to a significant deficiency.

A9. Law or regulation in some jurisdictions may establish a requirement (particularly for audits of listed entities) for the auditor to communicate to those charged with governance or to other relevant parties (such as regulators) one or more specific types of deficiency in internal control that the auditor has identified during the audit. Where law or regulation has established specific terms and definitions for these types of deficiency and requires the auditor to use these terms and definitions for the purpose of the communication, the auditor uses such terms and definitions when communicating in accordance with the legal or regulatory requirement.

A10. Where the jurisdiction has established specific terms for the types of deficiency in internal control to be communicated but has not defined such terms, it may be necessary for the auditor to use judgment to determine the matters to be communicated further to the legal or regulatory requirement. In doing so, the auditor may consider it

⁷ 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.

⁸ SA 315, paragraph A62.



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appropriate to have regard to the requirements and guidance in this SA. For example, if the purpose of the legal or regulatory requirement is to bring to the attention of those charged with governance certain internal control matters of which they should be aware, it may be appropriate to regard such matters as being generally equivalent to the significant deficiencies required by this SA to be communicated to those charged with governance.

A11. The requirements of this SA remain applicable notwithstanding that law or regulation may require the auditor to use specific terms or definitions.

Communication of Deficiencies in Internal Control

Communication of Significant Deficiencies in Internal Control to Those Charged with Governance (Ref: Para. 9)

A12. Communicating significant deficiencies in writing to those charged with governance reflects the importance of these matters, and assists those charged with governance in fulfilling their oversight responsibilities. SA 260 (Revised) establishes relevant considerations regarding communication with those charged with governance when all of them are involved in managing the entity.⁹

A13. In determining when to issue the written communication, the auditor may consider whether receipt of such communication would be an important factor in enabling those charged with governance to discharge their oversight responsibilities. In addition, in case of listed entities, those charged with governance may need to receive the auditor's written communication before the date of approval of the financial statements in order to discharge specific responsibilities in relation to internal control for regulatory or other purposes. For other entities, the auditor may issue the written communication at a later date. Nevertheless, in the latter case, as the auditor's written communication of significant deficiencies forms part of the final audit file, the written communication is subject to the overriding requirement¹⁰ for the auditor to complete the assembly of the final audit file on a timely basis. SA 230 (Revised) states that 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 report¹¹.

A14. Regardless of the timing of the written communication of significant deficiencies, the auditor may communicate these orally in the first instance to management and, when appropriate, to those charged with governance to assist them in taking timely remedial action to minimize the risks of material misstatement. Doing so, however, does not relieve the auditor of the responsibility to communicate the significant deficiencies in writing, as this SA requires.

A15. The level of detail at which to communicate significant deficiencies is a matter of the auditor's professional judgment in the circumstances. Factors that the auditor may consider in determining an appropriate level of detail for the communication include, for example:

- The nature of the entity. For instance, the communication required for a public interest entity may be different from that for a non-public interest entity.
- The size and complexity of the entity. For instance, the communication required for a complex entity may be different from that for an entity operating a simple business.
- The nature of significant deficiencies that the auditor has identified.
- The entity's governance composition. For instance, more detail may be needed if those charged with governance include members who do not have significant experience in the entity's industry or in the affected areas.

⁹ SA 260 (Revised), paragraph 9.

¹⁰ SA 230 (Revised), "Audit Documentation", paragraph 14.

¹¹ SA 230 (Revised), paragraph A21.



Communicating Deficiencies in Internal Control

- Legal or regulatory requirements regarding the communication of specific types of deficiency in internal control.

A16. Management and those charged with governance may already be aware of significant deficiencies that the auditor has identified during the audit and may have chosen not to remedy them because of cost or other considerations. The responsibility for evaluating the costs and benefits of implementing remedial action rests with management and those charged with governance. Accordingly, the requirement in paragraph 9 applies regardless of cost or other considerations that management and those charged with governance may consider relevant in determining whether to remedy such deficiencies.

A17. The fact that the auditor communicated a significant deficiency to those charged with governance and management in a previous audit does not eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken. If a previously communicated significant deficiency remains, the current year's communication may repeat the description from the previous communication, or simply reference the previous communication. The auditor may ask management or, where appropriate, those charged with governance, why the significant deficiency has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency.

Considerations Specific to Smaller Entities

A18. 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 larger entities.

Communication of Deficiencies in Internal Control to Management (Ref: Para. 10)

A19. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the deficiencies in internal control and to take the necessary remedial action. For significant deficiencies, the appropriate level is likely to be the chief executive officer or chief financial officer (or equivalent) as these matters are also required to be communicated to those charged with governance. For other deficiencies in internal control, the appropriate level may be operational management with more direct involvement in the control areas affected and with the authority to take appropriate remedial action.

Communication of Significant Deficiencies in Internal Control to Management (Ref: Para. 10(a))

A20. Certain identified significant deficiencies in internal control may call into question the integrity or competence of management. For example, there may be evidence of fraud or intentional non-compliance with laws and regulations by management, or management may exhibit an inability to oversee the preparation of adequate financial statements that may raise doubt about management's competence. Accordingly, it may not be appropriate to communicate such deficiencies directly to management.

A21. SA 250 (Revised) establishes requirements and provides guidance on the reporting of identified or suspected non-compliance with laws and regulations, including when those charged with governance are themselves involved in such non-compliance¹². SA 240 (Revised) establishes requirements and provides guidance regarding communication to those charged with governance when the auditor has identified fraud or suspected fraud involving management¹³.

Communication of Other Deficiencies in Internal Control to Management (Ref: Para. 10(b))

A22. During the audit, the auditor may identify other deficiencies in internal control that are not significant deficiencies but that may be of sufficient importance to merit management's attention. The determination as to which other deficiencies in internal control merit management's attention is a matter of professional judgment in the

¹² SA 250 (Revised), "Consideration of Laws and Regulations in an Audit of Financial Statements," paragraphs 22-28.

¹³ SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements," paragraph 41.



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circumstances, taking into account the likelihood and potential magnitude of misstatements that may arise in the financial statements as a result of those deficiencies.

A23. The communication of other deficiencies in internal control that merit management's attention need not be in writing but may be oral. Where the auditor has discussed the facts and circumstances of the auditor's findings with management, the auditor may consider an oral communication of the other deficiencies to have been made to management at the time of these discussions. Accordingly, a formal communication need not be made subsequently.

A24. If the auditor has communicated deficiencies in internal control other than significant deficiencies to management in a prior period and management has chosen not to remedy them for cost or other reasons, the auditor need not repeat the communication in the current period. The auditor is also not required to repeat information about such deficiencies if it has been previously communicated to management by other parties, such as internal auditors or regulators. It may, however, be appropriate for the auditor to re-communicate these other deficiencies if there has been a change of management, or if new information has come to the auditor's attention that alters the prior understanding of the auditor and management regarding the deficiencies. Nevertheless, the failure of management to remedy other deficiencies in internal control that were previously communicated may become a significant deficiency requiring communication with those charged with governance. Whether this is the case depends on the auditor's judgment in the circumstances.

A25. In some circumstances, those charged with governance may wish to be made aware of the details of other deficiencies in internal control the auditor has communicated to management, or be briefly informed of the nature of the other deficiencies. Alternatively, the auditor may consider it appropriate to inform those charged with governance of the communication of the other deficiencies to management. In either case, the auditor may report orally or in writing to those charged with governance as appropriate.

A26. SA 260 (Revised) establishes relevant considerations regarding communication with those charged with governance when all of them are involved in managing the entity¹⁴.

A27. In the case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the auditors may have additional responsibilities to communicate deficiencies in internal control that the auditor has identified during the audit, in ways, at a level of detail and to parties not envisaged in this SA. For example, significant deficiencies may have to be communicated to the legislature or other governing body. Law, regulation or other authority may also mandate that the auditors report deficiencies in internal control, irrespective of the significance of the potential effects of those deficiencies. Further, legislation may require the auditors to report on broader internal control-related matters than the deficiencies in internal control required to be communicated by this SA, for example, controls related to compliance with legislative authorities, regulations, or provisions of contracts or grant agreements.

Content of Written Communication of Significant Deficiencies in Internal Control (Ref: Para. 11)

A28. In explaining the potential effects of the significant deficiencies, the auditor need not quantify those effects. The significant deficiencies may be grouped together for reporting purposes where it is appropriate to do so. The auditor may also include in the written communication suggestions for remedial action on the deficiencies, management's actual or proposed responses, and a statement as to whether or not the auditor has undertaken any steps to verify whether management's responses have been implemented.

A29. The auditor may consider it appropriate to include the following information as additional context for the communication:

- An indication that if the auditor had performed more extensive procedures on internal control, the auditor might

¹⁴ SA 260 (Revised), paragraph 9.



Communicating Deficiencies in Internal Control

have identified more deficiencies to be reported, or concluded that some of the reported deficiencies need not, in fact, have been reported.

- An indication that such communication has been provided for the purposes of those charged with governance, and that it may not be suitable for other purposes.

A30. Law or regulation may require the auditor or management to furnish a copy of the auditor's written communication on significant deficiencies to appropriate regulatory authorities. Where this is the case, the auditor's written communication may identify such regulatory authorities.

Material Modifications to ISA 265, “Communicating Deficiencies in Internal Control to Those Charged with Governance and Management”

Deletions

- 1 Paragraph A7 of ISA 265 provides the examples of the indicators of significant deficiencies in internal control which may include restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud. 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 A27 of ISA 265 deals with the additional responsibilities of the public sector auditors to communicate/report deficiencies in internal control to the legislature or governing 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 additional responsibilities may also be imposed on the auditor 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 A22, highlighting the fact, has been retained though a specific reference to public sector entities has been deleted.



Training Manual on Engagement and Quality Control Standards

Limited Revision Consequential to issuance of Standard on Auditing (SA) 265, “Communicating Deficiencies in Internal Control to Those Charged with Governance and Management”

The amendments to the following Standards on Auditing (SAs) have been shown in track change mode.

SA 240 (Revised), “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”

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:

- ...
- 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~~ deficiencies in internal control.
- ...

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~~ deficient controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential ~~weakness~~ deficiency in internal control since there is an opportunity for management override of controls.

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:

- ...
- A failure by management to appropriately address identified ~~material weaknesses~~ significant deficiencies in internal control, or to appropriately respond to an identified fraud.
- ...

Appendix 1 – Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting

Opportunities

...

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

- ...



Communicating Deficiencies in Internal Control

- Accounting and information systems that are not effective, including situations involving significant deficiencies ~~material weaknesses~~ in internal control.

Attitudes/Rationalizations

- ...
- Management failing to ~~correct~~ remedy known significant deficiencies ~~material weaknesses~~ in internal control on a timely basis.
- ...

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, ineffective monitoring of management and ~~weaknesses~~ other deficiencies 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.

Attitudes/Rationalizations

- ...
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to ~~correct~~ take appropriate remedial action on known deficiencies ~~in internal control deficiencies~~.
- ...

Appendix 3 – Examples of Circumstances that Indicate the Possibility of Fraud

Problematic or unusual relationships between the auditor and management, including:

- ...
- An unwillingness to address identified deficiencies ~~weaknesses~~ in internal control on a timely basis.
- ...

SA 260 (Revised), “Communicating with Those Charged with Governance”

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. In addition, Proposed SA 265¹⁵ establishes specific requirements regarding the communication of significant deficiencies in internal control the auditor has identified during the audit to those charged with governance. 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)

¹⁵ SA 265, “Communicating Deficiencies in Internal Control to Those Charged with Governance and Management”.



Training Manual on Engagement and Quality Control Standards

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, 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 or SA 330;~~
 - (i) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; (Ref: Para. A23) and
 - (ii) 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)

Supplementary Matters (Ref: Para. 3)

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 issues regarding governance structures or processes, and significant decisions or actions by senior management that lack appropriate authorisation.

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:

- ...
- 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, the auditor it may be appropriate to communicate orally to those charged with governance as soon as practicable significant deficiencies material weaknesses in the design, implementation or operating effectiveness of in internal control that the auditor has identified prior to communicating these in writing as required by SA 265¹⁶. have come to the auditor's attention as soon as practicable.

¹⁶ SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", paragraphs 9 and A14.



Communicating Deficiencies in Internal Control

SA 300 (Revised), “Planning the Audit of Financial Statements”

Appendix – Considerations in Establishing the Overall Audit Strategy

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

- Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified ~~weaknesses~~ deficiencies and action taken to address them.

SA 315 , “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment”

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

- ~~(f) Material Weakness—A weakness in internal control that could have a material effect on the financial statements.~~

...

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 deficiencies in the control environment ~~weaknesses~~. (Ref: Para. A65-A74)

...

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 determine if there is a ~~material weakness~~ significant deficiency in internal control with regard to 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 determine whether it represents a significant deficiency ~~material weakness in the entity’s internal control~~. (Ref: Para. A76)

...

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 remedial~~ actions to deficiencies in its controls. (Ref: Para. A94-A96)

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)~~



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~~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", with those charged with governance (unless all of those charged with governance are involved in managing the entity). (Ref: Para. A126)~~

...

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 (including deficiencies in 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.

...

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 significant deficiency in the entity's internal control.

...

Effect of the control environment on the assessment of the risks of material misstatement

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, deficiencies 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.

...

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 remedial



Communicating Deficiencies in Internal Control

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.

...

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~~ remedial action to the control.

...

Assessment of Risks of Material Misstatement at the Financial Statement Level (Ref: Para. 24 (a))

A99. Risks at the financial statement level may derive in particular from a ~~weak~~ deficient control environment (although these risks may also relate to other factors, such as, declining economic conditions). For example, ~~deficiencies, 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.

...

Understanding Controls Related to Significant Risks (Ref: Para. 28)

A119. In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. Failure by management to implement such controls is an indicator of a ~~This may indicate a~~ significant deficiency ~~material weakness in the entity's~~ internal control.¹⁷

...

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.~~

Appendix 1 – Internal Control Components

Monitoring of Controls

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

¹⁷ SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", Paragraph A7.



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communicate information about strengths and ~~weaknesses~~ deficiencies in internal control and recommendations for improving internal control.

Appendix 2 – Conditions and Events that may Indicate Risks of Material Misstatement

- ...
- ~~Weaknesses~~ Significant Deficiencies in internal control, especially those not addressed by management.
- ...

SA 330, “The Auditor’s Responses to Assessed Risks”

~~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”, with those charged with governance (unless all of those charged with governance are involved in managing the entity).~~

Overall Responses (Ref: Para. 5)

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. ~~Deficiencies 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.

Controls that have not changed from previous audits (Ref: Para. 14(b))

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-deficient~~ control environment.
- ~~Weak-Deficient~~ 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-Deficient~~ general IT-controls.

Evaluating the Operating Effectiveness of Controls (Ref: Para. 16-19)

A40. A material misstatement detected by the auditor’s procedures ~~may indicate~~ is a strong indicator of the existence of a material weakness-significant deficiency in internal control.



Communicating Deficiencies in Internal Control

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~~ significant deficiency 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.

SA 540 (Revised), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"

Obtaining an Understanding of How Management Identifies the Need for Accounting Estimates (Ref: Para. 8(b))

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—deals with circumstances where the auditor identifies risks of material misstatement that management failed to identify, including determining whether there is a significant deficiency in internal control with regard to in the entity's risk assessment processes~~¹⁸.

SA 550 (Revised), "Related Parties"

The Entity's Controls over Related Party Relationships and Transactions (Ref: Para. 14)

A18. Controls over related party relationships and transactions within some entities may be ~~weak, ineffective~~ deficient or non-existent for a number of reasons, such as:

- ...

¹⁸ SA 315, paragraph 16.



SA 320(REVISED)

MATERIALITY IN PLANNING AND PERFORMING AN AUDIT

*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2010)*

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Material Modifications to ISA 320, "Materiality in Planning and Performing an Audit"



Materiality in Planning and Performing an Audit

Standard on Auditing (SA) 320 (Revised), “Materiality in Planning and Performing an Audit” should be read in the context of the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services¹,” which sets out the authority of SAs and proposed SA 200 (Revised), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”².

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

² Presently, SA 200, “Basic Principles Governing an Audit” and SA 200A, “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). Post revision, the principles covered by SA 200 (AAS 1) and SA 200A (AAS 2) will be merged into one Standard, i.e., SA 200.



Training Manual on Engagement and Quality Control Standards

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. SA 450³, explains how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

Materiality in the Context of an Audit

2. Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:
 - Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
 - Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
 - Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group.⁴ The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.
3. Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to in paragraph 2 provide the auditor with such a frame of reference.
4. The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:
 - (a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
 - (b) Understand that financial statements are prepared, presented and audited to levels of materiality;
 - (c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
 - (d) Make reasonable economic decisions on the basis of the information in the financial statements.
5. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report. (Ref: Para. A1)

³ SA 450, "Evaluation of Misstatements Identified during the Audit".

⁴ For example, paragraph 10 of the "Framework for the Preparation and Presentation of Financial Statements," issued by the Institute of Chartered Accountants of India (ICAI) in July 2000, indicates for a profit-oriented entity that "as providers of risk capital to the enterprise, investor need more comprehensive information than other users. The provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy".



Materiality in Planning and Performing an Audit

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

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

The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. Although, it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements.⁵

Effective Date

7. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

8. The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.

Definition

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

Requirements

Determining Materiality and Performance Materiality when Planning the Audit

10. When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. (Ref: Para. A2-A11)
11. The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (Ref: Para. A12)

⁵ SA 450, paragraph A16.



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Revision as the Audit Progresses

12. The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. (Ref: Para. A13)
13. If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

Documentation

14. The audit documentation shall include the following amounts and the factors considered in their determination:
 - (a) Materiality for the financial statements as a whole (see paragraph 10);
 - (b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures (see paragraph 10);
 - (c) Performance materiality (see paragraph 11); and
 - (d) Any revision of (a)-(c) as the audit progressed (see paragraphs 12-13).

* * *

Application and Other Explanatory Material

Materiality and Audit Risk (Ref: Para. 5)

- A1. In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.⁶ The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level⁷. Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of

⁶ Presently, SA 200, "Basic Principles Governing an Audit" and SA 200A, "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). Post revision, the principles covered by SA 200 (AAS 1) and SA 200A (AAS 2) will be merged into one Standard, i.e., SA 200. ISA 200 (Revised and Redrafted), paragraph 11 states as follows:

"In conducting an audit of financial statements, the overall objectives of the auditor are:

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

⁷ ISA 200 (Revised and Redrafted), paragraph 17 states as follows:

"To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion."



Materiality in Planning and Performing an Audit

material misstatement and detection risk⁸. Materiality and audit risk are considered throughout the audit, in particular, when:

- (a) Identifying and assessing the risks of material misstatement⁹;
- (b) Determining the nature, timing and extent of further audit procedures¹⁰; and
- (c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report¹¹.

Determining Materiality and Performance Materiality when Planning the Audit (Ref: Para. 10)

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

- A2. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:
- The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
 - Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
 - The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
 - The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
 - The relative volatility of the benchmark.
- A3. Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.
- A4. In relation to the chosen benchmark, relevant financial data ordinarily includes prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates. For example, when, as a starting point, the materiality for the financial statements

⁸ ISA 200 (Revised and Redrafted), paragraph 13(c) defines the *Audit Risk* as follows:

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

⁹ SA 315, "Identifying and Assessing the Risks of Material Misstatements Through Understanding the Entity and Its Environment".

¹⁰ SA 330, "The Auditor's Responses to Assessed Risks".

¹¹ Currently, SA 700 (AAS 28), "The Auditor's Report on Financial Statements", issued by ICAI in January 2003 is in force. The Auditing and Assurance Standards Board has issued an Exposure Draft of the Revised SA 700 corresponding to International Standard on Auditing (ISA) 700, "Forming an Opinion and Reporting on Financial Statements". The said Exposure Draft has been published in the June, 2009 issue of the Journal and has also been hosted on ICAI's website.



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as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that the materiality for the financial statements as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.

- A5. Materiality relates to the financial statements on which the auditor is reporting. Where the financial statements are prepared for a financial reporting period of more or less than twelve months, such as may be the case for a new entity or a change in the financial reporting period, materiality relates to the financial statements prepared for that financial reporting period.
- A6. Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in different circumstances.

Considerations Specific to Small Entities

- A7. When an entity's profit before tax from continuing operations is consistently nominal, as might be the case for an owner-managed business where the owner takes much of the profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be more relevant.
- A8. In the case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), legislators and regulators are often the primary users of its financial statements. Furthermore, the financial statements may be used to make decisions other than economic decisions. The determination of materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) in an audit of the financial statements of those entities may therefore be influenced by legislative and regulatory requirements, and by the financial information needs of legislators and the public in relation to public utility programs/projects, such as, Accelerated Irrigation Benefit Programme (AIBP), Pradhan Mantri Gram Sadak Yojana (PMGSY) undertaken by the Central/State governments or related government entities .
- A9. In an audit of the entities doing public utility programs/projects, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for that particular program/project activity. Where an entity has custody of the assets, assets may be an appropriate benchmark.

Materiality Level or Levels for Particular Classes of Transactions, Account Balances or Disclosures (Ref: Para. 10)

- A10. Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements include the following:
- Whether law, regulations or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions, and the remuneration of management and those charged with governance).
 - The key disclosures in relation to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company).



Materiality in Planning and Performing an Audit

- Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, a newly acquired business).
- A11. In considering whether, in the specific circumstances of the entity, such classes of transactions, account balances or disclosures exist, the auditor may find it useful to obtain an understanding of the views and expectations of those charged with governance and management.

Performance Materiality (Ref: Para. 11)

- A12. Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

Revision as the Audit Progresses (Ref: Para. 12)

- A13. Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. For example, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

Material Modifications to ISA 320, "Materiality in Planning and Performing an Audit"

Deletions

1. Paragraph A2 of ISA 320 dealt with the determination of materiality for the financial statements as a whole or for particular assertion in an audit of financial statements of a public sector entity, which is influenced by legislative and regulatory requirements, and by the financial information needs of legislators and the public in relation to public sector programs. 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 situation may exist in case of Central/State governments or related government entities, or programs/projects launched by them, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A2, highlighting such fact, has been retained and the paragraph has been re-numbered as A8.



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2. Paragraph A9 of ISA 320 states that in an audit of the public sector entities, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for program/project activities. Where a public sector entity has custody of assets, assets may be an appropriate benchmark. 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 situation may exist in case of Central/State governments or related government entities, or programs/projects launched by them, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A9, highlighting such fact, has been retained



Materiality in Planning and Performing an Audit

Limited Revision Consequential to issuance of the Standard on Auditing (SA) 320 (Revised), “Materiality in Planning and Performing an Audit”

The amendments to the following Standards on Auditing (SAs) have been shown in track change mode.

SA 230 (Revised), “Audit Documentation”

A17. 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 determined in accordance with SA 320(Revised)¹², assessed risks, significant matters noted during the audit, and conclusions reached.

SA 260 (Revised), “Communication with Those Charged with Governance”

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 the concept of materiality with the auditor, and to identify any areas in which they may request the auditor to undertake additional procedures ...

A17. Matters communicated may include:

- The application of the concept of materiality in the context of an audit.

SA 300 (Revised), “Planning an Audit of Financial Statements”

Appendix

Considerations in Establishing the Overall Audit Strategy

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

- The determination of appropriate materiality levels in accordance with SA 320 (Revised),¹³ and, where applicable: including:
 - Setting materiality for planning purposes.
 - ◆ Setting Determination of materiality for components and communications materiality for thereof to component auditors of components.
 - Reconsidering materiality as audit procedures are performed during the course of the audit.
 - ◆ Preliminary identification of material significant components and material classes of transactions, account balances and disclosures.

SA 315, “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment”

A1. The understanding establishes a frame of reference within which the auditor plans to audit and exercise professional judgment throughout the audit, for example, when: ...

¹² SA 320 (Revised), “Materiality in Planning and Performing an Audit”.

¹³ SA 320 (Revised), “Materiality in Planning and Performing an Audit”.



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- ~~Establishing~~ Determining materiality in accordance with SA 320(Revised) ~~and evaluating whether the judgment about materiality remains appropriate as the audit progresses;~~¹⁴ ...

SA 540 (Revised), “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”

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~~ performance materiality is adequate for the purposes of evaluating the reasonableness of management’s point estimate.

A122. 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 & A94).

¹⁴ SA 320 (Revised), “Materiality in Planning and Performing an Audit”.



SA 402(REVISED)

AUDIT CONSIDERATIONS RELATING TO AN ENTITY USING A SERVICE ORGANISATION

(Effective for all audits relating to
accounting periods beginning on or after April 1, 2010)

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Standard on Auditing (SA) 402 (Revised), “Audit Considerations Relating to an Entity Using a Service Organisation”, 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 and proposed SA 200 (Revised), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”².

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

² Presently, SA 200, “Basic Principles Governing an Audit” and SA 200A, “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). Post revision, the principles covered by SA 200 (AAS 1) and SA 200A (AAS 2) will be merged into one Standard, i.e., SA 200.



Entities Using Service Organisations

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organisations. Specifically, it expands on how the user auditor applies SA 315³ and SA 330⁴ in obtaining an understanding of the user entity, including internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.
2. Many entities outsource aspects of their business to organisations that provide services ranging from performing a specific task under the direction of an entity to replacing an entity's entire business units or functions, such as the tax compliance function. Many of the services provided by such organisations are integral to the entity's business operations; however, not all those services are relevant to the audit.
3. Services provided by a service organisation are relevant to the audit of a user entity's financial statements when those services, and the controls over them, are part of the user entity's information system, including related business processes, relevant to financial reporting. Although most controls at the service organisation are likely to relate to financial reporting, there may be other controls that may also be relevant to the audit, such as controls over the safeguarding of assets. A service organisation's services are part of a user entity's information system, including related business processes, relevant to financial reporting if these services affect any of the following:
 - (a) The classes of transactions in the user entity's operations that are significant to the user entity's financial statements;
 - (b) The procedures, within both information technology (IT) and manual systems, by which the user entity's transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
 - (c) The related accounting records, either in electronic or manual form, supporting information and specific accounts in the user entity's financial statements that are used to initiate, record, process and report the user entity's transactions; this includes the correction of incorrect information and how information is transferred to the general ledger;
 - (d) How the user entity's information system captures events and conditions, other than transactions, that are significant to the financial statements;
 - (e) The financial reporting process used to prepare the user entity's financial statements, including significant accounting estimates and disclosures; and
 - (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.
4. The nature and extent of work to be performed by the user auditor regarding the services provided by a service organisation depend on the nature and significance of those services to the user entity and the relevance of those services to the audit.
5. This SA does not apply to services provided by financial institutions that are limited to processing, for an entity's account held at the financial institution, transactions that are specifically authorised by the entity, such as the processing of checking account transactions by a bank or the processing of securities transactions by a broker. In addition, this SA does not apply to the audit of transactions arising from proprietary financial interests in other entities, such as partnerships, corporations and joint ventures, when proprietary interests are accounted for and reported to interest holders.

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".



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Effective Date

6. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objectives

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

Definitions

8. For purposes of the SAs, the following terms have the meanings attributed below:
- (a) *Complementary user entity controls* – Controls that the service organisation assumes, in the design of its service, will be implemented by user entities, and which, if necessary to achieve control objectives, are identified in the description of its system.
 - (b) *Report on the description and design of controls at a service organisation (referred to in this SA as a Type 1 report)* – A report that comprises:
 - (i) A description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls that have been designed and implemented as at a specified date; and
 - (ii) A report by the service auditor with the objective of conveying reasonable assurance that includes the service auditor's opinion on the description of the service organisation's system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives.
 - (c) *Report on the description, design, and operating effectiveness of controls at a service organisation (referred to in this SA as a Type 2 report)* – A report that comprises:
 - (i) A description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls, their design and implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period; and
 - (ii) A report by the service auditor with the objective of conveying reasonable assurance that includes:
 - a. The service auditor's opinion on the description of the service organisation's system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; and
 - b. A description of the service auditor's tests of the controls and the results thereof.
 - (d) *Service auditor* – An auditor who, at the request of the service organisation, provides an assurance report on the controls of a service organisation.
 - (e) *Service organisation* – A third-party organisation (or segment of a third-party organisation) that provides services to user entities that are part of those entities' information systems relevant to financial reporting.
 - (f) *Service organisation's system* – The policies and procedures designed, implemented and maintained by the service organisation to provide user entities with the services covered by the service auditor's report.



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- (g) *Subservice organisation* – A service organisation used by another service organisation to perform some of the services provided to user entities that are part of those user entities' information systems relevant to financial reporting.
- (h) *User auditor* – An auditor who audits and reports on the financial statements of a user entity.
- (i) *User entity* – An entity that uses a service organisation and whose financial statements are being audited.

Requirements

Obtaining an Understanding of the Services Provided by a Service Organisation, Including Internal Control

9. When obtaining an understanding of the user entity in accordance with SA 315,⁵ the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity's operations, including: (Ref: Para. A1-A2)

- (a) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control; (Ref: Para. A3-A5)
- (b) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation; (Ref: Para. A6)
- (c) The degree of interaction between the activities of the service organisation and those of the user entity; and (Ref: Para. A7)
- (d) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organisation. (Ref: Para. A8-A11)

10. When obtaining an understanding of internal control relevant to the audit in accordance with SA 315,⁶ the user auditor shall evaluate the design and implementation of relevant controls at the user entity that relate to the services provided by the service organisation, including those that are applied to the transactions processed by the service organisation. (Ref: Para. A12-A14)

11. The user auditor shall determine whether a sufficient understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit has been obtained to provide a basis for the identification and assessment of risks of material misstatement.

12. If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor shall obtain that understanding from one or more of the following procedures: (Ref: Para. A15-A20)

- (a) Obtaining a Type 1 or Type 2 report, if available;
- (b) Contacting the service organisation, through the user entity, to obtain specific information;
- (c) Visiting the service organisation and performing procedures that will provide the necessary information about the relevant controls at the service organisation; or
- (d) Using another auditor to perform procedures that will provide the necessary information about the relevant controls at the service organisation.

⁵ SA 315, paragraph 11.

⁶ SA 315, paragraph 12.



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Using a Type 1 or Type 2 Report to Support the User Auditor's Understanding of the Service Organisation

13. In determining the sufficiency and appropriateness of the audit evidence provided by a Type 1 or Type 2 report, the user auditor shall be satisfied as to: (Ref: Para. A21)

- (a) The service auditor's professional competence (except where the service auditor is a member of the Institute of Chartered Accountants of India) and independence from the service organisation; and
- (b) The adequacy of the standards under which the Type 1 or Type 2 report was issued.

14. If the user auditor plans to use a Type 1 or Type 2 report as audit evidence to support the user auditor's understanding about the design and implementation of controls at the service organisation, the user auditor shall: (Ref: Para. A22-A23)

- (a) Evaluate whether the description and design of controls at the service organisation is at a date or for a period that is appropriate for the user auditor's purposes;
- (b) Evaluate the sufficiency and appropriateness of the evidence provided by the report for the understanding of the user entity's internal control relevant to the audit; and
- (c) Determine whether complementary user entity controls identified by the service organisation are relevant to the user entity and, if so, obtain an understanding of whether the user entity has designed and implemented such controls.

Responding to the Assessed Risks of Material Misstatement

15. In responding to assessed risks in accordance with SA 330, the user auditor shall: (Ref: Para. A24-A28)

- (a) Determine whether sufficient appropriate audit evidence concerning the relevant financial statement assertions is available from records held at the user entity; and, if not,
- (b) Perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organisation on the user auditor's behalf.

Tests of Controls

16. When the user auditor's risk assessment includes an expectation that controls at the service organisation are operating effectively, the user auditor shall obtain audit evidence about the operating effectiveness of those controls from one or more of the following procedures: (Ref: Para. A29-A30)

- (a) Obtaining a Type 2 report, if available;
- (b) Performing appropriate tests of controls at the service organisation; or
- (c) Using another auditor to perform tests of controls at the service organisation on behalf of the user auditor.

Using a Type 2 Report as Audit Evidence that Controls at the Service Organisation Are Operating Effectively

17. If, in accordance with paragraph 16(a), the user auditor plans to use a Type 2 report as audit evidence that controls at the service organisation are operating effectively, the user auditor shall determine whether the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment by: (Ref: Para. A31-A39)

- (a) Evaluating whether the description, design and operating effectiveness of controls at the service organisation is at a date or for a period that is appropriate for the user auditor's purposes;
- (b) Determining whether complementary user entity controls identified by the service organisation are relevant to the user entity and, if so, obtaining an understanding of whether the user entity has designed and implemented such controls and, if so, testing their operating effectiveness;



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

Type 1 and Type 2 Reports that Exclude the Services of a Subservice Organisation

18. If the user auditor plans to use a Type 1 or a Type 2 report that excludes the services provided by a subservice organisation and those services are relevant to the audit of the user entity's financial statements, the user auditor shall apply the requirements of this SA with respect to the services provided by the subservice organisation. (Ref: Para. A40)

Fraud, Non-Compliance with Laws and Regulations and Uncorrected Misstatements in Relation to Activities at the Service Organisation

19. The user auditor shall inquire of management of the user entity whether the service organisation has reported to the user entity, or whether the user entity is otherwise aware of, any fraud, non-compliance with laws and regulations or uncorrected misstatements affecting the financial statements of the user entity. The user auditor shall evaluate how such matters affect the nature, timing and extent of the user auditor's further audit procedures, including the effect on the user auditor's conclusions and user auditor's report. (Ref: Para. A41)

Reporting by the User Auditor

20. The user auditor shall modify the opinion in the user auditor's report in accordance with SA 705⁷ if the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation relevant to the audit of the user entity's financial statements. (Ref: Para. A42)

21. The user auditor shall not refer to the work of a service auditor in the user auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the user auditor's report shall indicate that the reference does not diminish the user auditor's responsibility for the audit opinion. (Ref: Para. A43)

22. If reference to the work of a service auditor is relevant to an understanding of a modification to the user auditor's opinion, the user auditor's report shall indicate that such reference does not diminish the user auditor's responsibility for that opinion. (Ref: Para. A44)

Application and Other Explanatory Material

Obtaining an Understanding of the Services Provided by a Service Organisation, Including Internal Control

Sources of Information (Ref: Para. 9)

A1. Information on the nature of the services provided by a service organisation may be available from a wide variety of sources, such as:

- User manuals.
- System overviews.

⁷ Currently, the concept of a modified opinion is dealt with in SA 700, "The Auditor's Report on Financial Statements", issued by ICAI in January 2003. The Auditing and Assurance Standards Board has issued an Exposure Draft of the Proposed SA 705, "Modifications to the Opinion in the Independent Auditor's Report" corresponding to ISA 705. The said Exposure Draft has been published in the June, 2009 issue of the Journal. See paragraph 6 of the said Exposure Draft.



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- Technical manuals.
- The contract or service level agreement between the user entity and the service organisation.
- Reports by service organisations, internal auditors or regulatory authorities on controls at the service organisation.
- Reports by the service auditor, including management letters, if available.

A2. Knowledge obtained through the user auditor's experience with the service organisation, for example through experience with other audit engagements, may also be helpful in obtaining an understanding of the nature of the services provided by the service organisation. This may be particularly helpful if the services and controls at the service organisation over those services are highly standardised.

Nature of the Services Provided by the Service Organisation (Ref: Para. 9(a))

A3. A user entity may use a service organisation such as one that processes transactions and maintains related accountability, or records transactions and processes related data. Service organisations that provide such services include, for example, bank trust departments that invest and service assets for employee benefit plans or for others; mortgage bankers that service mortgages for others; and application service providers that provide packaged software applications and a technology environment that enables customers to process financial and operational transactions.

A4. Examples of service organisation services that are relevant to the audit include:

- Maintenance of the user entity's accounting records.
- Management of assets.
- Initiating, recording or processing transactions as agent of the user entity.

Considerations Specific to Smaller Entities

A5. Smaller entities may use external bookkeeping services ranging from the processing of certain transactions (e.g., payment of payroll taxes) and maintenance of their accounting records to the preparation of their financial statements. The use of such a service organisation for the preparation of its financial statements does not relieve management of the smaller entity and, where appropriate, those charged with governance of their responsibilities for the financial statements.⁸

Nature and Materiality of Transactions Processed by the Service Organisation (Ref: Para. 9(b))

A6. A service organisation may establish policies and procedures that affect the user entity's internal control. These policies and procedures are at least in part physically and operationally separate from the user entity. The significance of the controls of the service organisation to those of the user entity depends on the nature of the services provided by the service organisation, including the nature and materiality of the transactions it processes for the user entity. In certain situations, the transactions processed and the accounts affected by the service organisation may not appear to be material to the user entity's financial statements, but the nature of the transactions processed may be significant and the user auditor may determine that an understanding of those controls is necessary in the circumstances.

⁸ Presently, SA 200, *Basic Principles Governing an Audit*, and SA 200A, *Objective and Scope of the Audit of Financial Statements*, correspond to the International Standard on Auditing (ISA) 200. 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 and SA 200A will be merged into one Standard, i.e., SA 200.



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The Degree of Interaction between the Activities of the Service Organisation and the User Entity (Ref: Para. 9(c))

A7. The significance of the controls of the service organisation to those of the user entity also depends on the degree of interaction between its activities and those of the user entity. The degree of interaction refers to the extent to which a user entity is able to and elects to implement effective controls over the processing performed by the service organisation. For example, a high degree of interaction exists between the activities of the user entity and those at the service organisation when the user entity authorises transactions and the service organisation processes and does the accounting for those transactions. In these circumstances, it may be practicable for the user entity to implement effective controls over those transactions. On the other hand, when the service organisation initiates or initially records, processes, and does the accounting for the user entity's transactions, there is a lower degree of interaction between the two organisations. In these circumstances, the user entity may be unable to, or may elect not to, implement effective controls over these transactions at the user entity and may rely on controls at the service organisation.

Nature of the Relationship between the User Entity and the Service Organisation (Ref: Para. 9(d))

A8. The contract or service level agreement between the user entity and the service organisation may provide for matters such as:

- The information to be provided to the user entity and responsibilities for initiating transactions relating to the activities undertaken by the service organisation;
- The application of requirements of regulatory bodies concerning the form of records to be maintained, or access to them;
- The indemnification, if any, to be provided to the user entity in the event of a performance failure;
- Whether the service organisation will provide a report on its controls and, if so, whether such report would be a Type 1 or Type 2 report;
- Whether the user auditor has rights of access to the accounting records of the user entity maintained by the service organisation and other information necessary for the conduct of the audit; and
- Whether the agreement allows for direct communication between the user auditor and the service auditor.

A9. There is a direct relationship between the service organisation and the user entity and between the service organisation and the service auditor. These relationships do not necessarily create a direct relationship between the user auditor and the service auditor. When there is no direct relationship between the user auditor and the service auditor, communications between the user auditor and the service auditor are usually conducted through the user entity and the service organisation. A direct relationship may also be created between a user auditor and a service auditor, taking into account the relevant ethical and confidentiality considerations. A user auditor, for example, may use a service auditor to perform procedures on the user auditor's behalf, such as:

- (a) Tests of controls at the service organisation; or
- (b) Substantive procedures on the user entity's financial statement transactions and balances maintained by a service organisation.

A10. Auditors generally have broad rights of access established by legislation. However, there may be situations where such rights of access are not available, for example when the service organisation is located in a different jurisdiction. In such situations, the auditor may need to obtain an understanding of the legislation applicable in the different jurisdiction to determine whether appropriate access rights can be obtained. In such cases, the auditor may also obtain or ask the user entity to incorporate rights of access in any contractual arrangements between the user entity and the service organisation.



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A11. In the above context, the auditors may also use another auditor to perform tests of controls or substantive procedures in relation to compliance with law, regulation or other authority.

Understanding the Controls relating to Services provided by the Service Organisation (Ref: Para. 10)

A12. The user entity may establish controls over the service organisation's services that may be tested by the user auditor and that may enable the user auditor to conclude that the user entity's controls are operating effectively for some or all of the related assertions, regardless of the controls in place at the service organisation. If a user entity, for example, uses a service organisation to process its payroll transactions, the user entity may establish controls over the submission and receipt of payroll information that could prevent or detect material misstatements. These controls may include:

- Comparing the data submitted to the service organisation with reports of information received from the service organisation after the data has been processed.
- Recomputing a sample of the payroll amounts for clerical accuracy and reviewing the total amount of the payroll for reasonableness.

A13. In this situation, the user auditor may perform tests of the user entity's controls over payroll processing that would provide a basis for the user auditor to conclude that the user entity's controls are operating effectively for the assertions related to payroll transactions.

A14. As noted in SA 315,⁹ in respect of some risks, the user 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 and account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. Such automated processing characteristics may be particularly present when the user entity uses service organisations. In such cases, the user entity's controls over such risks are relevant to the audit and the user auditor is required to obtain an understanding of, and to evaluate, such controls in accordance with paragraphs 9 and 10 of this SA.

Further Procedures When a Sufficient Understanding Cannot Be Obtained from the User Entity (Ref: Para. 12)

A15. The user auditor's decision as to which procedure, individually or in combination, in paragraph 12 to undertake, in order to obtain the information necessary to provide a basis for the identification and assessment of the risks of material misstatement in relation to the user entity's use of the service organisation, may be influenced by such matters as:

- The size of both the user entity and the service organisation;
- The complexity of the transactions at the user entity and the complexity of the services provided by the service organisation;
- The location of the service organisation (for example, the user auditor may decide to use another auditor to perform procedures at the service organisation on the user auditor's behalf if the service organisation is in a remote location);
- Whether the procedure(s) is expected to effectively provide the user auditor with sufficient appropriate audit evidence; and
- The nature of the relationship between the user entity and the service organisation.

A16. A service organisation may engage a service auditor to report on the description and design of its controls (Type 1 report) or on the description and design of its controls and their operating effectiveness (Type 2 report). Type

⁹ SA 315, paragraph 29.



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1 or Type 2 reports may be issued under [proposed] Standard on Assurance Engagements (SAE) 3402¹⁰ or under standards established by an authorised or recognised standards setting organisation (which may identify them by different names, such as Type A or Type B reports).

A17. The availability of a Type 1 or Type 2 report will generally depend on whether the contract between a service organisation and a user entity includes the provision of such a report by the service organisation. A service organisation may also elect, for practical reasons, to make a Type 1 or Type 2 report available to the user entities. However, in some cases, a Type 1 or Type 2 report may not be available to user entities.

A18. In some circumstances, a user entity may outsource one or more significant business units or functions, such as its entire tax planning and compliance functions, or finance and accounting or the controllership function to one or more service organisations. As a report on controls at the service organisation may not be available in these circumstances, visiting the service organisation may be the most effective procedure for the user auditor to gain an understanding of controls at the service organisation, as there is likely to be direct interaction of management of the user entity with management at the service organisation.

A19. Another auditor may be used to perform procedures that will provide the necessary information about the relevant controls at the service organisation. If a Type 1 or Type 2 report has been issued, the user auditor may use the service auditor to perform these procedures as the service auditor has an existing relationship with the service organisation. The user auditor using the work of another auditor may find the guidance in SA 600¹¹ useful as it relates to understanding another auditor (including that auditor's independence and professional competence¹²), involvement in the work of another auditor in planning the nature, extent and timing of such work, and in evaluating the sufficiency and appropriateness of the audit evidence obtained.

A20. A user entity may use a service organisation that in turn uses a subservice organisation to provide some of the services provided to a user entity that are part of the user entity's information system relevant to financial reporting. The subservice organisation may be a separate entity from the service organisation or may be related to the service organisation. A user auditor may need to consider controls at the subservice organisation. In situations where one or more subservice organisations are used, the interaction between the activities of the user entity and those of the service organisation is expanded to include the interaction between the user entity, the service organisation and the subservice organisations. The degree of this interaction, as well as the nature and materiality of the transactions processed by the service organisation and the subservice organisations are the most important factors for the user auditor to consider in determining the significance of the service organisation's and subservice organisation's controls to the user entity's controls.

Using a Type 1 or Type 2 Report to Support the User Auditor's Understanding of the Service Organisation (Ref: Para. 13-14)

A21. The user auditor may make inquiries about the service auditor to the service auditor's professional organisation or other practitioners and inquire whether the service auditor is subject to regulatory oversight. The service auditor may be practicing in a jurisdiction where different standards are followed in respect of reports on controls at a service organisation, and the user auditor may obtain information about the standards used by the service auditor from the standard setting organisation.

¹⁰ [Proposed] SAE 3402, "Assurance Reports on Controls at a Third-Party Service Organisation". The Standard is being formulated by AASB in the light of the corresponding International Standard.

¹¹ Hitherto known as SA 600, "Using the Work of Another Auditor". The Standard is being revised in the light of ISA 600 (Revised and Redrafted).

¹² Except where such other auditor is a member of the Institute of Chartered Accountants of India.



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A22. A Type 1 or Type 2 report, along with information about the user entity, may assist the user auditor in obtaining an understanding of:

- (a) The aspects of controls at the service organisation that may affect the processing of the user entity's transactions, including the use of subservice organisations;
- (b) The flow of significant transactions through the service organisation to determine the points in the transaction flow where material misstatements in the user entity's financial statements could occur;
- (c) The control objectives at the service organisation that are relevant to the user entity's financial statement assertions; and
- (d) Whether controls at the service organisation are suitably designed and implemented to prevent or detect processing errors that could result in material misstatements in the user entity's financial statements.

A Type 1 or Type 2 report may assist the user auditor in obtaining a sufficient understanding to identify and assess the risks of material misstatement. A type 1 report, however, does not provide any evidence of the operating effectiveness of the relevant controls.

A23. A Type 1 or Type 2 report that is as of a date or for a period that is outside of the reporting period of a user entity may assist the user auditor in obtaining a preliminary understanding of the controls implemented at the service organisation if the report is supplemented by additional current information from other sources. If the service organisation's description of controls is as of a date or for a period that precedes the beginning of the period under audit, the user auditor may perform procedures to update the information in a Type 1 or Type 2 report, such as:

- Discussing the changes at the service organisation with user entity personnel who would be in a position to know of such changes;
- Reviewing current documentation and correspondence issued by the service organisation; or
- Discussing the changes with service organisation personnel.

Responding to the Assessed Risks of Material Misstatement (Ref: Para. 15)

A24. Whether the use of a service organisation increases a user entity's risk of material misstatement depends on the nature of the services provided and the controls over these services; in some cases, the use of a service organisation may decrease a user entity's risk of material misstatement, particularly if the user entity itself does not possess the expertise necessary to undertake particular activities, such as initiating, processing, and recording transactions, or does not have adequate resources (e.g., an IT system).

A25. When the service organisation maintains material elements of the accounting records of the user entity, direct access to those records may be necessary in order for the user auditor to obtain sufficient appropriate audit evidence relating to the operations of controls over those records or to substantiate transactions and balances recorded in them, or both. Such access may involve either physical inspection of records at the service organisation's premises or interrogation of records maintained electronically from the user entity or another location, or both. Where direct access is achieved electronically, the user auditor may thereby obtain evidence as to the adequacy of controls operated by the service organisation over the completeness and integrity of the user entity's data for which the service organisation is responsible.

A26. In determining the nature and extent of audit evidence to be obtained in relation to balances representing assets held or transactions undertaken by a service organisation on behalf of the user entity, the following procedures may be considered by the user auditor:

- (a) Inspecting records and documents held by the user entity: the reliability of this source of evidence is determined by the nature and extent of the accounting records and supporting documentation retained by the user entity. In



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some cases, the user entity may not maintain independent detailed records or documentation of specific transactions undertaken on its behalf.

- (b) Inspecting records and documents held by the service organisation: the user auditor's access to the records of the service organisation may be established as part of the contractual arrangements between the user entity and the service organisation. The user auditor may also use another auditor, on its behalf, to gain access to the user entity's records maintained by the service organisation.
- (c) Obtaining confirmations of balances and transactions from the service organisation: where the user entity maintains independent records of balances and transactions, confirmation from the service organisation corroborating the user entity's records may constitute reliable audit evidence concerning the existence of the transactions and assets concerned. For example, when multiple service organisations are used, such as an investment manager and a custodian, and these service organisations maintain independent records, the user auditor may confirm balances with these organisations in order to compare this information with the independent records of the user entity.

If the user entity does not maintain independent records, information obtained in confirmations from the service organisation is merely a statement of what is reflected in the records maintained by the service organisation. Therefore, such confirmations do not, taken alone, constitute reliable audit evidence. In these circumstances, the user auditor may consider whether an alternative source of independent evidence can be identified.

- (d) Performing analytical procedures on the records maintained by the user entity or on the reports received from the service organisation: the effectiveness of analytical procedures is likely to vary by assertion and will be affected by the extent and detail of information available.

A27. Another auditor may perform procedures that are substantive in nature for the benefit of user auditors. Such an engagement may involve the performance, by another auditor, of procedures agreed upon by the user entity and its user auditor and by the service organisation and its service auditor. The findings resulting from the procedures performed by another auditor are reviewed by the user auditor to determine whether they constitute sufficient appropriate audit evidence. In addition, there may be requirements imposed by governmental authorities or through contractual arrangements whereby a service auditor performs designated procedures that are substantive in nature. The results of the application of the required procedures to balances and transactions processed by the service organisation may be used by user auditors as part of the evidence necessary to support their audit opinions. In these circumstances, it may be useful for the user auditor and the service auditor to agree, prior to the performance of the procedures, to the audit documentation or access to audit documentation that will be provided to the user auditor.

A28. In certain circumstances, in particular when a user entity outsources some or all of its finance function to a service organisation, the user auditor may face a situation where a significant portion of the audit evidence resides at the service organisation. Substantive procedures may need to be performed at the service organisation by the user auditor or another auditor on its behalf. A service auditor may provide a Type 2 report and, in addition, may perform substantive procedures on behalf of the user auditor. The involvement of another auditor does not alter the user auditor's responsibility to obtain sufficient appropriate audit evidence to afford a reasonable basis to support the user auditor's opinion. Accordingly, the user auditor's consideration of whether sufficient appropriate audit evidence has been obtained and whether the user auditor needs to perform further substantive procedures includes the user auditor's involvement with, or evidence of, the direction, supervision and performance of the substantive procedures performed by another auditor.



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Tests of Controls (Ref: Para. 16)

A29. The user auditor is required by SA 330¹³ to design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls in certain circumstances. In the context of a service organisation, this requirement applies when:

- (a) The user auditor's assessment of risks of material misstatement includes an expectation that the controls at the service organisation are operating effectively (i.e., the user auditor intends to rely on the operating effectiveness of controls at the service organisation in determining the nature, timing and extent of substantive procedures); or
- (b) Substantive procedures alone, or in combination with tests of the operating effectiveness of controls at the user entity, cannot provide sufficient appropriate audit evidence at the assertion level.

A30. If a Type 2 report is not available, a user auditor may contact the service organisation, through the user entity, to request that a service auditor be engaged to provide a Type 2 report that includes tests of the operating effectiveness of the relevant controls or the user auditor may use another auditor to perform procedures at the service organisation that test the operating effectiveness of those controls. A user auditor may also visit the service organisation and perform tests of relevant controls if the service organisation agrees to it. The user auditor's risk assessments are based on the combined evidence provided by the work of another auditor and the user auditor's own procedures.

Using a Type 2 Report as Audit Evidence that Controls at the Service Organisation Are Operating Effectively (Ref: Para. 17)

A31. A Type 2 report may be intended to satisfy the needs of several different user auditors; therefore tests of controls and results described in the service auditor's report may not be relevant to assertions that are significant in the user entity's financial statements. The relevant tests of controls and results are evaluated to determine that the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment. In doing so, the user auditor may consider the following factors:

- (a) The time period covered by the tests of controls and the time elapsed since the performance of the tests of controls;
- (b) The scope of the service auditor's work and the services and processes covered, the controls tested and tests that were performed, and the way in which tested controls relate to the user entity's controls; and
- (c) The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.

A32. For certain assertions, the shorter the period covered by a specific test and the longer the time elapsed since the performance of the test, the less audit evidence the test may provide. In comparing the period covered by the Type 2 report to the user entity's financial reporting period, the user auditor may conclude that the Type 2 report offers less audit evidence if there is little overlap between the period covered by the Type 2 report and the period for which the user auditor intends to rely on the report. When this is the case, a Type 2 report covering a preceding or subsequent period may provide additional audit evidence. In other cases, the user auditor may determine it is necessary to perform, or use another auditor to perform, tests of controls at the service organisation in order to obtain sufficient appropriate audit evidence about the operating effectiveness of those controls.

A33. It may also be necessary for the user auditor to obtain additional evidence about significant changes to the relevant controls at the service organisation outside of the period covered by the Type 2 report or determine additional audit procedures to be performed. Relevant factors in determining what additional audit evidence to obtain

¹³ SA 330, paragraph 8.



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about controls at the service organisation that were operating outside of the period covered by the service auditor's report may 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 user auditor intends to reduce further substantive procedures based on the reliance on controls; and
- The effectiveness of the control environment and monitoring of controls at the user entity.

A34. Additional audit evidence may be obtained, for example, by extending tests of controls over the remaining period or testing the user entity's monitoring of controls.

A35. If the service auditor's testing period is completely outside the user entity's financial reporting period, the user auditor will be unable to rely on such tests for the user auditor to conclude that the user entity's controls are operating effectively because they do not provide current audit period evidence of the effectiveness of the controls, unless other procedures are performed.

A36. In certain circumstances, a service provided by the service organisation may be designed with the assumption that certain controls will be implemented by the user entity. For example, the service may be designed with the assumption that the user entity will have controls in place for authorising transactions before they are sent to the service organisation for processing. In such a situation, the service organisation's description of controls may include a description of those complementary user entity controls. The user auditor considers whether those complementary user entity controls are relevant to the service provided to the user entity.

A37. If the user auditor believes that the service auditor's report may not provide sufficient appropriate audit evidence, for example, if a service auditor's report does not contain a description of the service auditor's tests of controls and results thereon, the user auditor may supplement the understanding of the service auditor's procedures and conclusions by contacting the service organisation, through the user entity, to request a discussion with the service auditor about the scope and results of the service auditor's work. Also, if the user auditor believes it is necessary, the user auditor may contact the service organisation, through the user entity, to request that the service auditor perform procedures at the service organisation. Alternatively, the user auditor, or another auditor at the request of the user auditor, may perform such procedures.

A38. The service auditor's Type 2 report identifies results of tests, including exceptions and other information that could affect the user auditor's conclusions. Exceptions noted by the service auditor or a modified opinion in the service auditor's Type 2 report do not automatically mean that the service auditor's Type 2 report will not be useful for the audit of the user entity's financial statements in assessing the risks of material misstatement. Rather, the exceptions and the matter giving rise to a modified opinion in the service auditor's Type 2 report are considered in the user auditor's assessment of the testing of controls performed by the service auditor. In considering the exceptions and matters giving rise to a modified opinion, the user auditor may discuss such matters with the service auditor. Such communication is dependent upon the user entity contacting the service organisation, and obtaining the service organisation's approval for the communication to take place.



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Communication of Deficiencies in Internal Control identified during the Audit

A39. The user auditor is required to communicate in writing significant deficiencies identified during the audit to both management and those charged with governance on a timely basis.¹⁴ The user auditor is also required to communicate to management at an appropriate level of responsibility on a timely basis other deficiencies in internal control identified during the audit that, in the user auditor's professional judgment, are of sufficient importance to merit management's attention.¹⁵ Matters that the user auditor may identify during the audit and may communicate to management and those charged with governance of the user entity include:

- Any monitoring of controls that could be implemented by the user entity, including those identified as a result of obtaining a Type 1 or Type 2 report;
- Instances where complementary user entity controls are noted in the Type 1 or Type 2 report and are not implemented at the user entity; and
- Controls that may be needed at the service organisation that do not appear to have been implemented or that are not specifically covered by a Type 2 report.

Type 1 and Type 2 Reports that Exclude the Services of a Subservice Organisation (Ref: Para. 18)

A40. If a service organisation uses a subservice organisation, the service auditor's report may either include or exclude the subservice organisation's relevant control objectives and related controls in the service organisation's description of its system and in the scope of the service auditor's engagement. These two methods of reporting are known as the inclusive method and the carve-out method, respectively. If the Type 1 or Type 2 report excludes the controls at a subservice organisation, and the services provided by the subservice organisation are relevant to the audit of the user entity's financial statements, the user auditor is required to apply the requirements of this SA in respect of the subservice organisation. The nature and extent of work to be performed by the user auditor regarding the services provided by a subservice organisation depend on the nature and significance of those services to the user entity and the relevance of those services to the audit. The application of the requirement in paragraph 9 assists the user auditor in determining the effect of the subservice organisation and the nature and extent of work to be performed.

Fraud, Non-Compliance with Laws and Regulations and Uncorrected Misstatements in Relation to Activities at the Service Organisation (Ref: Para. 19)

A41. A service organisation may be required under the terms of the contract with user entities to disclose to affected user entities any fraud, non-compliance with laws and regulations or uncorrected misstatements attributable to the service organisation's management or employees. As required by paragraph 19, the user auditor makes inquiries of the user entity management regarding whether the service organisation has reported any such matters and evaluates whether any matters reported by the service organisation affect the nature, timing and extent of the user auditor's further audit procedures. In certain circumstances, the user auditor may require additional information to perform this evaluation, and may request the user entity to contact the service organisation to obtain the necessary information.

Reporting by the User Auditor (Ref: Para. 20)

A42. When a user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation relevant to the audit of the user entity's financial statements, a limitation on the scope of the audit exists. This may be the case when:

- The user auditor is unable to obtain a sufficient understanding of the services provided by the service organisation and does not have a basis for the identification and assessment of the risks of material misstatement;

¹⁴ SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", paragraph 9 and 10.

¹⁵ SA 265, paragraph 9.



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- A user auditor's risk assessment includes an expectation that controls at the service organisation are operating effectively and the user auditor is unable to obtain sufficient appropriate audit evidence about the operating effectiveness of these controls; or
- Sufficient appropriate audit evidence is only available from records held at the service organisation, and the user auditor is unable to obtain direct access to these records.

Whether the user auditor expresses a qualified opinion or disclaims an opinion depends on the user auditor's conclusion as to whether the possible effects on the financial statements are material or pervasive.

Reference to the Work of a Service Auditor (Ref: Para. 21-22)

A43. In some cases, law or regulation may require a reference to the work of a service auditor in the user auditor's report, for example, for the purposes of transparency in the public sector. In such circumstances, the user auditor may need the consent of the service auditor before making such a reference.

A44. The fact that a user entity uses a service organisation does not alter the user auditor's responsibility under SAs to obtain sufficient appropriate audit evidence to afford a reasonable basis to support the user auditor's opinion. Therefore, the user auditor does not make reference to the service auditor's report as a basis, in part, for the user auditor's opinion on the user entity's financial statements. However, when the user auditor expresses a modified opinion because of a modified opinion in a service auditor's report, the user auditor is not precluded from referring to the service auditor's report if such reference assists in explaining the reason for the user auditor's modified opinion. In such circumstances, the user auditor may need the consent of the service auditor before making such a reference.

Material Modifications to ISA 402, "Audit Considerations Relating to an Entity Using a Service Organisation"

1. Paragraphs A10 and A11 of ISA 402 deal with the application of the requirements of ISA 402 to public sector auditors who have broad rights of access established by legislation. 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.

However, since the situation envisaged in paragraphs A10 and A11 may be possible even in case of auditors of non-public sector entities, the spirit of paragraphs A10 and A11 has been retained and made generic.

2. Paragraph 13 (a) and paragraph A19 of ISA 402 deal with assessment of the service auditor's professional competence and independence from the service organisation for obtaining sufficient and appropriate audit evidence and for reporting purposes. The corresponding paragraphs of SA 402 also require such assessment of professional competence except where the service auditor is also a member of the Institute of Chartered Accountants of India.



SA 450

EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT

(Effective for all audits relating to accounting periods beginning on or after April 1, 2010)

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Material Modifications to ISA 450, "Evaluation of Misstatements Identified during the Audit"



Evaluation of Misstatements Identified During the Audit

Standard on Auditing (SA) 450, “Evaluation of Misstatements Identified during the Audit” should be read in the context of the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services¹,” which sets out the authority of SAs and proposed SA 200 (Revised), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”².

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

² Presently, SA 200, “Basic Principles Governing an Audit” and SA 200A, “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). Post revision, the principles covered by SA 200 (AAS 1) and SA 200A (AAS 2) will be merged into one Standard, i.e., SA 200.



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Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. SA 700 (Revised)³ deals with the auditor's responsibility, in forming an opinion on the financial statements, to conclude whether reasonable assurance has been obtained about whether the financial statements as a whole are free from material misstatement. The auditor's conclusion required by SA 700 (Revised) takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements, in accordance with this SA. SA 320(Revised)⁴ deals with the auditor's responsibility to apply the concept of materiality appropriately in planning and performing an audit of financial statements.

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

3. The objective of the auditor is to evaluate:
- (a) The effect of identified misstatements on the audit; and
 - (b) The effect of uncorrected misstatements, if any, on the financial statements.

Definitions

4. For purposes of the SAs, the following terms have the meanings attributed below:
- (a) Misstatement – A difference between the amounts, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. (Ref: Para. A1)

When the auditor expresses an opinion on whether the financial statements give a true and fair view or are presented fairly, in all material respects, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to give a true and fair view or present fairly, in all material respects.

- (b) Uncorrected misstatements – Misstatements that the auditor has accumulated during the audit and that have not been corrected.

Requirements

Accumulation of Identified Misstatements

5. The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial. (Ref: Para. A2-A3)

³ Currently, SA 700 (AAS 28), "The Auditor's Report on Financial Statements", issued by the Institute of Chartered Accountants of India (ICAI) in January 2003 is in force. The Auditing and Assurance Standards Board (AASB) has issued an Exposure Draft of the Revised SA 700 corresponding to the International Standard on Auditing (ISA) 700 "Forming an Opinion and Reporting on Financial Statements". The said Exposure Draft has been published in the June, 2009 issue of the Journal. See paragraph 11 of the said Exposure Draft.

⁴ SA 320 (Revised), "Materiality in Planning and Performing an Audit".



Evaluation of Misstatements Identified During the Audit

Consideration of Identified Misstatements as the Audit Progresses

6. The auditor shall determine whether the overall audit strategy and audit plan need to be revised if:
 - (a) The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material; or (Ref: Para. A4)
 - (b) The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320 (Revised). (Ref: Para. A5)
7. If, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected, the auditor shall perform additional audit procedures to determine whether misstatements remain. (Ref: Para. A6)

Communication and Correction of Misstatements

8. The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation⁵. The auditor shall request management to correct those misstatements. (Ref: Para. A7-A9)
9. If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement. (Ref: Para. A 10)

Evaluating the Effect of Uncorrected Misstatements

10. Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with SA 320 (Revised) to confirm whether it remains appropriate in the context of the entity's actual financial results. (Ref: Para. A11-A12)
11. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:
 - (a) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and (Ref: Para. A13-A17, A19-A20)
 - (b) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole. (Ref: Para. A18)

Communication with Those Charged with Governance

12. The auditor shall communicate with those charged with governance⁶ uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected. (Ref: Para. A21-A23)

⁵ SA 260 (Revised), "Communication with Those Charged with Governance", paragraph A4.

⁶ In accordance with the paragraph 9 of SA 260 (Revised), "Communication with Those Charged with Governance," if this matter has been communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matter need not be communicated again with those same person(s) in their governance role.



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13. The auditor shall also communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

Written Representation

14. The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation. (Ref: Para. A24)

Documentation

15. The audit documentation shall include: (Ref: Para. A25)

- (a) The amount below which misstatements would be regarded as clearly trivial (paragraph 5);
- (b) All misstatements accumulated during the audit and whether they have been corrected (paragraphs 5,8 and 12); and
- (c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion. (paragraph 11)

* * *

Application and Other Explanatory Material

Misstatements (Ref: Para. 4(a))

A1. Misstatements may result from:

- (a) An inaccuracy in gathering or processing data from which the financial statements are prepared;
- (b) An omission of an amount or disclosure;
- (c) An incorrect accounting estimate arising from overlooking, or clear misinterpretation of, facts; and
- (d) Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

Examples of misstatements arising from fraud are provided in SA 240 (Revised).⁷

Accumulation of Identified Misstatements (Ref: Para. 5)

A2. The auditor may designate an amount below which misstatements would be clearly trivial and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. "Clearly trivial" is not another expression for "not material". Matters that are "clearly trivial" will be of a wholly different (smaller) order of magnitude than materiality determined in accordance with SA 320 (Revised), and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.

⁷ SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements," paragraphs A1-A6.



Evaluation of Misstatements Identified During the Audit

A3. To assist the auditor in evaluating the effect of misstatements accumulated during the audit and in communicating misstatements to management and those charged with governance, it may be useful to distinguish between factual misstatements, judgmental misstatements and projected misstatements.

- Factual misstatements are misstatements about which there is no doubt.
- Judgmental misstatements are differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate.
- Projected misstatements are 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. Guidance on the determination of projected misstatements and evaluation of the results is set out in SA 530 (Revised)⁸.

Consideration of Identified Misstatements as the Audit Progresses (Ref: Para. 6-7)

A4. A misstatement may not be an isolated occurrence. Evidence that other misstatements may exist include, for example, where the auditor identifies that a misstatement arose from a breakdown in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity.

A5. If the aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320 (Revised), there may be a greater than an acceptably low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements accumulated during the audit, could exceed the materiality. Undetected misstatements could exist because of the presence of sampling risk and non-sampling risk.⁹

A6. The auditor may request management to examine a class of transactions, account balance or disclosure in order for management to understand the cause of a misstatement identified by the auditor, perform procedures to determine the amount of the actual misstatement in the class of transactions, account balance or disclosure, and to make appropriate adjustments to the financial statements. Such a request may be made, for example, based on the auditor's projection of misstatements identified in an audit sample to the entire population from which it was drawn.

Communication and Correction of Misstatements (Ref: Para. 8-9)

A7. Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the items are misstatements, inform the auditor if it disagrees, and take action as necessary. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the misstatements and to take the necessary action.

A8. Law or regulation may restrict the auditor's communication of certain misstatements to management, or others, within the entity. 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 seeking legal advice.

A9. The correction by management of all misstatements, including those communicated by the auditor, enables management to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.

⁸ SA 530 (Revised), "Audit Sampling", paragraphs 14-15.

⁹ SA 530 (Revised), paragraphs 5(c) and (d).



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A10. SA 700 (Revised) requires the auditor to evaluate whether the financial statements are prepared and presented, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation includes consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments¹⁰, which may be affected by the auditor's understanding of management's reasons for not making the corrections.

Evaluating the Effect of Uncorrected Misstatements (Ref: Para. 10-11)

A11. The auditor's determination of the materiality in accordance with SA 320 (Revised) is often based on estimates of the entity's financial results, because the actual financial results may not yet be known. Therefore, prior to the auditor's evaluation of the effect of uncorrected misstatements, it may be necessary to revise materiality determined in accordance with SA 320 (Revised) based on the actual financial results.

A12. SA 320 (Revised) explains that, as the audit progresses, the materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) is revised in the event of the auditor becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially¹¹. Thus, any significant revision is likely to have been made before the auditor evaluates the effect of uncorrected misstatements. However, if the auditor's reassessment of materiality determined in accordance with SA 320(Revised) (see paragraph 10 of this SA) gives rise to a lower amount (or amounts), then performance materiality and the appropriateness of the nature, timing and extent of the further audit procedures, are reconsidered so as to obtain sufficient appropriate audit evidence on which to base the audit opinion.

A13. Each individual misstatement is considered to evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions, account balance or disclosure, if any, has been exceeded.

A14. If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. For example, if revenue has been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses. It may be appropriate to offset misstatements within the same account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate¹².

A15. Determining whether a classification misstatement is material involves the evaluation of qualitative considerations, such as the effect of the classification misstatement on debt or other contractual covenants, the effect on individual line items or sub-totals, or the effect on key ratios. There may be circumstances where the auditor concludes that a classification misstatement is not material in the context of the financial statements as a whole, even though it may exceed the materiality level or levels applied in evaluating other misstatements. For example, a misclassification between balance sheet line items may not be considered material in the context of the financial statements as a whole when the amount of the misclassification is small in relation to the size of the related balance sheet line items and the misclassification does not affect the income statement or any key ratios.

A16. The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are

¹⁰ See paragraph 12 of the Exposure Draft of the Revised SA 700, "Forming an Opinion and Reporting on Financial Statements". The Exposure Draft has been issued in the June, 2009 issue of the ICAI's Journal.

¹¹ SA 320 (Revised), paragraph 12.

¹² The identification of a number of immaterial misstatements within the same account balance or class of transactions may require the auditor to re-assess the risk of material misstatement for that account balance or class of transactions.



Evaluation of Misstatements Identified During the Audit

lower than the materiality for the financial statements as a whole. Circumstances that may affect the evaluation include the extent to which the misstatement:

- Affects compliance with regulatory requirements;
- Affects compliance with debt covenants or other contractual requirements;
- Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements;
- Makes a change in earnings or other trends, especially in the context of general economic and industry conditions;
- Affects ratios used to evaluate the entity's financial position, results of operations or cash flows;
- Affects segment information presented in the financial statements (for example, the significance of the matter to a segment or other portion of the entity's business that has been identified as playing a significant role in the entity's operations or profitability);
- Has the effect of increasing management compensation, for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied;
- Is significant having regard to the auditor's understanding of known previous communications to users, for example in relation to forecast earnings;
- Relates to items involving particular parties (for example, whether external parties to the transaction are related to members of the entity's management);
- Is an omission of information not specifically required by the applicable financial reporting framework but which, in the judgment of the auditor, is important to the users' understanding of the financial position, financial performance or cash flows of the entity; or
- Affects other information that will be communicated in documents containing the audited financial statements (for example, information to be included in a "Management Discussion and Analysis" or an "Operating and Financial Review") that may reasonably be expected to influence the economic decisions of the users of the financial statements. SA 720¹³ deals with the auditor's consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements.

These circumstances are only examples; not all are likely to be present in all audits nor is the list necessarily complete. The existence of any circumstances such as these does not necessarily lead to a conclusion that the misstatement is material.

A17. SA 240 (Revised)¹⁴, explains how the implications of a misstatement that is, or may be, the result of fraud ought to be considered in relation to other aspects of the audit, even if the size of the misstatement is not material in relation to the financial statements.

A18. The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements. There are different acceptable approaches to the auditor's

¹³ SA 720, "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements".

¹⁴ SA 240 (Revised), paragraph 35.



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evaluation of such uncorrected misstatements on the current period's financial statements. Using the same evaluation approach provides consistency from period to period.

A19. In the case of an audit of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the evaluation whether a misstatement is material may also be affected by legislation or regulation and additional responsibilities for the auditor to report other matters, including, for example, fraud.

A20. Furthermore, issues such as public interest, accountability, probity and ensuring effective legislative oversight, in particular, may affect the assessment whether an item is material by virtue of its nature. This is particularly so for items that relate to compliance with regulation, legislation or other authority.

Communication with Those Charged with Governance (Ref: Para. 12)

A21. If uncorrected misstatements have been communicated with person(s) with management responsibilities and those person(s) also have governance responsibilities, they need not be communicated again with those same person(s) in their governance role. The auditor nonetheless has to 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.¹⁵

A22. Where there is a large number of individual immaterial uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each individual uncorrected misstatement.

A23. SA 260 (Revised) requires the auditor to communicate with those charged with governance the written representations the auditor is requesting (see paragraph 14 of this SA).¹⁶ The auditor may discuss with those charged with governance the reasons for, and the implications of, a failure to correct misstatements, having regard to the size and nature of the misstatement judged in the surrounding circumstances, and possible implications in relation to future financial statements.

Written Representation (Ref: Para. 14)

A24. Because management and, where appropriate, those charged with governance are responsible for adjusting the financial statements to correct material misstatements, the auditor is required to request them to provide a written representation about uncorrected misstatements. In some circumstances, management and, where appropriate, those charged with governance may not believe that certain uncorrected misstatements are misstatements. For that reason, they may want to add to their written representation words such as: "We do not agree that items and constitute misstatements because [description of reasons]." Obtaining this representation does not, however, relieve the auditor of the need to form a conclusion on the effect of uncorrected misstatements.

Documentation (Ref: Para. 15)

A25. The auditor's documentation of uncorrected misstatements may take into account:

- (a) The consideration of the aggregate effect of uncorrected misstatements;
- (b) The evaluation of whether the materiality level or levels for particular classes of transactions, account balances or disclosures, if any, have been exceeded; and
- (c) The evaluation of the effect of uncorrected misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (for example, debt covenants).

¹⁵ SA 260 (Revised), paragraph 9.

¹⁶ SA 260 (Revised), paragraph 12(c)(iii).



Evaluation of Misstatements Identified During the Audit

Material Modifications to ISA 450, “Evaluation of Misstatements Identified during the Audit”

Deletions

Paragraph A19 of ISA 450 states that in the case of an audit of public sector entities, the evaluation whether a misstatement is material may also be affected by legislation or regulation and additional responsibilities for the auditor to report other matters, including, for example, fraud. 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 situation may exist in case of Central/State governments or related government entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A19, highlighting such fact, has been retained though a specific reference to public sector entities has been deleted.



SA 510 (REVISED)*

INITIAL AUDIT ENGAGEMENTS – OPENING BALANCES

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

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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 Services¹,” which sets out the authority of SAs and proposed SA 200 (Revised), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”².

* Published in March, 2009 issue of the Journal.

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

² Presently, SA 200, “Basic Principles Governing an Audit” and SA 200A, “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). Post revision, the principles covered by SA 200 (AAS 1) and SA 200A (AAS 2) will be merged into one Standard, i.e., SA 200.



Initial Audit Engagements – Opening Balances

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)³ also apply. SA 300 (Revised)⁴ 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.

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.

³ Currently, SA 710 (AAS 25), "Comparatives" is in force. The Standard is being revised in the light of the corresponding International Standard.

⁴ SA 300 (Revised), "Planning an Audit of Financial Statements".



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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 Loss⁵;
- (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 450⁶.

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 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 315.⁷

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 705.⁸ (Ref:

⁵ 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.

⁶ Standard on Auditing (SA) 450, "Evaluation of Misstatements Identified During the Audit", paragraphs 8 and 12.

⁷ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

⁸ 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). The Auditing and Assurance Standards Board (AASB) has issued the Exposure Drafts of Revised SA 700, "Forming An Opinion and Reporting on Financial Statements"; SA 705, "Modifications to the Opinion in the Independent Auditor's Report"; and SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report",



Initial Audit Engagements – Opening Balances

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:

- (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)

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



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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.

Material Modifications vis a vis ISA 510, "Initial Audit Engagements - Opening Balances"

Deletions

* Profit & Loss Account.

* Balance Sheet.



Initial Audit Engagements – Opening Balances

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.



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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.⁹
- 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.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements¹⁰

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.¹¹ 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.

* 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). The Auditing and Assurance Standards Board (AASB) has issued the Exposure Drafts of Revised SA 700, "Forming An Opinion and Reporting on Financial Statements"; SA 705, "Modifications to the Opinion in the Independent Auditor's Report"; and SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", corresponding to the ISA 700, ISA 705 and ISA 706. These Exposure Drafts are published in the June 2009 issue of the Journal.

⁹ 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.

¹⁰ 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.

¹¹ 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".



Initial Audit Engagements – Opening Balances

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 presentation¹² 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.¹³ 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.

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.

¹² 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".

¹³ 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".



Training Manual on Engagement and Quality Control Standards

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)
(Designation¹⁴)
Membership Number

Place of Signature

Date

¹⁴ Partner or Proprietor, as the case may be.



Initial Audit Engagements – Opening Balances

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.¹⁵
- 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 Statements¹⁶

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 presentation¹⁷ 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,

¹⁵ 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.

¹⁶ 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.

¹⁷ 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".



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the auditor considers internal control relevant to the entity's preparation and presentation¹⁸ 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.¹⁹ 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 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 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.

¹⁸ 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".

¹⁹ 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 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".



Initial Audit Engagements – Opening Balances

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)

(Designation²⁰)
Membership Number

Place of Signature

Date

²⁰ Partner or Proprietor, as the case may be.



SA 550(REVISED)*

RELATED PARTIES

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

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* Published in March, 2009 issue of the Journal.



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"¹, which sets out the authority of SAs and proposed SA 200 (Revised), "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing"².

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

² Presently, SA 200, "Basic Principles Governing an Audit" and SA 200A, "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). Post revision, the principles covered by SA 200 (AAS 1) and SA 200A (AAS 2) will be merged into one Standard, i.e., SA 200.



Training Manual on Engagement and Quality Control Standards

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 315³, SA 330⁴ and SA 240⁵ 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.

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 240⁶ 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

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".

⁶ SA 240 (Revised), paragraph 24.



Related Parties

the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs⁷. In the context of related parties, the potential effects of 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 200⁸ 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:
 - 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*)

⁷ See footnote no. 2.

⁸ See footnote no. 2.



Training Manual on Engagement and Quality Control Standards

- (i) A related party as defined in the applicable financial reporting framework⁹; or
- (ii) Where the applicable financial reporting framework establishes minimal or no related party requirements:
 - a. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
 - b. Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
 - c. Another entity that is under common control with the reporting entity through having:
 - i. Common controlling ownership;
 - ii. Owners who are close family members; or
 - iii. Common key management.

However, entities that are under common control by a state (i.e., a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

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 require¹¹ 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
- (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)

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.

¹⁰ SA 315, paragraph 5; and SA 240 (Revised), paragraph 16.

¹¹ SA 315, paragraph 10; and SA 240 (Revised), paragraph 15.



Related Parties

- (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.



Training Manual on Engagement and Quality Control Standards

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*)
- (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

¹³ SA 330, paragraphs 5-6.

¹⁴ SA 240 (Revised), paragraph 32(c).



Related Parties

- (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)

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)

¹⁵ The Auditing and Assurance Standards Board (AASB) has issued the Exposure Drafts of Revised SA 700, "Forming An Opinion and Reporting on Financial Statements"; SA 705, "Modifications to the Opinion in the Independent Auditor's Report"; and SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", corresponding to the ISA 700, ISA 705 and ISA 706. These Exposure Drafts are published in the June 2009 issue of the Journal.



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Documentation

28. In meeting the documentation requirements of SA 230¹⁶ 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.

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 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 210¹⁸ the auditor determined that the framework is acceptable¹⁹.

¹⁶ SA 230 (Revised), "Audit Documentation".

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."

¹⁸ SA 210 (Revised), "Agreeing the Terms of Audit Engagements," paragraph 4(a).

¹⁹ Exposure Draft of SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements", paragraph 19.



Related Parties

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:

- (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 entity²⁰ may be a related party of the entity because the entity may in substance control it, even if the entity owns little or none of the special-purpose entity's equity.

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.

²⁰ SA 315, paragraphs A23a-A23b, provides guidance regarding the nature of a special-purpose entity.



Training Manual on Engagement and Quality Control Standards

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



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- 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)

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 acknowledged and understand that they have responsibility for the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, and for such: ~~This includes the design, implementation and maintenance of internal control as management and, where appropriate, those charged with governance, determine is necessary to enable 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.²³

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.

²² SA 200 [See footnote 2].

²³ These changes have been made pursuant to the issuance of Standard on Auditing (SA) 210 (Revised), "Agreeing the Terms of Audit Engagements", which is effective for all audits of financial statements for periods beginning on or after April 1, 2010.



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A17. In meeting the SA 315 requirement to obtain an understanding of the control environment,²⁴ 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~~ deficient or non-existent for a number of reasons, such as²⁵:

- 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 705²⁶, consider the implications for the audit, including the auditor's report.

²⁴ SA 315, paragraph 14.

²⁵ These changes had been made pursuant to the issuance of Standard on Auditing (SA) 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", which is effective for all audits of financial statements for periods beginning on or after April 1, 2010.

²⁶ At present, there is no separate Standard on Auditing (SA) corresponding to International Standard on Auditing (ISA) 705, "Modifications to the



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A19. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.²⁷ 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.
- 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.

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). The Auditing and Assurance Standards Board (AASB) has issued the Exposure Drafts of Revised SA 700, "Forming An Opinion and Reporting on Financial Statements"; SA 705, "Modifications to the Opinion in the Independent Auditor's Report"; and SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", corresponding to the ISA 700, ISA 705 and ISA 706. These Exposure Drafts are published in the June 2009 issue of the Journal.

²⁷ SA 240 (Revised), paragraphs 31 and A4.



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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.



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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.²⁸ 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.

²⁸ SA 240 (Revised), Appendix 1.



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- 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.

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.²⁹

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

²⁹ 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.



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related party may have established directly or indirectly with the entity and to determine the need for further appropriate substantive audit procedures:

- 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,³⁰ 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 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.

³⁰ SA 330, paragraph 8(b).



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- 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 500,³¹ 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.

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

³¹ SA 500 (Revised), "Audit Evidence".



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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.



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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.³² 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 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.

³² 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.



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Communication with Those Charged with Governance (Ref: Para. 27)

A50. Communicating significant matters arising during the audit³³ 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.

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.

³³ SA230 (Revised), "Audit Documentation", paragraph A8 provides further guidance on the nature of significant matters arising during the audit.



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Limited Revision Consequential to issuance of Revised Standard on Auditing (SA) 550, “Related Parties”

The 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.³⁴

³⁴ SA 550 (Revised), “Related Parties,” paragraph A7.



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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.



SA 610 (REVISED)

USING THE WORK OF INTERNAL AUDITORS

(Effective for all audits relating to accounting periods beginning on or after April 1, 2010)

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Standard on Auditing (SA) 610 (Revised), "Using the Work of Internal Auditors" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services¹," which sets out the authority of SAs and proposed SA 200 (Revised), "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing"².

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

² Presently, SA 200, "Basic Principles Governing an Audit" and SA 200A, "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). Post revision, the principles covered by SA 200 (AAS 1) and SA 200A (AAS 2) will be merged into one Standard, i.e., SA 200.



Using the Work of Internal Auditors

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the external auditor's responsibilities regarding the work of internal auditors when the external auditor has determined, in accordance with SA 315,³ that the internal audit function is likely to be relevant to the audit. (Ref: Para. A1-A2)
2. This SA does not deal with instances when individual internal auditors provide direct assistance to the external auditor in carrying out audit procedures or where, in terms of the applicable legal and regulatory framework, it is not permissible for the internal auditor to provide access to his working papers to the third parties.

Relationship between the Internal Audit Function and the External Auditor

3. The role and objectives of the internal audit function are determined by management and, where applicable, those charged with governance. While the objectives of the internal audit function and the external auditor are different, some of the ways in which the internal audit function and the external auditor achieve their respective objectives may be similar. (Ref: Para. A3)
4. Irrespective of the degree of autonomy and objectivity of the internal audit function, such function is not independent of the entity as is required of the external auditor when expressing an opinion on financial statements. The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal auditors.

Effective Date

5. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objectives

6. The objectives of the external auditor, where the entity has an internal audit function that the external auditor has determined is likely to be relevant to the audit, are to determine:
 - (a) Whether, and to what extent, to use specific work of the internal auditors; and
 - (b) If so, whether such work is adequate for the purposes of the audit.

Definitions

7. For purposes of the SAs, the following terms have the meanings attributed below:
 - (a) Internal audit function – An appraisal activity established or provided as a service to the entity. Its functions include, amongst other things, examining, evaluating and monitoring the adequacy and effectiveness of internal control. The Preface to the Standards on Internal Audit, issued by the Institute of Chartered Accountants of India, issued in November 2004 describes internal audit as “an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system. Internal audit, therefore, provides assurance that there is transparency in reporting, as a part of good governance.”
 - (b) Internal auditors – Those individuals who perform the activities of the internal audit function. Internal auditors may belong to an internal audit department or equivalent function.

Requirements

Determining Whether and to What Extent to Use the Work of the Internal Auditors

³ SA 315, “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment,” paragraph 22a.



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8. The external auditor shall determine:
- (a) Whether the work of the internal auditors is likely to be adequate for purposes of the audit; and
 - (b) If so, the planned effect of the work of the internal auditors on the nature, timing or extent of the external auditor's procedures.
9. In determining whether the work of the internal auditors is likely to be adequate for purposes of the audit, the external auditor shall evaluate:
- (a) The objectivity of the internal audit function;
 - (b) The technical competence of the internal auditors;
 - (c) Whether the work of the internal auditors is likely to be carried out with due professional care; and
 - (d) Whether there is likely to be effective communication between the internal auditors and the external auditor. (Ref: Para. A4)
10. In determining the planned effect of the work of the internal auditors on the nature, timing or extent of the external auditor's procedures, the external auditor shall consider:
- (a) The nature and scope of specific work performed, or to be performed, by the internal auditors;
 - (b) The assessed risks of material misstatement at the assertion level for particular classes of transactions, account balances, and disclosures; and
 - (c) The degree of subjectivity involved in the evaluation of the audit evidence gathered by the internal auditors in support of the relevant assertions. (Ref: Para. A5)

Using Specific Work of the Internal Auditors

11. In order for the external auditor to use specific work of the internal auditors, the external auditor shall evaluate and perform audit procedures on that work to determine its adequacy for the external auditor's purposes. (Ref: Para. A6)
12. To determine the adequacy of specific work performed by the internal auditors for the external auditor's purposes, the external auditor shall evaluate whether:
- (a) The work was performed by internal auditors having adequate technical training and proficiency;
 - (b) The work was properly supervised, reviewed and documented;
 - (c) Adequate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions;
 - (d) Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed; and
 - (e) Any exceptions or unusual matters disclosed by the internal auditors are properly resolved.

Documentation

13. When the external auditor uses specific work of the internal auditors, the external auditor shall document conclusions regarding the evaluation of the adequacy of the work of the internal auditors, and the audit procedures performed by the external auditor on that work, in accordance with paragraph 11.



Application and Other Explanatory Material

Scope of this SA (Ref: Para. 1)

A1. As described in SA 315⁴, the entity's internal audit function is likely to be relevant to the audit if the nature of the internal audit function's responsibilities and activities are related to the entity's financial reporting, and the auditor expects to use the work of the internal auditors to modify the nature or timing, or reduce the extent, of audit procedures to be performed.

A2. Carrying out procedures in accordance with this SA may cause the external auditor to re-evaluate the external auditor's assessment of the risks of material misstatement. Consequently, this may affect the external auditor's determination of the relevance of the internal audit function to the audit. Similarly, the external auditor may decide not to otherwise use the work of the internal auditors to affect the nature, timing or extent of the external auditor's procedures. In such circumstances, the external auditor's further application of this SA may not be necessary.

Scope and Objectives of the Internal Audit Function (Ref: Para. 3)

A3. The objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. The activities of the internal audit function may include one or more of the following:

- Monitoring of internal control. The internal audit function may be assigned specific responsibility for reviewing controls, monitoring their operation and recommending improvements thereto.
- Examination of financial and operating information. The internal audit function may be assigned to review the means used to identify, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.
- Review of operating activities. The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non- financial activities of an entity.
- Review of compliance with laws and regulations. The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.
- Risk management. The internal audit function may assist the organization by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and control systems.
- Governance. The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.

Determining Whether and to What Extent to Use the Work of the Internal Auditors

***Whether the Work of the Internal Auditors Is Likely to Be Adequate for Purposes of the Audit* (Ref: Para. 9)**

A4. Factors that may affect the external auditor's determination of whether the work of the internal auditors is likely to be adequate for the purposes of the audit include:

Objectivity

- The status of the internal audit function within the entity and the effect such status has on the ability of the internal auditors to be objective.

⁴ SA 315, paragraph A96a.



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- Whether the internal audit function reports to those charged with governance or an officer with appropriate authority, and whether the internal auditors have direct access to those charged with governance.
- Whether the internal auditors are free of any conflicting responsibilities.
- Whether those charged with governance oversee employment decisions related to the internal audit function.
- Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance.
- Whether, and to what extent, management acts on the recommendations of the internal audit function, and how such action is evidenced.

Technical competence

- Whether the internal auditors are members of relevant professional bodies.
- Whether the internal auditors have adequate technical training and proficiency as internal auditors.
- Compliance with the mandatory/ recommendatory Standards on Internal Audit (SIAs) issued by Internal Audit Standards Board of the Institute of Chartered Accountants of India (ICAI).
- Whether there are established policies for hiring and training internal auditors.

Due professional care

- Whether activities of the internal audit function are properly planned, supervised, reviewed and documented.
- The existence and adequacy of audit manuals or other similar documents, work programs and internal audit documentation.

Communication

Communication between the external auditor and the internal auditors may be most effective when the internal auditors are free to communicate openly with the external auditors, and:

- Meetings are held at appropriate intervals throughout the period;
- The external auditor is advised of and has access to relevant internal audit reports and is informed of any significant matters that come to the attention of the internal auditors when such matters may affect the work of the external auditor; and
- The external auditor informs the internal auditors of any significant matters that may affect the internal audit function.

Planned Effect of the Work of the Internal Auditors on the Nature, Timing or Extent of the External Auditor's Procedures (Ref: Para. 10)

A5. Where the work of the internal auditors is to be a factor in determining the nature, timing or extent of the external auditor's procedures, it may be useful to agree in advance the following matters with the internal auditors:

- The timing of such work;
- The extent of audit coverage;
- Materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures), and performance materiality;
- Proposed methods of item selection;
- Documentation of the work performed; and



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- Review and reporting procedures.

Using Specific Work of the Internal Auditors (Ref: Para. 11)

A6. The nature, timing and extent of the audit procedures performed on specific work of the internal auditors will depend on the external auditor's assessment of the risk of material misstatement, the evaluation of the internal audit function, and the evaluation of the specific work of the internal auditors. Such audit procedures may include:

- Examination of items already examined by the internal auditors;
- Examination of other similar items; and
- Observation of procedures performed by the internal auditors.

Material Modifications to ISA 610, "Using the Work of Internal Auditors"

Addition

Paragraph 2 of ISA 610 deals with the situations where this ISA would not be applicable. 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 situation, "where, in terms of the applicable legal and regulatory framework, it is not permissible for the internal auditor to provide access to his working papers to the third parties" has been added.



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Limited Revision Consequential to issuance of the Standard on Auditing (SA) 610 (Revised), “Using the Work of Internal Auditors”

The 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”

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)

22a. If the entity has an internal audit function,* the auditor shall obtain an understanding of the following in order to determine whether the internal audit function is likely to be relevant to the audit:

(a) The nature of the internal audit function’s responsibilities and how the internal audit function fits in the entity’s organisational structure; and

(b) The activities performed, or to be performed, by the internal audit function. (Ref: Para. A96a - A96c)

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 that purpose. (Ref: Para. A97)

[When the conforming amendments are included in SA 315, paragraph 22a will become paragraph 23 and the SA will be re-numbered accordingly.]

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 auditor or personnel performing similar functions contribute to the monitoring of an entity’s activities. [Proposed] SA 610 (Revised) establishes requirements and provides guidance on the auditor’s consideration of the work of internal auditing. Management’s monitoring activities may also include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.~~

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.

Internal Audit Functions (Ref: Para 22a)

A96a. The entity’s internal audit function is likely to be relevant to the audit if the nature of the internal audit function’s responsibilities and activities are related to the entity’s financial reporting, and the auditor expects to use the work of the internal auditors to modify the nature or timing, or reduce the extent, of audit procedures to be performed. When the auditor determines that the internal audit function is likely to be relevant to the audit, SA 610 (Revised) applies.

* The term “internal audit function” is defined in SA 610 (Revised), “Using the Work of Internal Auditors”, paragraph 7(a).



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A96b. The objectives of an internal audit function, and therefore the nature of its responsibilities and its status within the organisation, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. The responsibilities of an internal audit function may include, for example, monitoring of internal control, risk management, and review of compliance with laws and regulations. On the other hand, the responsibilities of the internal audit function may be limited to the review of the economy, efficiency and effectiveness of operations, for example, and accordingly, may not relate to the entity's financial reporting.

A96c. If the nature of the internal audit function's responsibilities are related to the entity's financial reporting, the external auditor's consideration of the activities performed, or to be performed by, the internal audit function may include review of the internal audit function's audit plan for the period, if any, and discussion of that plan with the internal auditors.

[When the conforming amendments are included in SA 315, paragraphs A96a-A96c will become paragraphs A97-A99 and the SA will be re-numbered accordingly.]



SA 720*

THE AUDITOR'S RESPONSIBILITY IN RELATION TO OTHER INFORMATION IN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS

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

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Standard on Auditing (SA) 720, "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services¹", which sets out the authority of SAs and proposed SA 200 (Revised), "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing"².

* Published in the April, 2009 issue of the Journal.

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

² Presently, SA 200, "Basic Principles Governing an Audit" and SA 200A, "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). Post revision, the principles covered by SA 200 (AAS 1) and SA 200A (AAS 2) will be merged into one Standard, i.e., SA 200.



The Auditor's Responsibility in Relation to Other Information

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion does not cover other information and the auditor has no specific responsibility for determining whether or not other information is properly stated. However, the auditor reads the other information because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. (Ref: Para. A1)

2. In this SA "documents containing audited financial statements" refers to annual reports (or similar documents), that are issued to owners (or similar stakeholders), containing audited financial statements and the auditor's report thereon. This SA may also be applied, adapted as necessary in the circumstances, to other documents containing audited financial statements. (Ref: Para. A2-A4)

Effective Date

3. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

4. The objective of the auditor is to respond appropriately when documents containing audited financial statements and the auditor's report thereon include other information that could undermine the credibility of those financial statements and the auditor's report.

Definitions

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

- (a) Other information – Financial and non-financial information (other than the financial statements and the auditor's report thereon) which is included, either by law, regulation or custom, in a document containing audited financial statements and the auditor's report thereon.
- (b) Inconsistency – Other information that contradicts information contained in the audited financial statements. A material inconsistency may raise doubt about the audit conclusions drawn from audit evidence previously obtained and, possibly, about the basis for the auditor's opinion on the financial statements.
- (c) Misstatement of fact – Other information that is unrelated to matters appearing in the audited financial statements that is incorrectly stated or presented. A material misstatement of fact may undermine the credibility of the document containing audited financial statements.

Requirements

Reading Other Information

6. The auditor shall read the other information to identify material inconsistencies, if any, with the audited financial statements.

7. The auditor shall make appropriate arrangements with management or those charged with governance to obtain the other information prior to the date of the auditor's report. If it is not possible to obtain all the other information prior to the date of the auditor's report, the auditor shall read such other information as soon as practicable. (Ref: Para. A5)



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Material Inconsistencies

8. If, on reading the other information, the auditor identifies a material inconsistency, the auditor shall determine whether the audited financial statements or the other information needs to be revised.

Material Inconsistencies Identified in Other Information Obtained Prior to the Date of the Auditor's Report

9. When revision of the audited financial statements is necessary and management refuses to make the revision, the auditor shall modify the opinion in accordance with [proposed] SA 705.³

10. When revision of the other information is necessary and management refuses to make the revision, the auditor shall communicate this matter to those charged with governance; and

- (a) Include in the auditor's report an Other Matter(s) paragraph describing the material inconsistency in accordance with [proposed] SA 706; or
- (b) Where withdrawal is legally permitted, withdraw from the engagement. (Ref: Para. A6- A7)

Material Inconsistencies Identified in Other Information Obtained Subsequent to the Date of the Auditor's Report

11. When revision of the audited financial statements is necessary, the auditor shall follow the relevant requirements in SA 560 (Revised).⁴

12. When revision of the other information is necessary and management agrees to make the revision, the auditor shall carry out the procedures necessary under the circumstances. (Ref: Para. A8)

13. When revision of the other information is necessary, but management refuses to make the revision, the auditor shall notify those charged with governance of the auditor's concern regarding the other information and take any further appropriate action. (Ref: Para. A9)

Material Misstatements of Fact

14. If, on reading the other information for the purpose of identifying material inconsistencies, the auditor becomes aware of an apparent material misstatement of fact, the auditor shall discuss the matter with management. (Ref: Para. A10)

15. When, following such discussions, the auditor still considers that there is an apparent material misstatement of fact, the auditor shall request management to consult with a qualified third party, such as the entity's legal counsel, and the auditor shall consider the advice received.

16. When the auditor concludes that there is a material misstatement of fact in the other information which management refuses to correct, the auditor shall notify those charged with governance of the auditor's concern regarding the other information and take any further appropriate action. (Ref: Para. A11)

³ At present, there is no separate Standard on Auditing (SA) corresponding to International Standards on Auditing (ISA) 705, "Modifications to the Opinion in the Independent Auditor's Report." and ISA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report". However, the concepts of 'modified audit report' and 'emphasis of matter paragraph' have been discussed in SA 700, "The Auditor's Report on Financial Statements". The Auditing and Assurance Standards Board has issued the Exposure Drafts of Revised SA 700, "Forming an opinion and Reporting on Financial Statements", SA 705, "Modifications to the opinion in the Independent Auditor's Report" and SA 706, "Emphasis of Matter paragraphs and Other Matter Paragraphs in the Independent Auditor's Report" corresponding to ISA 700, ISA 705 and ISA 706. These Exposure Drafts have been published in the June, 2009 issue of the Journal.

⁴ SA 560 (Revised), "Subsequent Events", paragraphs 10-17.



The Auditor's Responsibility in Relation to Other Information

Application and Other Explanatory Material

Scope of this SA (Ref: Para. 1-2)

A1. The auditor may have additional responsibilities, through statutory or other regulatory requirements, in relation to other information that are beyond the scope of this SA. For example, certain statutory and regulatory requirements may require the auditor to apply specific procedures to certain of the other information such as required supplementary data or to express an opinion on the reliability of performance indicators described in the other information. When there are such obligations, the auditor's additional responsibilities are determined by the nature of the engagement and by law, regulation and professional standards. If such other information is omitted or contains deficiencies, the auditor may be required by law or regulation to refer to the matter in the auditor's report.

A2. Other information may comprise, for example:

- A report by management or those charged with governance on operations.
- Financial summaries or highlights.
- Planned capital expenditures.
- Financial ratios.
- Selected quarterly data.

A3. For purposes of the SAs, other information does not encompass, for example:

- A press release or a transmittal memorandum, such as a covering letter, accompanying the document containing audited financial statements and the auditor's report thereon.
- Information contained in analyst briefings.
- Information contained on the entity's web site.

Considerations Specific to Smaller Entities (Ref: Para. 2)

A4. Unless required by law or regulation, smaller entities are less likely to issue documents containing audited financial statements. However, an example of such a document would be where a legal requirement exists for an accompanying report by those charged with governance.

Reading Other Information (Ref: Para. 7)

A5. Obtaining the other information prior to the date of the auditor's report enables the auditor to resolve possible material inconsistencies and apparent material misstatements of fact with management on a timely basis. An agreement with management as to when the other information will be available may be helpful.

Material Inconsistencies

Material Inconsistencies Identified in Other Information Obtained Prior to the Date of the Auditor's Report (Ref: Para. 10)

A6. When management refuses to revise the other information, the auditor may base any decision on what further action to take on advice from the auditor's legal counsel.

A7. In case of certain entities such as, Central/State governments and related government entities (for example, agencies, boards, commissions), withdrawal from the engagement may not be an option. In such cases the auditor may issue a report to the appropriate statutory body giving details of the inconsistency.



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Material Inconsistencies Identified in Other Information Obtained Subsequent to the Date of the Auditor's Report (Ref: Para. 12-13)

A8. When management agrees to revise the other information, the auditor's procedures may include reviewing the steps taken by management to ensure that individuals in receipt of the previously issued financial statements, the auditor's report thereon, and the other information are informed of the revision.

A9. When management refuses to make the revision of such other information that the auditor concludes is necessary, appropriate further actions by the auditor may include obtaining advice from the auditor's legal counsel.

Material Misstatements of Fact (Ref: Para. 14-16)

A10. When discussing an apparent material misstatement of fact with management, the auditor may not be able to evaluate the validity of some disclosures included within the other information and management's responses to the auditor's inquiries, and may conclude that valid differences of judgment or opinion exist.

A11. When the auditor concludes that there is a material misstatement of fact that management refuses to correct, appropriate further actions by the auditor may include obtaining advice from the auditor's legal counsel.

Material Modifications *vis a vis* ISA 720, "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements"

Deletions

1. Paragraph 10 of ISA 720 dealt with the circumstances where the revision of the financial statements is necessary and management refuses to make the revision. In these circumstances, the auditor shall communicate this matter to those charged with governance and include in the auditor's report an Other Matter(s) paragraph describing the material inconsistency in accordance with ISA 706; or withhold the auditor's report; or where withdrawal is legally permitted, withdraw from the engagement. Since in India, the practice of withholding the auditor's report is not in vogue, an option of withholding the auditor's report by the auditor has been deleted. Similarly in paragraph A7 of the Application Section, an option of withholding the auditor's report by the auditor has been deleted.

2. Paragraph A2 of ISA 720 provides the examples of the other information including 'employment data' and 'names of officers and directors'. Reference to these two specific examples has been deleted so that the auditor can focus on more relevant aspects of other information.

3. Paragraph A4 of ISA 720 provides an example of the other information that may be included in a document containing the audited financial statements of a smaller entity are a detailed income statement and a management report. Since, in India, the terminology of "detailed income statement" and a "management report" do not exist; these have been deleted completely from the SA.

4. Paragraph A7 of ISA 720 provides that in case of public sector entities, withdrawal from the engagement or withholding the auditor's report may not be the options. In such cases the auditor may issue a report to the appropriate statutory body giving details of the inconsistency. 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 withdrawal from the engagement may not be an option even in case of non public sector entities pursuant to a requirement under the statute or regulation under which they operate. Paragraph A7 has, accordingly, been made more generic in its application.