STANDARDS ON AUDITING

S.A. 200: Basic Principles governing an audit

- Integrity, Objectivity & Independence – Integrity refers to honesty of the auditor, objectivity refers to his impartial behaviours and independence implies that he should not be susceptible to any influence or pressure from the client.
- The auditor should maintain the confidentiality of client information and should not disclose it to third parties unless authorised by the client or when there is legal or professional duty to do so.
- Audit process should be carried out with due professional care i.e. he should perform his duties diligently and carefully. He should also constantly update his skills and competence through continuing education. He should obtain knowledge of latest developments affecting his audit work such as changes in law, professional pronouncements, etc.
- The auditor should exercise reasonable care and skill while relying on the work of others. This is important because the responsibility of preparing the report on the financial statements remains with the auditor even though the work is being performed by others.
- Documentation – All audit evidence obtained by the auditor should be documented by the auditor. S.A. 230 describes the form, content, custody and ownership of working papers. Documentation refers to working papers. He should obtain sufficient appropriate evidence to enable him to draw reasonable conclusion and express an opinion.
- The auditor should reasonably assess the adequacy of the accounting system and related internal controls. He should evaluate the internal control system.
- The auditor should review and assess the conclusions drawn from the audit evidence and knowledge of the entity acquired. He should assess whether financial information complies with recognized accounting principles.

S.A. 200A: Objective and scope of audit of financial statements

- General purpose of financial statements includes Balance Sheet, Profit and Loss Account, Cash Flow Statements and explanatory notes.
- Objective of audit of financial statements is to enable an auditor to express an opinion as to the truthfulness and fairness of financial statements.
- The auditor's opinion helps to establish reliability of the financial statements. S.A. 200A has specifically pointed out that "The user should not assume that the auditor's opinion is an assurance as to future viability of the enterprise or the efficiency or effectiveness

with which the management has conducted the affairs of the enterprise." Thus, the auditor does not give an opinion on the propriety of business conduct or its future prospects.

- While determining the scope of audit, the auditor should consider factors such as terms of engagement, the requirements of relevant legislations and the pronouncements of ICAI.
- Coverage – The auditor's work should cover all material items at individual level or at group level. He should satisfy himself that information contained in the financial statements and other source data is reliable and sufficient for preparation of financial statements.
- Limitations – Absolute certainty in auditing is rarely attainable because –
  a) The audit work involves judgement and
  b) The nature of evidence is persuasive which enable the auditor to draw only reasonable conclusions therefrom. There is always an unavoidable risk that some material misstatement may remain undiscovered in an audit because of the test nature and other inherent limitations of any system of internal control. An audit therefore cannot be relied upon to ensure discovery of all frauds and errors.

S.A. 230: Documentation

- The objective is to elaborate upon the basic principle governing audit – documentation.
- Documentation is synonymous with working papers. Auditor's working papers constitute all documents prepared or obtained and retained by the auditor during the course of audit and the audit conclusions.
- Advantages –
  a) aids in planning,
  b) aids in supervision and review of audit work and
  c) substantiating auditor's report.
- The content and form of working papers depend upon several factors like nature of engagement, nature of auditor's report, nature and complexity of the business of the enterprise under audit. Some generalised characteristics are:
  - In order to have uniformity in presentation, many audit firms have standardised the design of working papers.
  - The extent of working papers is a matter of professional judgement of the auditor. However, all working papers must contain sufficient information to show that financial statements agree with client's records.
  - The auditor sometimes uses the working papers prepared by the client or the staff members for e.g. details of receivables, list of investments, bank reconciliation, etc. The auditor should decide in advance the format of such working papers.

- In case of recurring audits, the auditor may divide the working papers into two parts – permanent file and current file.

➢ Permanent File – Should contain information which is of continuing interest and relevance to succeeding audits. Most of the information contained in this is collected in the first audit and is updated for each subsequent audit. It normally includes the following information:
  - Information regarding legal and organisational structure of the entity.
  - Extracts of important legal documents, agreements, minutes relevant to the audit.
  - Record and evaluation of internal control reports.
  - Analysis of significant ratios and their trends.
  - Record of communication with the retiring auditor.
  - Notes regarding significant accounting policies.

➢ Current File – Contains information relating to and relevant to the audit of current period. Following information is normally included in the current audit file:
  - Correspondence relating to acceptance of annual reappointment.
  - Extracts of important matters in the minutes of board and general meeting as relevant to audit.
  - Audit plan and audit programme.
  - Analysis of transactions and balances.
  - Evidence regarding supervision and review of work of assistants.
  - Copies of letters or notes concerning audit matters communicated to or discussed with client.
  - Copies of communication with other auditors.

➢ Ownership and custody of working papers:
  - The ownership of the working paper will remain with the auditor. However, he may make copies available to his client on request. This right of ownership of the auditor is based on clause I, Part I of second Schedule to the Chartered Accountants Act, 1949, which prohibits disclosure of confidential information of client without management's consent except where required by law.
  - The auditor should take adequate steps to maintain the safe custody and confidentiality of working papers. The safe custody is required to maintain confidentiality of client information, e.g. Director's remuneration, profit margin on individual products, etc
  - There are no specific rules relating to the retention of working papers. They should be retained as long as the auditor opines them to be useful in serving the client or to comply with legal or professional requirements. The Expert Advisory Committee of the ICAI has suggested that an auditor should retain his records relating to audit and other services rendered to the client for a minimum period of 10 years.

S.A. 240: Auditor's Responsibility to consider Frauds and Errors in audit of financial statements.

- This audit standard provides extended guidance on the auditor's responsibility for identifying and reporting on frauds and errors.
- The primary responsibility for the detection of frauds and errors is of those charged with governance and the management of the entity.
- Responsibilities of Auditor:
  - A financial audit is conducted by the auditor to obtain reasonable assurance that financial statements are free from material misstatements caused by fraud and error. Due to certain inherent limitations, even an audit that is properly planned and performed in accordance with generally accepted auditing standards may fail to detect a cleverly concealed fraud.
  - The term reasonable assurance implies that some risk of material misstatement could be present in the financial statements and the auditor will fail to detect it. The auditor therefore cannot be held responsible for the prevention of frauds and errors.
  - If the auditors knew of the existence of frauds and errors and still did not report them, it is a serious dereliction of duty on their part and they will be liable to compensate the third parties who suffer a loss as a result of relying on the accounts. Further, this also amounts to professional misconduct and renders the auditors liable for disciplinary action by ICAI.
- Frauds and Errors:
  - Misstatements in financial statements can arise from frauds and errors.
  - Error in context of audit has been defined by S.A. 240 as "unintentional" misstatement in the financial statements. Management may get involved in committing frauds to obtain an illegal advantage or personal gain. Fraud generally involves either misappropriation of assets that may be called as "employee fraud" or manipulation of books of accounts that is referred to as "management fraud".
  - Employee Fraud – Generally involves the theft of assets. Mostly cash or goods of the firm, computer hardware, etc. Transactions are recorded in such a manner so as to conceal theft.
  - Management Fraud - It involves manipulation of accounts by the upper level management for the purpose of deliberately misrepresenting the firm's financial position or results of operation to evade taxes, to receive higher remuneration, to show better management performance, etc. This is called "Window Dressing".
- As indicated by definition and examples, intent is the underlying difference between an error and a fraud. The auditor's responsibility for detecting frauds and errors is identical as both result in misstatement on financial statements. However the distinction is important because fraud raises doubt about the integrity of management and those charged with governance.

- According to S.A. 240, fraud involves:
  - Motivation to commit a fraud – Individuals may be motivated to misappropriate assets, because the individuals are living beyond their means. Fraudulent financial reporting may be committed because management is under pressure from sources outside or inside the entity, to achieve an expected earnings target.
  - Perceived opportunity – A perceived opportunity for fraudulent financial reporting or misappropriation of assets may exist when an individual believes internal control could be circumvented, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in the internal control system.
- Based on the fraud risk assessment the auditor assesses the inherent and control risk and then determines the level of detection risk. The auditor then designs the procedures to address them.
- The auditor should plan and perform an audit with an attitude of professional skepticism. The attitude of professional skepticism involves:
  - Questioning mind and a critical assessment of audit evidence.
  - The auditor should conduct the engagement with a mindset that recognises the possibility that a material misstatement due to fraud could be present, regardless of past experience with the entity and his belief about management's honesty and integrity.
  - Professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material fraud has occurred.
  - In gathering and evaluating evidence, the auditor should not be satisfied with less persuasive evidence because of a belief that management is honest.
  - Thus, attitude of professional skepticism does not imply suspicious mind but it implies an open and alert mind.
- Procedures when circumstances indicate a possible misstatement:
  - Communicate the misstatement to the appropriate level and management on a timely basis.
  - Communicate the weaknesses in internal control system relating to the detection and prevention of frauds and errors to the management.
  - The auditor should perform modified or additional procedures, if the misstatement has a material effect on financial statements.
  - He may advice the management to take appropriate steps and take legal action.
  - If the management refuses to his advice, then he must give a qualified report.
  - In some cases, the auditor may be unable to obtain sufficient audit evidence to confirm or dispel a suspicion of fraud or error. He should, in such circumstances, assess the impact of such fraud or error on financial statements and deal with them as per standard audit standards.

S.A. 500: Audit Evidence

- Significance – Audit evidence is a fundamental constituent of an audit process. It is defined as any document, record or information which is available to substantiate any assertion made in financial statement or transactions recorded in the books of accounts.
- For an auditor, persuasiveness of evidence is far more important than conclusiveness. This is because, cost of obtaining conclusive evidence may exceed the usefulness of the evidence obtained and also because audit is designed to provide reasonable and not absolute assurance about management's assertions in financial statements. The auditor should evaluate the sufficiency and appropriateness of evidence before drawing his conclusions keeping in consideration the following factors:
    - The degree of risk of misstatements in an item.
    - The materiality of the item.
    - The experience gained during the previous audit.
    - The result of audit procedure including frauds and errors, which may have been found.
    - The type of information available.
    - The trend indicated by accounting ratios and analysis.
- Procedure to obtain evidence – The auditor obtains evidence through the compliance and substantive procedures.
    - Compliance procedures – to test whether the internal control exists and is operating effectively, that the internal control system has operated in the same way throughout the year.
    - Substantive procedures – tests designed to obtain evidence to verify balance of an account or a specific financial statement assertion i.e. to check whether an asset exists or not, that an event has occurred and pertains to the entity during the period under audit, that there are no fictitious items recorded, etc.
- Reliability of evidence:
    - External evidence is more reliable than internal evidence. Reliability of internal evidence depends upon the strength of related internal control system.
    - Evidence obtained by the auditor himself through physical examination, observation, inspection, etc is more reliable than that obtained from the entity.
    - Documentary evidence is more reliable then oral representations.
- Audit evidence may either be internal or external evidence.
    - Evidence which originates within the organisation being audited is internal evidence. Evidence which originates outside the client's organisation is external evidence.
    - Internal evidence is more prone to manipulation than external evidence. This is because internal evidence generation is under the control of the client and external evidence is not under the client's control. External evidence can be manipulated

only with the outside party's collusion which is very difficult because third parties have no interest in manipulating accounting information of others.

- External evidence is more reliable than internal evidence.
- Satisfactory operation of internal control makes internal evidence more reliable.

➢ Techniques of Audit Evidence

- Inspection
- Observation
- Enquiry
- Confirmation
- Computation
- Analytical Review

S.A. 400: Risk Assessments and Internal Control

➢ Internal Control System consists of all the policies and procedures adopted by the management of an entity to assist in achieving the following objectives;

- The orderly and efficient conduct of business
- Adherence to management policies
- The safeguarding of assets
- Accurate and complete accounting records, and
- The timely preparation of financial information

➢ The internal control system comprises of:

1) Control Environment – It is the overall attitude, awareness and action of directors and management regarding the internal control system and its importance in the entity. It includes the entity's organisation structure, functions of board of directors and its committees, management's philosophy and operating cycle, management's control system including internal audit function, personnel policies and procedures.
2) Control Procedures – It means those policies and procedures in addition to the control environment which management has established to achieve the entity's specific objectives. Control procedures include – reporting and reviewing, reconciliations, checking arithmetical accuracy of records, controlling applications and environment of CIS, maintaining and reviewing control accounts, approving and controlling of documents, comparing internal data with external sources of information, restricting direct access to assets, records and information.

➢ Audit Risk – means the risk that the auditor may give an inappropriate audit opinion where the financial statements are materially misstated.

- Inherent Risk – means the susceptibility of transactions to be recorded wrongly or to be influenced by management's fraudulent activity.
- Control Risk – means that a material misstatement could occur but would not be prevented or quickly detected by organisation's control.
- Detection Risk – means the risk that the auditor will fail to detect a material misstatement in the financial statements.
- Audit Approach
- Assessment of Inherent Risk –
    1) The auditor must assess the inherent risk in each class of transactions and also at the level of financial statements.
    2) The evaluation of inherent risks is based on information available with the auditor and professional judgement.
    3) If the auditor is of the opinion that inherent risk is not high, he should document the reasons for such assessment.
- Assessment of Control Risk –
    1) The auditor should assess control risk as high as assertion level, for each material account balance or class of transactions when internal controls are known to be ineffective or internal controls are effective but the auditor opines that performing tests of control and reduced substantive tests would not be cost effective.
    2) S.A. 400 (Revised) requires the auditor to document the understanding and evaluation of the organisation's accounting and internal control system and preliminary risk assessment on every audit.
       Documentation is also required where the auditor assesses the control risk as high. However, when the control risk is assessed as less than high, the auditor must document the basis for conclusion i.e. types of tests performed along with their results.
    3) Perform Tests of Control - Tests of control consist of audit procedures directed towards testing the effectiveness of the design or the operation of internal controls. They include inspection of documents, inquires, re-performance of internal control and various computer-assisted audit techniques (CAATs).
       Ideally test controls should be applied to transactions and detailed records that were executed and prepared throughout the entire period. The auditor always performs test of controls on interim visits.
- Assessment of Detection Risk – Detection risk relates directly to the effectiveness of the audit procedures. For the purposes of restricting detection risk to an acceptable level, the auditor should consider –
    1) Assessed level of inherent and control risk
    2) Nature, timing and extent of substantive tests.

Inherent and control risk are inversely related to detection risk i.e. higher a client's assessed level of inherent and control risks, the less detection risk an auditor can accept. In other words, if inherent and control risk are high, substantive procedure will be adopted so that detection risk is low.

- Inherent limitations of Internal Control
    1) Management's consideration that control be cost-effective.
    2) Most of the controls do not tend to be directed at unusual transaction.
    3) The potential for human errors.
    4) Controls may be circumvented through collusion.
    5) Persons responsible for exercising control may abuse the authority.
    6) Compliance with procedures may deteriorate because of procedures becoming inadequate in changed conditions.
- The auditor's primary objective is not to certify the soundness of internal controls or obtain knowledge of the entity's accounting system and internal control. This is only a means of and not the end itself. Accordingly S.A. 400 states that the auditor is concerned with only those policies and procedures of accounting and internal control systems that are relevant to the financial statement assertions, namely – existence, rights and obligations, occurrence, completeness, valuation, measurement and presentation and disclosure.
- Communicate the weakness in internal control system – During the course of audit work the auditor may notice material weaknesses in internal control system. He should communicate such weakness to the management or the audit committee, if any, on a timely basis.

S.A. 610: Using the work of an internal auditor

- The main objective of the internal audit function varies from organization to organization. Following are the general objectives of internal audit:
    1) To review and report on the internal control system. This is normally done by the internal audit department. Such a review is necessary to detect the errors and frauds and safeguarding of assets of the enterprise.
    2) The management sets the standards to measure an entity's economical and efficient use of resources and the internal auditor is responsible for:
        i) Assessing whether the standards are understood and are being met
        ii) Identifying deviations and their causes and corrective actions taken, and
        iii) Identifying conditions such as under utilisation of facilities, non-productive work, procedures which are not cost justified and corrective action taken.
    3) To review management information system i.e. identification, measurement, classification and reporting of financial and operating information.
    4) The internal auditor has a responsibility to examine and verify physical existence and condition of assets of the entity.
- According to S.A. 610:

1) The external auditor is solely responsible for his audit report. However much of the work done by the internal auditor may be useful to him in determining the nature, timing and extent of his auditing procedures.
2) The external auditor should evaluate the internal audit function. If based on such evaluation, the auditor concludes he can rely on the internal audit his procedures will be less extensive than otherwise required.
3) He should not rely on internal audit function without evaluating it.
4) The report of the external auditor is his sole responsibility. That responsibility is not by any means reduced because of his reliance on the internal auditor's work.

- Relationship between internal and statutory auditor:
  The objective of internal and statutory auditor differ. But there are a number of areas where the statutory auditor may gainfully use the internal auditor's knowledge of the business, particularly existence of fixed assets, the ascertainment of liabilities and audit risk associated with the business. The important points with regards to their relationship are summarised as follows:
  1) The external auditor should assess the quality of work done by the internal auditor before relying upon the work of the internal auditor. He should consider factors like integrity, independence, competence, etc while evaluating the work.
  2) The statutory auditor should determine the areas where he could rely upon the work of the internal auditor. Regular meetings with the internal auditor, access to internal auditor's report and communication with internal auditor about any significant matter will help in achieving better co-ordination.
  3) The internal/statutory auditor should take into account the scope of the internal auditor, examine whether the audit work was properly planned and the work of assistants was properly supervised, reviewed and documented.
  4) The external auditor should examine whether sufficient evidence was obtained to afford a reasonable basis for the conclusions reached.
  5) However, the degree of reliance that is placed by the external auditor on such work of the internal auditor is a matter of professional judgement.

S.A. 300: Planning and Audit of Financial Statement

- Audit planning amplifies the basic principle stated in S.A. 200, i.e. the auditor should plan his work to enable him to conduct an effective audit in a efficient and timely manner.
- Objectives of planning:
  1) To ensure that appropriate attention is paid to important areas of audit.
  2) To ensure prompt identification of potential problems.
  3) To ensure speedy completion of work.

4) To ensure proper co-ordination of work.

- Factors to be considered while planning:
  - Complexity of the audit
  - Environment in which the entity operates
  - Previous experience of the auditor with his client
  - Knowledge of the client's business
- Audit planning involves:
  - Development of an overall plan for the expected scope of audit
  - Development of an audit programme showing the nature, timing and extent of audit procedures.
- Review if the Audit Plan:
  - Planning should be continuous throughout the engagement
  - It should commence at the conclusion of the previous year's audit
  - The audit programme should be kept flexible so that it can be reviewed or modified if necessary during the course of audit.

S.A. 620: Using the work of an expert

- The auditor's education and experience enable him to be knowledgeable about business matter in general, but he is not expected to be an expert in all fields and professions. In this case, an expert may be defined as a person who is an expert in field other than accounting and auditing.
- Areas where an auditor can seek the help of experts:
  - Valuation of assets like property, jewellery, diamonds, stock valuation.
  - Measurement of work done on long term contracts.
  - Legal interpretations of agreements, statutes, etc.
  - Legal opinions on the outcome of disputes, litigations, etc.
  - Actuarial advice in assessing the cost of gratuity, pension plans, etc.
- Before the auditor seeks the advice of the expert, he should consider the skills and competence of the expert. He should possess the necessary qualification, have the experience and also the reputation. The expert should have an unbiased attitude. Where the expert has been appointed by the client, the auditor should enquire into his scope and matter of work, and obtain clarification of the expert's relationship with the client. The auditor should seek reasonable assurance that the expert's work constitutes appropriate audit evidence.
- If after this, the auditor concludes that the work of the expert is inconsistent with the information in the financial statements, or that the work of the expert does not constitute sufficient appropriate audit evidence, he should express a qualified opinion, a disclaimer of opinion or an adverse opinion, as may be appropriate.

- When expressing an unqualified opinion, the auditor should not refer to the work of an expert in his report. If, as a result of the work of an expert, the auditor decides to express other than an unqualified opinion, it may in some circumstances benefit the reader of his report if the auditor, in explaining the nature of his reservation, refers to or describes the work of the expert.

S.A. 600: Using the work of another auditor

- "Principal auditor" means the auditor with responsibility for reporting on financial information of an entity when that financial information includes the financial information of one or more components audited by another auditor.
- "Other auditor" means an auditor, other than the principal auditor, with responsibility for reporting on the financial information of a component (division, branch subsidiary, joint venture, etc), which is included in the financial statement audited by the principal auditor.
- When the principal auditor uses the work of another auditor, the principal auditor should determine how the work of the other auditor will affect the audit.
- The principal auditor should consider whether his own participation is sufficient to be able to act as principal auditor. For this purpose he should consider:
  - Materiality of the portion of the financial information which the principal auditor audits.
  - His own degree of knowledge regarding the business of the components.
  - The risk of material misstatements in the financial information of the components audited by the other auditor, and
  - The performance of additional procedures as set out in this S.A. regarding the components audited by other auditor resulting in the principal auditor having significant participation in such audit.
- Procedure to be followed by the Principal Auditor
  - Advise the other auditor of the use that is to be made of his work and report.
  - Inform the other auditor of the matters such as areas requiring special attention, time required for completion of audit and procedures for identification of inter-component transactions that may require disclosure.
  - Make sufficient arrangement for coordination of their efforts at the planning stage of this audit.
  - Discuss with the other auditor the procedures applied.
  - Advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.
  - Consider the significant audit findings of the other auditor.
  - Discuss with the other auditor the management of the component, the audit findings or other matters affecting the financial statements of the components.

- Where he considers necessary, request the other auditor to perform supplementary tests of records of financial statements of the component.

- The principal auditor should consider the professional competence & independence of the other auditor.
- The principal auditor has the right to visit the component and examine the books of account and other records when another auditor has been appointed. However, the principal auditor has no right of access to the working papers of the other auditor.
- Reporting Considerations:
  1) The principal auditor's report should clearly indicate the extent to which the financial statements of components audited by the other auditors have been included in the financial statements of the entity.
  2) When the principal auditor concludes, based on his procedures, that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified report, or disclaimer of opinion because there is a limitation on the scope of audit.
  3) If the other auditor modifies his report, the principal auditor should consider whether the subject of modification is material enough in relation to the financial statements of the entity as a whole to merit a modification in principal auditor's report.
- Working Papers:
  The principal auditor's working papers should contain the following:
  - Components whose financial statements are audited by other auditors.
  - Name of other auditors.
  - Significance of other components financial statements to the entity as a whole.
  - The procedures applied by the other auditors.
- Division of Responsibility
  1) The principal auditor would not be responsible in respect of the work entrusted to the other auditor, except in circumstances which should have aroused his suspicion about the reliability of the work performed by the other auditors.
  2) When the principal auditor has to base his opinion on the financial statements of the entity as a whole, relying upon the statements and reports of the other auditor, his report should clearly state the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity.

S.A. 580: Written Representation

- Written Representation refers to written or oral confirmation by management regarding the items presented in financial statements. The auditor can use the representation as audit evidence considering the following procedure:
  1) Auditor should generally obtain the representation by management in writing.
  2) Evaluate the representation and find out whether it is consistent with other audit evidence available.
  3) Whether the person making representation on behalf of management is well-informed of the matter.
- Following are the basic elements of Management representations:
  1) It should be addressed to the auditor.
  2) It should be dated as of the report date or a date prior to it.
  3) It should be signed by the C.E.O or the C.F.O.
  4) It should contain relevant information.
- Professional judgement should be used by the auditor for determining the matters on which he wishes to obtain representations.
- Management representation is not a substitute for other audit evidence and if contradicted by such other audit evidence, the auditor may reconsider the reliability of management representations.
- In case management is not willing to give in writing the representations made by it during the course of audit, the auditor should prepare a letter in writing setting out his understanding of management's representations that have been made to him during the course of his audit and send it to the management with a request to acknowledge and confirm that his understanding of the representations is correct. If the management refuses to acknowledge or confirm the letter sent by the auditor, this will constitute a limitation on the scope of his examination. In such circumstances the auditor should evaluate any reliance on those representations and consider if the refusal may have any additional effect on his report.

S.A. 299: Responsibility of Joint Auditors

- Joint Auditors refers to audit of financial statements of business by more than one auditor. Such auditors are called Joint Auditors. These auditors conduct audit jointly and report on the financial statements of the entity.
- An effective audit requires proper division of work among the auditors, co-ordination between them and assumption and fixation of responsibility including reporting responsibilities amongst them.
- Division of work may be on the basis of identifiable units or specified areas. It may be with reference to items of assets and liabilities or income and expenditure. Important areas of audit should not be divided. The division of work should be properly documented and communicated.

- During the course of audit the auditor may come across some matter which is material for ascertaining the true and fair view of state of affairs of the operations of the entity as a whole. He should communicate such matter to the joint auditors.
- Joint and Several Liability:
  1) Work that is not divided and is carried out by all.
  2) Joint decisions taken regarding audit procedures to be performed by any one of them.
  3) Disclosure requirements regarding financial statement.
  4) For obtaining and evaluation information and explanations from the management.
- Individual Liability:
  1) Reviewing the reports of the divisions or branches allocated to him.
  2) Carrying out that part of audit work assigned to him in accordance with the generally accepted principles and audit procedures.
  3) Ensuring compliance with all the legal and professional requirements regarding the disclosures to be made and presenting a true and fair view of the state of affairs and of the results of the division or branch assigned to him for audit.
- Report:
  The joint auditors should give one single report. But if they do not agree in any respect, then they should express their opinion through a separate report.

S.A. 320: Materiality in planning and performing an audit

- "Information is material if its misstatement could influence the economic decisions of the users taken on the basis of the financial information."
- Factors affecting judgement:
  1) Materiality is a relative concept.
  2) It may be judged on the basis of the impact of the item on the overall financial statement level.
  3) Legal and regulatory requirements for example – disclosure requirements regarding payments to directors.
  4) Cumulative effect of small amounts may be considered material.
- Audit risk means the risk that the auditor gives an inappropriate audit opinion when financial statements are materially misstated. Materiality is being closely linked to the concept of audit risk in determining the nature, timing and extent of audit procedures.
- There is an inverse relationship between materiality and the degree of audit risk which means the higher the materiality level, lower the audit risk and lower the materiality level higher the audit risk. The auditor takes the inverse relationship between materiality and the audit risk into account when determining the nature, timing and extent of audit procedures. For example, if, after planning for specific audit procedures, the auditor determines that the acceptable materiality level is lower, audit risk is

increased. In simple words, if the auditor thinks that in this company even Rs.500 is material, it means the auditor is setting the materiality level low.

The auditor would compensate for this either by:

1) Reducing the assessed degree of control risk, where this is possible, and supporting the reduced degree by carrying out extended or additional tests of control, or
2) Reducing detection risk by modifying the nature, timing and extent of planned substantive procedures.

- Materiality level may be changed depending upon the experience gained during the audit process. Materiality may be different at the time of initially planning the audit of the engagement from that at the time of evaluating the audit procedure.
- Errors detected during the audit may be communicated to the management and the management may be asked to adjust the financial statement. However, if the management does not carry the required adjustment resulting from errors, the auditors after assessing and reviewing may form qualified or adverse opinion.

S.A. 520: Analytical Procedures

- Analytical procedures mean the analysis of significant ratios and trends including resulting investigation of fluctuations in relationships that are inconsistent with other relevant information or which deviate from predicted amount.
- Analytical procedures are used for the following purpose:
  1) To assist the auditor in planning the nature, timing and extent of other audit procedures,
  2) As substantive procedures when their use can be more effective or efficient than tests of details reducing detection risk for specific financial statement assertions, and
  3) As an overall review of the financial statements in the final review stage of the audit.
- When intending to perform analytical procedures as substantive procedures, the auditor will need to consider a number of factors such as the-
  1) Objectives of the analytical procedures and the extent to which their results can be relied upon.
  2) Nature of the entity and the degree to which information can be disaggregated, for example, analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of diversified entity, than when applied to the entity as a whole.
  3) Availability of information, both financial – such as budgets or forecast, or non financial such as the number of units produced or sold.
  4) Reliability of the information available for example, whether budgets are prepared with sufficient care or not.

5) Relevance of the information available.
6) Source of information available, for example, sources independent of the entity are ordinarily more reliable than internal sources.
7) Knowledge gained during previous audits, together with the auditor's understanding of the effectiveness of the accounting and internal control systems and the types of problems that in prior periods have given rise to accounting adjustments.

- When analytical procedures identify significant fluctuations or relationships that are consistent with other relevant information or that deviate from predicted amounts, the auditor should investigate and obtain adequate explanations and appropriate corroborative evidence.
- Overall review: At the end of the audit, when the auditor forms an opinion or conclusion as to whether the financial statement as a whole is as per his expectation, the auditor should apply analytical procedures. The result drawn from such procedures should be corroborated with the result drawn from different components of financial statements. For example, Debtors shown in the Balance Sheet are at realizable value or not may be verified with the help of the Debtors turnover ratio.

S.A. 530: Audit Sampling

- Audit sampling may be defined as "a process of applying audit procedures to less than 100% of a population in order to estimate some characteristic about the population".
- S.A. 530 states that the auditor should design and select an audit sample, perform audit procedures thereon and evaluate the results so as to provide sufficient and appropriate audit evidence.
- Steps in Audit Sampling Plan:
  1) Specifying the audit objective to which sample relates.
  2) Defining the population and number of items.
  3) Specifying the sampling unit.
  4) Selecting the method of sampling - random, systematic and haphazard selection.
  5) Specifying the sample parameters such as confidence level and accuracy.
  6) Determining the sample size.
  7) Choosing a sample selection technique.
  8) Drawing a sample.
  9) Evaluating a sample.
  10) Determining whether adjustment to original plan is needed.
  11) Evaluating any changes.
  12) Formulating a conclusion.
- To assist in the efficient and effective design of the sample, stratification may be appropriate. Stratification is the process of dividing a population into sub-population,

each of which is a group of sampling units, which have a similar characteristic. The strata need to be explicitly defined so that each example unit can belong to only one stratum. This process reduces the variability of the items within each stratum. Stratification enables the auditor to direct audit efforts towards the items which, for example, contain the greatest potential monetary error.

- Sampling Risk arises from the possibility that the auditor's conclusion based on a sample may be different from the conclusion that would be reached if the entire population were subject to the same audit procedure.
- Tolerable Error is the maximum error in the population that the auditor would be willing to accept and still conclude that the result from the sample has achieved the audit objective. Tolerable error is considered during the planning stage and for substantive procedures, is related to the auditor's judgement about materiality. The smaller the tolerable error, the greater the sample size will need to be.
- Expected Risk – If the auditor expects error to be present in the population larger sample needs to be examined, than when no error is expected ordinarily.
- Methods of selection of sample
    1) Random Selection – which ensures that all items in the population have an equal chance of selection.
    2) Systematic Selection – which involves selecting items using a constant interval between selections, the first interval having a random start. The interval might be based on a certain number of items, for example every tenth voucher.
    3) Haphazard Selection – which may be an acceptable alternative to random selection, provided the auditor attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units. When the auditor uses this method, care needs to be taken to guard against making a selection that is biased.
- Measurement of Sample Risk – there are statistical tests to measure the sampling risk. A statistical sampling approach relies on generally accepted theories of maths and probability to quantify the sampling risk like standard deviation, skewness, etc. However, non statistical sampling risk as the sample size is not computed and inference drawn cannot be easily quantified through statistical formula.
- Evaluation of Sample Results – It is the responsibility of the auditor to –
    1) Analyse any errors detected in the sample.
    2) Projection of errors in the total population on the basis of sample result.
    3) Re-assessment of sampling result.
- Advantages of Sampling:
    1) It yields essentially the same results no matter who applies it, hence it gives objective results.
    2) It can quantify the sampling results.
    3) The deviation of the sample from the population can be projected.

S.A. 570: Going Concern

- Going concern is a fundamental accounting concept which is the basis on which the financial statements are prepared. The concept of "Going concern" implies that the business is a continuing enterprise and when applied then the accounting procedure will change and presentation of financial statements will also change.
- An entity's continuance as a going concern for the foreseeable future is assumed in the preparation of financial statements in the absence of information to the contrary. Accordingly, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business. If this assumption is unjustified then entity may not be able to realise its assets at the recorded 3 months and there may be changes in the amounts and maturity dates of liabilities.
- As per S.A. 570, while planning and performing audit procedures and evaluating thereof, the auditor should consider the appropriateness of the going concern assumption. When a question arises regarding the appropriateness of the going concern assumption, the auditor should gather sufficient appropriate audit evidence to attempt to resolve, to the auditor's satisfaction, the question regarding the entity's ability to continue in operation for the foreseeable future.
- The statement clarifies that auditor's report is not a guarantee as to the future viability of the entity. The responsibility of the auditor is to judge the entity's continuance as a going concern for the foreseeable future. Foreseeable future is generally a period not exceeding one year after the Balance Sheet date in the absence of information. If the going concern is not valid, the assets will be recorded at its disposal value and liabilities at its payment value.
- Following are the indicators of possible problems in the Going Concern Assumption:
  1) Negative Working Capital
  2) Adverse Financial Ratios
  3) Recurring losses
  4) Loss of Key personnel
  5) Labour problems
  6) Increasing stock levels
  7) Default in loans
  8) Inability of the entity to pay dividends
- If there are any indicators that the going concern assumption is not appropriate, perform appropriate procedures to confirm or dispel doubts. Procedures could include the following:
  1) Consideration of mitigating factor
     i) Disposal of assets
     ii) Re-scheduling loan payments

iii) Obtaining additional capital
iv) Funding arrangements backed by Government.

2) Analysis of cash flows and other relevant forecasts.
3) Review events after Balance Sheet.
4) Confirm the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assess the financial ability of the parties to provide additional capital.
5) Consider the entity's position concerning unfulfilled customer orders.
6) The auditor should obtain sufficient evidence that:
   i) Management plans are feasible
   ii) They are likely to be implemented
   iii) The outcome of these plans will improve the situation.

- If in the auditor's judgement, the going concern assumption is appropriate because of mitigating factors, in particular management's plans for future action, the auditor should consider whether such plans or other factors need to be disclosed in the financial statements. Where the auditor concludes that such plans or other factors need to be disclosed, but have not been adequately disclosed, the auditor should express a qualified opinion or adverse opinion as required.

S.A. 220: Quality control for Audit work

- Objective of this standard is to prescribe the procedures so that quality of audit conducted by the firm is maintained and enhanced. The standard prescribes the procedure to control the quality of audit by the audit firm.
- At the firm level:
  1) The personnel employed by the firm should be independent, objective and keep the information of the client confidential.
  2) The personnel employed should be technically competent to conduct the conduct as per auditing principles. They should have necessary professional qualification.
  3) While assigning the work to any audit assistant, the competence of the particular assistant as per the audit requirement should be judged.
  4) The audit firm must continuously monitor the policies and procedures followed by it for the purpose of audit.
  5) Due supervision should be exercised over the assistants to control whether work is being carried out as per audit programme and procedures.
  6) Outside consultation may be done by the audit firm for the matter of expertise like in legal cases judgement may be taken after consulting the legal experts.
- At the individual level:

1) Delegation – involves delegating work to the assistants and ensuring that the work will be performed with due care and by persons having the degree of professional competence.
2) Direction – involves informing the assistants of their responsibilities, objectives of the procedures they are to perform, and the nature of the entity's business.
3) Supervision – involves monitoring the progress of the audit conducted by the assistants, addressing significant accounting questions raised during the audit, resolving any differences of professional judgement between personnel and considering the level of consultation that is appropriate.
4) Review – involves considering whether work has been performed as per the audit programme, the results obtained have been adequately documented in the working papers.
5) Certain additional audit procedures by the personnel other than personnel deployed in particular audit.

S.A. 540: Auditing Accounting Estimates, Including Fair Value Accounting Estimates & Related Disclosures

- Accounting estimate means an approximation of the amount of an item in the absence of a precise means of measurement. Example – Provision for depreciation, provision for doubtful debts, provision for taxation, provision for loss from law suit, provision for warranty claims, provision for retirement benefits. It is actually the management's responsibility for making accounting estimates.
- Accounting estimates may be determined as part of routine accounting system operating on a continuing basis, or may be non routine, operating only at the end of the period. In many cases, accounting estimates are made by using a formula based on experience, such as the use of standard rates for depreciating each category of fixed assets. In such cases, the formula needs to be reviewed regularly by management and adjusted when necessary.
- The assumptions used in accounting estimate will be specific to the entity and would be based on internally generated data, while in other cases, the assumptions may be based in industry or government statistics.
- Auditor's responsibility: While evaluating accounting estimate of complex nature, auditor should exercise judgment based on past experience whether estimates are reasonable. In some cases, the management makes the estimates based on certain formula. In such cases the auditor should ensure that such formula is continuously reviewed.
- Audit procedures:
  1) To understand the method, procedures followed by the management to calculate accounting estimates.

2) Environment under which the accounting estimates are made by the management like internal control system, external/ internal evidence on which estimates are based.
3) Assumptions on which estimates are based.
4) Review and test the procedures followed by the management.
5) Compare, if possible with earlier year's estimates.
6) In case the accounting estimates are complex in nature, use the work of expert, for example, for provision of gratuity get the opinion of actuarial expert.
7) Consider, review and approve the procedures followed by the management at appropriate level for accounting estimates.
8) Make or obtain an independent estimate and compare it with the accounting estimates.
9) Review and consider the subsequent events after the Balance Sheet date but before the completion of audit to judge the appropriateness of the accounting estimates.

- As per the audit standard the auditor should make a final assessment of the reasonableness of the estimates based on auditor's knowledge of the business and whether the estimates are consistent with other audit evidence obtained during the audit. If after final assessment, auditor believes that difference is unreasonable, management should be requested to revise the estimates. If management refuses to comply, the auditor may consider giving a qualified report.

S.A. 560: Subsequent Events

- Events that occur after Balance Sheet date but before the date of auditor's report are referred to as "Subsequent Events", as per S.A. 560. Accounting standard 4, "Contingencies and Events occurring after the balance sheet deals with events between balance sheet and the date of approval of accounting by the Board of Directors".
- Type 1 Events – Those events that provide additional evidence with respect to conditions that existed on the date of Balance Sheet and effect the estimation made in preparation of financial statements. The statement should be adjusted for any change in the estimates resulting from the use of evidence of subsequent events. For example,
  1) Insolvency of debtors after balance sheet date,
  2) Dishonour of cheques/ bills of exchange accepted, due after balance sheet date.
  3) Subsequent fixation of purchase price or the proceeds of sale of assets purchased or sold before the year-end.
- Type 2 Events – Those subsequent events which involve conditions coming into existence after balance sheet date. They require disclosure otherwise financial statements would be misleading. For example,
  1) Mergers and Acquisitions after balance sheet

2) Closure of plant/ division due to labour problems
3) Changes in capital structure

- Audit procedures:
  1) Review the procedures that management followed to identify the subsequent events.
  2) Read the minutes of the meeting of the Board of Directors, executive committee, shareholders held after the balance sheet date.
  3) Read latest interim financial statements.
  4) Inquire about latest position of legal cases pending.
  5) Inquiring of the management as to whether any subsequent events have occurred after the Balance Sheet which might affect the financial statements.
- Subsequent Events and Branch Auditor's Report:
  If branch auditor has already audited the branch and submitted the report to the principal auditor, the principal auditor would follow audit procedures as mentioned above in respect of events occurring after balance sheet date but before signing of his Company Audit Report.
- Auditor's Report and Subsequent Events:
  If subsequent events, which are material, are not properly adjusted or disclosed depending upon the type of subsequent events, the auditor should express a qualified report or adverse report.

S.A. 310: Knowledge of Business

- The auditor who expresses his opinion on the financial statements is not an expert on the type of business conducted by the client, but an expert in the accounting and audit area only. However, he has to conduct the audit of various types of business. When the auditor evaluates the evidence of the transaction of different business, he can make better assessment if he has sufficient knowledge of the business.
- Obtaining the required knowledge of the business is a continuous and cumulative process of gathering and assessing the information and relating the resulting knowledge to audit evidence and information at all stages of the audit.
- For continuing engagements, the auditor would update and re-evaluate information gathered previously, including information in the prior year's working papers. The auditors would also perform procedures designed to identify significant changes that have taken place since the last audit.
- Sources of obtaining knowledge:
  The auditor can obtain knowledge of client's business and other related industry from various sources. Knowledge of client's business includes the following:
  a) Knowledge of economy
  b) Knowledge of related industry

c) Knowledge of client's entity or company

- Knowledge of economy implies:
  1. Knowledge of general level of economic activity
  2. Interest rate and availability of finance
  3. Inflation
  4. Government policies, etc.
- Knowledge of industry implies:
  1. The market and competition
  2. Changes in product technology
  3. Key financial ratios of the industry
  4. Regulatory framework
  5. Specific accounting policies and practices
- Knowledge about client's business:
  1. Structure of entity
  2. Ownership of business
  3. Capital structure of business
  4. Management's objective, philosophy and strategic plans
  5. Sources and method of financing
  6. Audit committees
  7. Key management personnel
  8. Internal audit functions
  9. Location of factories and facilities
  10. Product of the business
  11. Important suppliers of goods and services
  12. Key ratios of the client
- Using the knowledge of the purpose of Audit
  a) Assessing the risk and identifying the problems
  b) Planning and performing the audit effectively and efficiently
  c) Evaluating audit evidence
  d) Providing better services to client

S.A. 250: Consideration of laws and regulations in an audit of financial statements

- When planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognise that non-compliance by the entity with laws and regulations may materially affect the financial statements.
- Non-compliance are acts of omissions by the entity which are company to prevailing laws and regulations. It is the management's responsibility to comply with laws and regulations. The auditor is not and cannot be held responsible for detection of non-

compliances. The risk of non detection of non-compliances is greater than risk of non-detection of fraud.

- Whether an act constitutes non-compliance is a legal determination that is ordinarily beyond the auditor's professional competence. The auditor's training, experience and understanding of the entity and its industry may provide a basis for recognition that some acts coming to the auditor's attention may constitute non-compliance with laws and regulations.
- The auditor should verify whether the company has complied with Schedule VI requirements regarding disclosure in financial statements. He should also check whether the organisation has complied with laws relating to gratuity, bonus, Provident Fund, etc.
- Other than the above laws and regulations, the auditor should verify whether other laws and regulations have been complied with. He must evaluate the effect of the non-compliance on the financial statements. Even immaterial non-compliance should not be overlooked as these have implication on the integrity of the management.
- In accordance with specific statutory requirements, the auditor may be specifically required to report as part of the financial statements whether the entity complies with certain provisions of laws or regulations. In these circumstances, the auditor should plan to test of compliance with these provisions of the laws and regulations.
- In order to plan the audit, the auditor should obtain a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
- After obtaining the general understanding the auditor should perform procedures to identify instances of non-compliance with those laws and regulations.
- The auditor should obtain written representations that management has disclosed to the auditor all known. Actual or possible non-compliance with laws and regulations whose effects should be considered when preparing financial statements.
- When the auditor believes that there may be non-compliance, the auditor should document the finding and discuss them with the management. If management does not provide satisfactory information. The auditor should consult the entity's legal department about the application of the laws and the possible effects on the financial statements.
- If the auditor finds that non-compliance affects the true and fair position of the financial statements, he must communicate to the Board of Directors, the Audit Committee and senior management, especially where he is of opinion that it is intentional.
- If the entity does not take remedial action on his communication of the non-compliance, he may feel that withdrawal from the engagement is necessary. If he decides to withdraw from engagement on account of non-compliances, he should, in response to the incoming auditor's communication, mention the facts to him without disclosing unnecessary details.

S.A. 510: Initial Audit Engagements- Opening Balance

- Opening balance means the balance which existed in the beginning of the period, it is the same which was the closing balance in the immediately previous period.
- Auditor's responsibility regarding opening balances:
  1) The closing balances of the preceding period are correctly brought forward to the current period. This can be done if the auditor compares and checks the opening balance with the closing balances of the previous period.
  2) Auditor should consider whether any misstatement in opening balances is materially affecting the financial statements of the current period.
  3) Accounting policies followed in preceding period area also being followed in current period.
- Audit Procedures: The auditor should satisfy himself that:
  1) Closing balance of the preceding period has been correctly brought forward to the current period.
  2) The opening balance do not contain material misstatements and
  3) Appropriate accounting policies are being consistently applied.
     i) If financial statements were audited by another auditor and the auditor is satisfied, then copies of audited financial statements can be used to verify opening balances.
     ii) If financial statements were audited but the auditor is not satisfied or if previous financial statements were unaudited then the auditor should perform additional audit procedures.
     iii) If the auditor is unable to obtain sufficient appropriate evidence, he should give a qualified opinion or disclaimer of opinion.
     iv) If opening balances contain material misstatements whose effect has not been reflected/ disclosed, the auditor should give a qualified or adverse report.
- The auditor will need to consider whether the accounting policies followed in the preceding year, were appropriate and that those policies are consistently followed in the current period. If there is a change in the accounting policy, the auditor should ensure that they are adequately disclosed.

S.A. 550: Related Parties

- "Related Party" means two or more parties where one party has direct or indirect control of the other party, or one party has influence over the financial and operating policies of the other party.
- The auditor should perform the audit procedures with the objectives of obtaining sufficient appropriate evidence regarding identification and adequacy of disclosures of

related parties, and identification and adequacy of disclosures of material transaction with related parties. For example:

1) Transactions which have abnormal terms of trade, such as unusual prices, interest rates, guarantees and repayment terms.
2) Transaction which lack an apparent logical business reason for their occurrence.
3) Transaction in which substance differs form.
4) High volume transaction with certain customers only as compared with others.

- The auditor should assess the completeness of the information provided by the management of the entity, through management representations as to this identification and adequacy of necessary disclosures. He should -
  1) Refer to previous year's working papers to identify related parties.
  2) Assess the adequacy of company's procedures.
  3) Review the register of shareholders to identify significant shareholders.
  4) Review the memorandum of association, articles of association, minutes of meetings of shareholders and board of directors and other records.
  5) Communicate with earlier auditor or other auditor regarding their knowledge of related parties.
  6) Review entity's income tax returns and other information filed with regulatory authorities.
- Obtain evidence to ensure such transactions have been properly recorded and disclosed and perform additional audit procedures if necessary.
- The auditor should obtain a written representation from management concerning
  (a) completeness of information provided regarding identification of related parties, and
  (b) the adequacy of related party disclosures in the financial statements.
- If the auditor is unable to obtain sufficient appropriate evidence or in his opinion disclosures are not adequate he should give a disclaimer of opinion or a qualified report, as appropriate.

S. A. 402: Audit Consideration Relating to Entities Using Service Organisation

- Sometimes the auditor's client take the services of outside service organisations to carry out particular activities, for example-
  1) Information/ data processing
  2) Maintenance of accounting records.
  3) Execution of transactions on behalf of the client.
  4) Certain manufacturing activities.

  In such a situation, service organisation affects the client's books of accounts. Therefore, it is necessary for the auditor to consider the audit risk after taking into account the fact that the client is using service organisations for particular activities.

- While planning the audit, the auditor of the client should determine the significance of the activities of the service organisation to the client and their relevance to the audit. In doing so, the auditor of the client should consider the following-
  1) Nature of the services provided by the service organisation.
  2) Terms of contract and relationship between the client and their relevance to the audit.
  3) The material financial statement assertions that are affected by the use of the service organisation.
  4) Inherent risk associated with those assertions.
  5) Extent to which entity's internal controls interact with the systems at the service organisation.
  6) Client internal controls that are applied to the transactions processed by the service organisation.
  7) Service organisation's capability and financial strength including the possible effect of the failure of the service organisation on the client.
- The auditor of the client should also consider the availability of third-party reports from service organisation's internal auditors regulatory agencies, as a means of providing information about the internal control systems of the service organisations and about its operations and effectiveness.
- If the auditor of the client concludes that the activities of the service organisation are significant to the entity and relevant to the audit, the auditor should obtain sufficient information to understand the accounting and internal control systems of its service organisation and to assess the control to be performed.
- If the information is insufficient the auditor of the client would consider need to request the service organisation to have its auditor perform such procedures as to supply necessary information in the form of reports. If the reports are not made available within a reasonable time, the auditor of the client should consider the need to visit the service organisation to obtain relevant information.
- An auditor of the client wishing to visit a service organisation may advise the client to request the service organisation to give the auditor of the client access to necessary information.
- If the auditor of the client uses the report of a service organisation's auditor, he should consider the competence of the other auditor in the context of specific assignment if the other auditor is not a member of ICAI.
- If the auditor of the client uses the report of a service organisation auditor he should assess the usefulness and appropriateness of reports issued by the service organisation's auditor.
- If the auditor of the client uses the report of a service organisation auditor, no reference should be made in the client's audit report about the auditor's report of the service organisation.

S. A. 710: Comparatives

- The auditor should determine whether the comparatives comply, in all material respects, with the financial reporting framework relevant to the financial statements being audited.
- "Comparative means" comparative financial information for preceding financial periods presented for the comparative periods which provide users financial information necessary, to identify results and changes affecting an entity over a period of time.
- The auditor should obtain sufficient appropriate audit evidence that the corresponding figures meet the requirements of the relevant financial reporting framework.
- When the financial statements of the prior period have been audited by another auditor, or the financial statements of the prior period have not been audited, the incoming auditor should assess whether the corresponding figures meet the conditions specified above. The auditor should also comply with the requirements of S.A. 510 i.e. "Initial Engagements-Opening Balances".
- Reporting
  1) The auditor's report on the period, as previously issued, included a qualified opinion, disclaimer of opinion, or adverse opinion, and the matter which gave rise to the modification is unresolved-
     i) If the unresolved matter results in a modification of the auditor's report regarding the current period figures, the auditor's report should also be modified regarding the corresponding figures.
     ii) If not, the auditor's report should be modified regarding the corresponding figures only.
  2) The auditor's report on the period, as previously issued, included a qualified opinion, disclaimer of opinion, or adverse opinion, and the matter which gave rise to the modification is resolved and properly dealt with in the financial statements-
     i) The current report does not ordinarily refer to the previous modification.
     ii) If the matter is material to the current period, the auditor may include an emphasis of the matter paragraph in this regard.
  3) If the auditor becomes aware of material misstatements which affected prior period financial statements for which unmodified report has been issued, the auditor should examine that appropriate disclosures have been made in the current period financial statements. Appropriate disclosures may be in the form of Performa comparative information being presented in the notes to the financial statements. This would help the reader of the financial statements to clearly perceive the effect of misstatement on the corresponding figures. If appropriate disclosures are not made the auditor should issue a modified report on the current period financials modified with respect to the corresponding figures included.

4) When the prior period financial statements are not audited, the incoming auditor should state in the auditor's report that the corresponding figures are unaudited. Such a statement does not however, relieve the auditor from compliance with S.A. 510.

S.A. 210: Agreeing the terms of audit engagement

- An "Engagement Letter" is a written contract between the auditor and the client that serves to minimize misunderstanding. Though the objective and scope of the audit and the auditor's obligation are normally laid down in the applicable statute or regulations and the pronouncements of the ICAI, the audit engagement letters would be information to the client.
- In the interest of both the client and the auditor, the auditor should send an engagement letter, preferably before the commencement of the engagement. The engagement letter documents and confirms the auditor's acceptance of the appointment, the objective and scope of the audit and the extent of the auditor's responsibilities to the client.
- An engagement letter would normally include-
  1) Objective of audit of financial statements
  2) Management's responsibility for making judgment and estimates that are reasonable and prudent so as to give 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.
  3) Management's responsibility for maintenance of adequate accounting records and internal controls for safeguarding the assets of the company and for preventing and detecting frauds or other irregularities.
  4) The scope of the audit, including – reference to the applicable legislation, regulation and the pronouncements of the ICAI.
  5) The fact that having regard to the test nature of an audit, persuasive rather than conclusive nature of audit evidence together with inherent limitations of any accounting and internal control system there is an unavoidable risk that even some material misstatements, resulting from fraud, and to a lesser extent error exist may remain undetected.
  6) The fact that audit process may be started to a peer review under the Chartered Accounting Act, 1949.
  7) Basis on which fees are computed.
  8) Expectation of receiving from management written confirmation concerning representations made in connection with the audit.
  9) Arrangements concerning the involvement of other auditors and experts in some aspects of audit.

10) Any restriction of the auditor's liability when such possibility exists.

- Recurring audits
  1) On recurring audits, the auditor should consider whether circumstances require the terms of engagement to be reviewed and whether there is a need to remind the client of the existing terms of the engagement.
  2) The following factors may make it necessary to send a new letter:
     i) Any indication that the client misunderstands the objective and scope of the audit.
     ii) Any revised or special terms of the engagement.
     iii) A recent change of senior management, Board of Directors.
     iv) A significant change in nature and size of the client's business.
     v) Legal requirements or pronouncements of the ICAI, or changes in the existing ones.
- Changes in Audit Engagement – During the course of audit, if the terms of engagement are changed to provide a lower level of assurance then the auditor should –
  1) Examine the reason for such change along with its reasonableness.
  2) Consider legal or contractual implications of the change.

  If the auditor is of the opinion that change in terms of engagement is reasonable he should issue audit report according to the changed terms. However, if he is of the opinion that change in terms of engagement is unreasonable and is not allowed by the client to continue the original engagement, he should withdraw and communicate the reasons of withdrawal to the Board of Directors or to shareholders.

S.A. 260: Communication with those charged with governance

- "Those charged with governance" are persons who are entrusted with responsibility to supervise, control and direct an entity. Example, management and audit committee.
- It may be noted that the auditor is not required to adopt audit procedures to identify matters of governance interest. His responsibility is to communicate only those matters which have come to his notice during the course of audit and are of importance to those charged with governance. There matters may include –
  1) Overall scope of the audit.
  2) Adoption of or changes in significant accounting policies.
  3) Important accounting adjustments.
  4) Material uncertainties give rise to going concern doubt.
  5) Material weaknesses in internal control system.
  6) Suspected frauds and errors.
  7) Expected modification to the auditor's report.

- Communications between the auditor and those charged with governance are not a substitute for appropriate modification (qualified opinion or adverse opinion) in the audit report.
- Audit matters of Governance interest are those matters that satisfy the following conditions –
  1) They arise from the audit of financial statements and
  2) In the opinion of the auditor, they are both important and relevant to those charged with governance in overseeing the financial reporting and disclosure process.
- In a company where the Board of Directors has established an audit committee, the auditor may decide to communicate with the audit committee, or with the Board depending upon the importance of the matter. When the entity's governance structure is not clearly defined, the auditor comes to an agreement with the entity about with whom the audit matters of governance interest are to be communicated.
- The auditor's communication with those charged with governance may be made orally or in writing depending upon the size, operating structure and communication process of the entity, nature and sensitivity of the audit matters to be communicated.
- When audit matters of governance interest are communicated orally, the auditor should document in the working papers the matters communicated and any responses to those matters.
- Confidentiality
  1) The requirements of professional pronouncements, legislations or regulation may impose obligations of confidentiality that restrict the auditor's communications of audit matters of governance interest.
  2) The requirements of professional pronouncements, legislations or regulation may impose obligations on the auditor to make communications on governance related matters. For example, the requirements of regulation such as report under Section 619(3) of the Companies Act, 1956, in case of public sector banks, may impose obligation on the auditor to make communication on governance related matters.

S.A. 700: The Auditor's Report on Financial Statement

- The auditor's report is a clear written expression of opinion on the financial statements. This S.A. covers basic elements of auditor's report and types of auditor's report.
- Basic elements:
  1. Title
  2. Addressee
  3. Opening and introductory paragraph
  4. Scope paragraph
  5. Opinion paragraph

6. Date of Report
7. Place of signature
8. Auditor's signature
9. Any specific matter prescribed by law or the regulator

- Opening paragraph
  - The auditor's report should identify the financial statements of the entity that have been audited, including the date of and period covered by the financial statements.
  - The report should include a statement that the financial statements are the responsibility of the entity's management and a statement that the responsibility of the auditor is to express an opinion on the financial statements based on the audit.
  - The preparation of financial statements requires management to make significant accounting estimates and judgements, as well as to determine the appropriate accounting principles and methods used in preparation of the financial statements. In contrast, the auditor's responsibility is to audit these financial statements in order to express on opinion thereon.
- Scope paragraph
  - The auditor's report should describe the scope of the audit by stating that the audit was conducted in accordance with auditing standards generally accepted in India.
  - Scope refers to the auditor's ability to perform audit procedures deemed necessary in the circumstances. The report should include a statement that the audit was planned and performed to obtain reasonable assurance whether the financial statement are free of material misstatement
  - The auditor's report should describe the audit as including –
    - i) Examining, on a test basis, evidence to support the amounts and disclosures in financial statements.
    - ii) Assessing the accounting principles used in the preparation of its financial statements.
    - iii) Assessing the significant estimates made by management in the preparation of financial statements, and
    - iv) Evaluating the overall financial statement presentation.
- Opinion paragraph

  The audit report should contain the following in the opinion paragraph:
  1) Whether the financial statements are prepared in conformity with the relevant reporting framework. For example, financial statements of a company should be as per Schedule VI of Companies Act, 1956.
     Whether the financial statements give a true and fair view of the state of affairs of the business. The term "true and fair view" indicates that the auditor considers only those matters that are material to the financial statements.
  2) The date of an auditor's report on the financial statements is the date on which the auditor signs the report expressing an opinion on the financial statements.

3) The report should specify the location, which is ordinarily, the city where the audit report is signed.
4) The report should be signed in his personal name. Where the firm is appointed as auditor, the report should be signed in the personal name of the auditor and a name of the audit firm. The partner/ proprietor signing the audit report should also mention the membership number assigned by the ICAI.

- Unqualified opinion
  1) An unqualified opinion should be expressed when the auditor concludes that the financial statement give a true and fair view in accordance with the financial reporting framework used for the preparation of the financial statements.
  2) An unqualified opinion indicates that any changes in the accounting principles or in the method of their application, and the effects thereof have been properly determined and disclosed in the financial statements.
  3) An unqualified opinion also indicated that the financial statements have been prepared using the generally accepted accounting principles, which have been consistently applied.
- Qualified opinion
  1) A qualified opinion should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with the management is not as material and pervasive as to require an adverse opinion.
  2) A qualified opinion should be expressed as being "Subject to" or "Except for" the effect of the matter to which the qualification relates.
- Disclaimer of opinion

  A disclaimer of opinion should be expressed when the possible effect of a limitation on scope of audit is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and is accordingly, unable to express an opinion on the financial statements.
- Adverse opinion

  An adverse opinion should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.
- Limitation on scope
  a) A limitation on the scope of the auditor's work may sometime be imposed by the entity. When the limitation in the terms of a proposed engagement is such that the auditor believes the need to express a disclaimer of opinion exists, the auditor should not accept such a limited engagement, unless required by statute.
  b) A statutory auditor should not accept such an audit engagement when the limitation infringes on the auditor's statutory duties.

c) When there is a limitation on the scope of auditor's work that requires expression of a qualified opinion or a disclaimer of opinion, the auditor's report should describe the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.

- The auditor may disagree with management about matters such as the acceptability of accounting policies selected, the method of their application, or the adequacy of disclosures in financial statements. If such disagreements are material to the financial statement, the auditor should express a qualified or an adverse opinion.

S.A. 401: Auditing in C.I.S. Environment

- A CIS (Computer Information System) Environment exists when one or more computer of any type or size is involved in the processing of financial information, including quantitative data of significance to the audit. It does not matter whether those computers are operated by the entity or a third party.
- The objective of an auditor does not change in a CIS environment but it may affect the
  a) Procedures followed by the auditor to obtain a sufficient understanding of the accounting and internal control system.
  b) The auditor's evaluation of inherent risk and control risk and
  c) The auditor's design and performance of tests of control and substantive procedures.

  To obtain sufficient audit evidence, the auditor can use:
  1) Manual audit procedure
  2) Computer-assisted audit techniques (CAATs)
  3) A combination of both
- Skill and competence
  1) To understand sufficiently the effect of the CIS environment on accounting and internal control systems.
  2) To determine the effect of the CIS environment on the assessment of overall audit risk and of risk at the account balance and class of transactions level, and
  3) To design and perform appropriate tests of control and substantive procedures.
- Planning

  While evaluating the reliability of accounting and internal control system, the auditor would consider whether these systems ensure the following:
  1) That authorised, correct and complete data is made available for processing.
  2) Timely detection and correction of errors.
  3) In case of interruption, the system starts without distorting the completion of the entries and records.
  4) The accuracy and completeness of output.

5) Adequate data security against fire and other calamities, wrong processing, frauds etc.
6) Prevention of unauthorised amendments to the programs, and
7) Safe custody of source code of application software and data files.

- When the computer information systems are significant, the auditor should also obtain an understanding of the CIS environment and whether it may influence the assessment of inherent and control risks. The nature of the risks and the internal control characteristics in CIS environments include the following:
  1) Lack of transaction trails – some computer information systems are designed so that a complete transaction trail that is useful for audit purpose, might exist only in computer readable form.
  2) Uniform processing of transaction – the clerical errors ordinarily associated with manual processing are virtually eliminated. Conversely, programming errors will ordinarily result in all transaction being processed incorrectly.
  3) Lack of segregation of functions – many control procedures that would ordinarily be performed by separate individuals in manual systems may become concentrated in a CIS environment.
  4) Potential for errors and irregularities - the potential for human error in the development, maintenance and execution of CIS may be greater than in manual systems, partially because of the level of detail inherent in these activities.
  5) Assessment of Risk – the auditor should make as assessment of inherent and control risks for material financial statement assertions, in accordance with S.A. 400. The inherent and control risks in a CIS environment may have both a pervasive effect and an account-specific effect on the likelihood of material misstatements as follows:
     i) The risk may result from deficiencies in pervasive CIS activities such as program development and maintenance, system software support, operations, physical CIS security and control over access to special-privilege utility programs. These deficiencies would tend to have a pervasive impact on all application system that are processed on the computer.
     ii) The risks may increase the potential for errors or fraudulent activities in specific applications, in specific databases or master files, or in specific processing activities.

S.A. 505: External confirmations

- External confirmation is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item affecting assertions made by management in the financial statements.

- External confirmation in the process ordinarily consists of the following:
  1) Select the items like debtors, creditors, bank balances, etc for which confirmations are required.
  2) Design the form of confirmation requests.
  3) Communicate the requests to the third party concerned.
  4) Obtaining the response from the third party.
  5) Evaluating the information or non-receipt of confirmations.
- The auditor may use positive or negative external confirmations.
  1) A positive external confirmation request asks the respondent to reply to the auditor in all circumstances.
  2) The use of a positive external confirmation is preferable when the individual account balances are large, or when the internal controls are weak, or where the auditor has reasons to believe that there may be substantial number of accounts in dispute inaccurate or irregular.
  3) The auditor should perform alternative procedures when no response is received to a positive external confirmation request. The alternative procedures should be such as to provide the evidence about the financial statement assertion that the confirmation request was intended to provide.
  4) A negative confirmation request asks to respond only if he is in disagreement with the information provided in the request.
- When performing confirmation procedures, the auditor should maintain control over the process of selection of those to whom a request will be sent, the preparation and sending of confirmation request, and the responses to those requests. The auditor should ensure that the requests are properly addressed, and that it is requested that all replies and undelivered confirmations are delivered directly to the auditor.
- The auditor should consider whether there is any indication that external confirmations received may not be reliable. The auditor should consider the authenticity of the response and perform appropriate procedures to dispel any doubts.
- Any discrepancies revealed by the external confirmations received or by the procedures carried out by the auditor might have a bearing on the assertion and the accounts within the given assertion not selected for external confirmation. In such a case, the auditor should request the management to verify and reconcile the discrepancies.
- If auditor wants to confirm a particular debtor/creditor balance and management requests him not to do so, the auditor should
  1) Ask the management to give the request in writing with reasons.
  2) Ascertain gentility of management’s reasons by examining documentary evidence.
- If the auditor accepts management’s request, he should
  1) Document the reasons for accepting the request.
  2) Perform alternative procedures to obtain evidence regarding that matter.
- If the auditor does not accept the request and is prevented from confirming
  1) It is a limitation on scope of auditor’s work.

2) He should consider its possible impact on his report.
3) He should consider the reliability of management's explanations.

S.A. 501: Audit Evidence – Additional considerations for specific items

- The purpose of the Audit Standard is to establish standards on the auditor's responsibilities, audit procedures and provide additional guidance to what is contained in S.A. 500 i.e. Audit Evidence. It comprises of the following parts:
  1) Attendance at physical inventory counting
  2) Inquiry regarding litigation and claims
  3) Valuation and disclosure of long term investments
  4) Segment information
- Attendance at physical inventory counting:
  1) The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence during his attendance at physical inventory counting.
  2) Physical verification of inventories is the responsibility of the management, at least once in a year.
  3) When inventory is material to the financial statements the auditor should obtain sufficient appropriate audit evidence regarding its existence and condition by attendance at physical inventory counting unless impracticable due to factors such as the nature and location of the inventory.
  4) If unable to attend the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and where necessary, perform alternative audit procedures to assess whether the changed date are correctly recorded.
  5) Where attendance at physical inventory counting is impracticable, the auditor should consider whether alternative procedures provide sufficient appropriate audit evidence of existence and condition of inventory to conclude that the auditor need not make reference to a scope limitation.
- In planning attendance at the physical inventory count the auditor should consider the following:
  1) The nature of accounting and internal control system used regarding inventory.
  2) Inherent, control and detection risks and materiality related to inventory.
  3) Whether adequate procedures are established and proper instructions issued for physical inventory counting.
  4) The timing of the count.
  5) The location at which inventory is held and its nature.
  6) Whether an expert's assistance is required.
- When inventory is under the custody and control of a third party, the auditor would ordinarily obtain direct confirmation from the third party/ arrange with the entity for

sending requests for such confirmations as to the quantities and condition of inventory held on behalf of the entity. The auditor would also consider the following:

1) Conduct of the third party with the entity and independence of the third part.
2) Observing or arranging for another auditor to observe, the physical inventory count.
3) Obtaining another auditor's report on the adequacy of the third party's accounting and internal control systems for ensuring that the inventory is correctly counted and adequately safeguarded.
4) Inspect documentation regarding inventory held by third parties, for example warehouse receipts.
5) Subsequent receipt of goods from third parties.

- Inquiry regarding litigation and claims: The auditor should carry out audit procedures in order to become aware of any litigation and claims involving the entity which may have a material effect on the financial statements. Such procedures would include:
    1) Make appropriate enquiries of management including representations.
    2) Review board/ committee minutes and correspondence with entity's lawyers.
    3) Examine legal and other relevant expenses accounts.
    4) Use any information obtained regarding the entity's business including information obtained from discussions with in-house legal department.
- When litigation or claims have been identified by the management or when the auditor believes they may exist, and are likely to be material, the auditor may seek direct communication with the entity's lawyers and such other professionals.
- The letter seeking direct communication with the entity's lawyers should be prepared by the management. The auditor should maintain control over the process of preparation and sending the letter. The letter should request the entity's lawyers and such other professionals to whom the entity engages for litigation and claims to communicate directly with the auditor.
- If management refuses to give the auditor permission to communicate with the entity's lawyers, this would constitute a limitation on the scope of auditor's work that requires expression of a qualified opinion or disclaimer of opinion as the case may be.
- The auditor should obtain a written representation from management concerning the completeness and adequacy of information provided regarding the identification of litigation and claims, estimates of financial implication, including costs, etc.
- Valuation and disclosure of long term investment: When long term investments are material to the financial statements, the auditor should obtain sufficient evidence as to their valuation and disclosures.
- Audit procedures include obtaining audit evidence with respect to their ownership and existence, as to whether the entity has the ability to continue to hold the investments on long term basis and discussing with management as long term investments. Other procedures will include-

1) In case of quoted securities – considering related financial statements and other information such as market quotations, which provide an indication of value and comparing such values to the carrying amount of securities upto the date of auditor's report.
2) In care of unquoted securities – ascertaining the method adopted by the entity for determining the value of such securities as at the end of the year.
3) In case of investments other than in the form of securities – ensuring that the market value has been ascertained on the basis of authentic market reports, and/or based on expert's opinion, if warranted.

- The auditor should obtain a written representation from management regarding:
  1) The completeness of information provided regarding valuation and disclosure of long term investments.
  2) The valuation of long term investments in the financial statement including adequacy of provision for diminution in such valued, wherever required, and
  3) The intention of the management to continue to hold long term investments as long term investments.
- Segment information: When segment information is material to the financial statements, the auditor should obtain sufficient evidence regarding its disclosure in accordance with the applicable, identified financial reporting framework.
- The auditor should discuss with the management the methods used in determining segment information, and consider whether such methods are likely to result in disclosures in accordance with the applicable financial reporting framework. Auditor would consider sales, transfers and charges between segments, elimination of inter-segment amounts, companions with budgets, etc.
- The auditor should obtain a written representation from management concerning:
  1) The completeness of information provided regarding segments and disclosures thereof,
  2) Appropriateness of the selected segments based on risk and returns, and
  3) The organisational structure of an enterprise and its internal financial reporting system and any deviations therefrom.
- If the auditor is not able to obtain sufficient appropriate audit evidence concerning segment information or concludes that their disclosures in the financial statement is not adequate, the auditor should express a qualified opinion or a disclaimer of opinion in the audit report, as may be appropriate.

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