Contents

THIS IS A SUMMARY OF STANDARDS ON AUDITING, WHICH IS A LOGICAL CONTINUATION OF OUR SESSIONS ON AUDITING. THIS IS DONE ONLY FOR SELECTIVE STANDARDS. <u>THIS IS NOT IN SUBSTITUTION TO PRINTED NOTES</u> AND RUNNING NOTES, BUT IS TO ENABLE A SUMMARY PICTURE OF THE SAME.

<u>SO, I APPPEAL TO YOU THAT THIS NOTES SHOULD NOT BE SHARED WITH OTHER THAN OUR STUDENTS SINCE IT IS LIKELY TO HARM THEM MORE THAN HELPING THEM.</u>

I FOLLOWED A SEQUENCE OF STANDARDS TO ENABLE A FLOW, WHICH IS DIFFERENCE FROM THE SEQUENCE GIVEN BY ICAI SINCE THIS IS THE MANNER IN WHICH WE UNDERSTOOD TOPICS IN THE CLASS ROOM. You can contact me @ :

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SA 200: Overall Objective of Independent Auditor

Scope: Overall responsibility of an independent auditor for conducting an audit of financial statements.

Objective: To express an appropriate opinion after obtaining reasonable assurance on Financial statements as a whole, on whether the FS prepared by the management they are free from material misstatement.

- MATERIAL (significant)
- MISSTATEMENT (half truth / wrong disclosure)
- REASONABLE ASSURANCE: not absolute assurance because of inherent limitations of an audit.
- ASSURANCE: confirming that everything is acceptable
- PROFESSIONAL SKEPTICISM:
  - Alertness towards information provided by auditee/ client.
  - Bearing in mind a possibility of material misstatement
  - critical assessment to ascertain appropriateness of audit evidence
  - benefits in reducing the risk of overlooking inappropriate assumption or unusual circumstances.
- SUFFICIENT APPROPRIATE AUDIT EVIDENCE:
  - Sufficiency refers to quantum of audit evidence
  - Appropriate refers to quality. (Relevance/ Reliability).

  (i) Relevance:

  (ii) Reliability: it is of 2 types: a) Internal audit evidence b) external audit evidence.

  Audit evidence in the descending order of degree of reliability

  Source Destination:
  External – External audit evidence
  External – Internal audit evidence
  Internal – External audit evidence
  Internal – Internal audit evidence

PROFESSIONAL JUDGMENT: Judgment taken by auditor based on his professional experience in an audit situation. Judgment should be

i) Rational
ii) Reasonable
iii) Appropriate

➢ Audit Risk: Risk that an auditor may not able to meet his objectives & forms an inappropriate opinion. It is divided into 3 components:

A) Inherent risk: which is inborn in an account balance. Inherent risk is inherent vulnerability of an entity (overall) or an account balance to risk of material misstatement

- Points to remember:
  - To counter the risk, we need control
  - Inherent risk cant be ↑ or ↓ but can be controlled by management

B) Control risk: Risk that control established by management fail to meet the set standards/ objectives. Auditor shall make a combined assessment of A and B

C) Detection risk: Risk that, even after performing audit procedure, material misstatements remain undetected.

POINTS TO NOTE

➢ Combined Assessment: combination of Inherent risk and control risk
  - Risk should properly be controlled by the management
  - Auditor’s duty is to check that such controls are **existing**, **adequate** and **operating** effectively in **light of inherent risk**

SA 700: Forming an Opinion and Reporting on Financial Statements

SA 705: Modifications to the Opinion in the Independent Auditor’s Report

Audit Report

Clean Report → Everything is OK

Modified report:
- Qualified opinion → Except this Every thing is ok
- Adverse Opinion → nothing is ok
- Disclaimer of opinion → We don’t know as management has not provided required information

When to issue a negative opinion?

Sl no	Reason	Limited impact on financial statements under audit	Pervasive / overall impact on financial statements under audit
1	Auditors’ disagreement with management’s acts	Qualified opinion	Adverse opinion
2	Limitation on auditors’ scope of work placed by management	Qualified opinion	Disclaimer of Opinion

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

SA 706 is not any report. It is not an independent standard. It may come as a combination with SA 700 and SA 705

Emphasis of matter para in the audit report

a. This is not any negative opinion para. Hence, it is given after opinion paragraph of audit report. It clearly contains a statement explaining the fact that it is not any kind of modification.
b. **Attention of the user is drawn to a note in financial statements by giving reference to such note in the auditors' report. This is only to highlight an important aspect of financial statements**.

Other matters para in the audit report

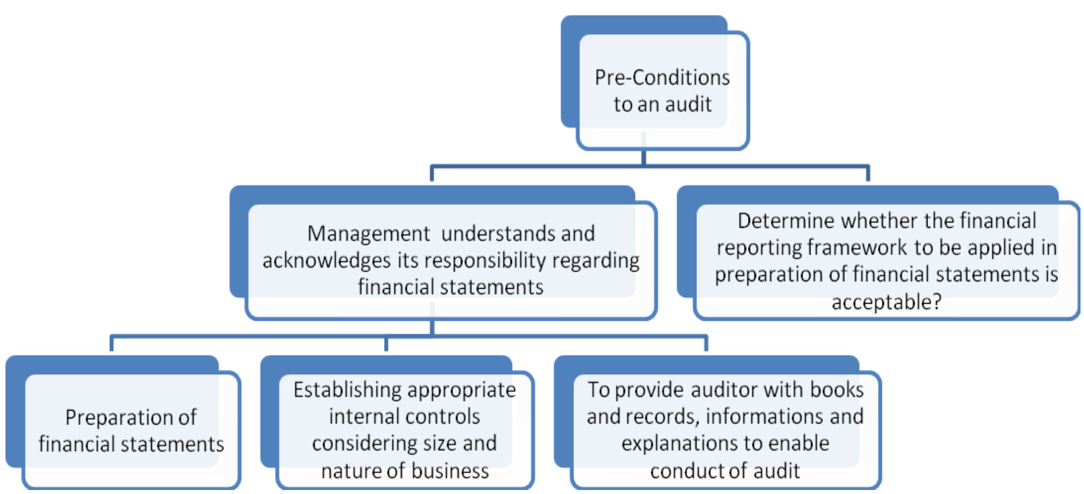
a. This is not any negative opinion para. Hence, it is given after opinion paragraph of audit report. It clearly contains a statement explaining the fact that it is not any kind of modification.
b. **This para is added to give clarity on auditors' responsibility. So, it doesn't contain any cross referencing to information given in financial statements**

SA 210: Agreeing the terms of audit engagement (revised)

What should auditor ascertain to accept or continue an audit engagement?

1. Ascertain whether the **pre-conditions for an audit** are present and
2. Confirming that there is a **common understanding between the auditor and management** of the terms of the audit engagement

What is the meaning of 'Pre-conditions' for an audit?



➢ Factors affecting acceptance of audit
- management do not accept its responsibility
- framework to be applied in preparation of F/s is un acceptable
- management imposes a limitation on scope of auditor's work

➢ Audit engagement letter

Terms of engagement letter

- responsibilities of auditor & management - scope of audit - Report format - F/s format

➢ Points to remember
- engagement letter → defines scope of work
- In case of voluntary audit (proprietary concern/ partnership firm) : audit terms are not prescribed by any law or regulation
- In case audit terms are prescribed by law, then auditor must state in engagement letter

In case of recurring audit where the same auditor is reappointed for subsequent years, the same engagement letter would be valid unless there is any change in the existing terms. Auditor should assess whether

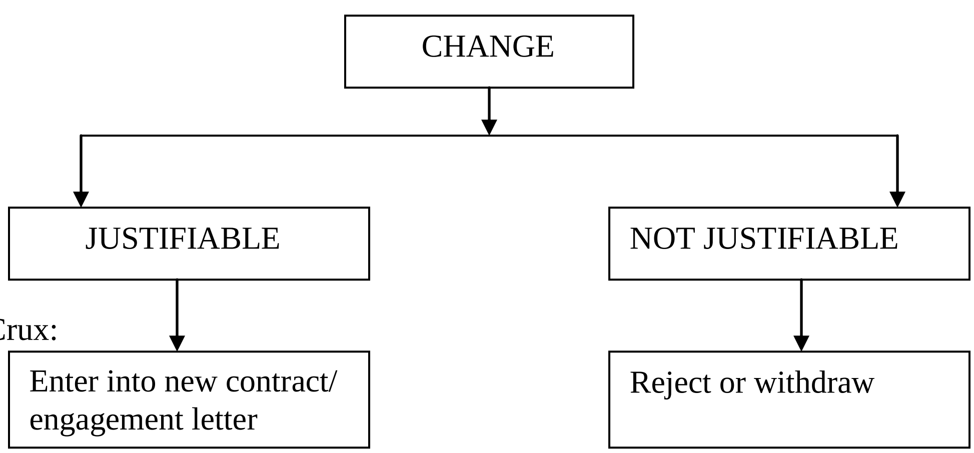
i. Circumstances require the terms of engagement to be revised

ii. There is a need to remind the entity of the existing terms of the audit engagement

- Check (auditor):

i) any change required in terms
ii) need to remind the entity of existing terms of audit engagement

a) If change in terms of audit engagement, then:



➢ Crux:

- If auditor finds change valid, then he may accept terms
- If auditor himself proposed change in engagement letter, then send a new engagement letter to client to communicate revision of terms & take clients acceptance

➢ Other considerations:

a) Financial reporting standards supplemented by law:
   - if any conflict i.e like conflict between ICAI pronouncements and Companies Act 1956, then ask management to give disclosure in financials to make such fact understandable

b) Financial reporting frame work

Acceptable

Not acceptable and
↓ if
Given by law
↓ then
Auditor should accept only if following conditions satisfy
   a) management agree to provide disclosure
   b) recognized that auditor will issue opinion with EOM and will not use true & fair, unless required by law

c) Auditors report prescribed by law
   - if all matters are clear → no additional responsibility
   - if any para stands confusing, auditor may add a para in audit report for clarity. In case if management prevents him from doing so, auditor may resign.

General Clarification 1- Whether it is necessary that the engagement letter issued by the auditor should be acknowledged by addressee and returned to the auditor to indicate that the client understands of the terms of the engagement is in accordance with the engagement letter issued by the auditor?	
1.	In case of statutory audits i.e audit engagements, where the objective and scope of the engagement and the auditor's obligations are laid down in the applicable statute or regulations. E.g., Audit under section 227 of the Companies Act, 1956, audit of public sector banks; it is not necessary that the engagement letter sent by the auditor is acknowledged by the addressee and returned to the auditor to establish that the client's understanding of the engagement is in accordance with the engagement letter issued by auditor.
2.	It is sufficient if an engagement letter is delivered to the client and the auditor retains the evidence of such delivery.
3.	In case of voluntary audits, obligations are not laid down in any statute or regulations, the auditor should request the client that a copy of the engagement letter be acknowledged by the addressee and returned to the auditor.

SA 220: Quality control for an audit of financial statements (revised)

Quality Control

↓

Firm level control (institution)	Individual audit level control

A) Firm level control:

- **i) Professional requirements: A**dhere to principles of integrity, objectivity etc.
- **ii) Skills & competence**
- **iii) Delegation:** Right person for right job to meet standards of quality.
- **iv) Consultation:** if require consult expert
- **v) Client evaluation:** evaluate client & related risk
- **vi) Monitoring:** monitor adequacy & effectiveness of quality control policies.

B) Individual Audit level control:

↓

Direction	Supervision	Review
↓	↓	↓
- depends on professional Competence - Inform assistants their Responsibility, procedures	- monitor progress of audit - obtain information about accounting & auditing - resolve differences of Professional judgment	- Audit work - Objectives - Significant matters

SA 230 Audit Documentation (revised) (wef 1st April 2009)

➢ **AUDIT DOCUMENTATION**

- Working papers contain all documents retained by auditor during the course of audit.
- Record of audit procedure, test performed, conclusion reached

➢ **EXPERIENCED AUDITOR**

- Having practical audit experience of reasonable understanding of audit processes
- SA'S & Law's
- Business Environment
- Auditing and financial reporting issues

- **WHAT SHOULD BE DOCUMENTED & HOW?**

  - Prepare audit documentation in a way experienced auditor should understand
  - Nature, timing, extent
  - Audit evidence obtained
  - Also record who performed
  - Who reviewed audit work
  - Important matters arising during audit

- **MATTERS ARISING AFTER DATE OF AUDIT REPORT**

  - Circumstances encountered
  - When, by whom changes were made
  - New audit procedures, audit evidence obtained, conclusions made & their effect on audit report

- **TIME LIMIT FOR DOCUMENTATION**

  - Within 60 days (<=60 days) from date of audit report, assembly of audit file
  - Retained for 7 yrs (>= 7 yrs) from the date of audit report
  - Do not delete audit documentation before the end of its retention period

- **OWNERSHIP OF DOCUMENTS**

  - Working papers belong to auditors
  - At his discretion, he may share with client but not with outsider
  - If required by law then it can be disclosed

- **AUDIT FILE**

  - It's a folder in physical or electronic form containing the records that comprises audit documentation for a specific engagement.
  - Working paper relevant of subsequent years

- **PERMANENT AUDIT FILE**

  - Information collected in last year & relevant for subsequent years
  - It includes information regarding legal documents, minutes, study & evaluation of internal controls
  - Copies of previous year audited F/s
  - Letter issued by management

➢ **CURRENT AUDIT FILE**

- Information only for current period
- Audit plan & programme
- Extracts of matters in minutes of board meetings & AGM
- Auditors conclusion on matters
- Copies of F/s, copies of communication with other auditors
-

➢ **PURPOSE OF AUDIT DOCUMENTATION**

- Audit documentation should be clear/ comprehensive
- Done in contemporaneous (same)
- Audit documentation must be self explanatory
- It assists team to plan of performance audit
- Enable team to accountable for its work
- Conduct of quality control review & inspection

SA 240 Auditor responsibility relating to fraud in audit of financial statements

Fraud: intentional misstatement which is material to F/S

Employee→ Theft of asset like cash
Fraud→ mis appropriation of cash
Management fraud→ Manipulation of accounts by upper level management to mis represent firm's financial position.

Responsible to prevent – management

➢ **Objective:**
- Assess risk of material misstatement
- Respond appropriately/ suspect fraud
- Obtain sufficient audit evidence about risk

➢ **Auditor responsibility in relation to fraud:**

ii) Obtain reasonable assurance
iii) Cleverly concealed frauds are difficult to detect
iv) Consider risk of material misstatement

- **Fraud occurs because there is**

a) Pressure to commit
b) Perceived opportunity to do so

- **Fraud risk factor :** Factors giving possible indication of fraud
- **Fraud risk assessment**:
  - **Step 1**: Identification of frauds and assessing their impact
  - **Step 2**: Auditor responding to fraud risk factor with audit procedures

- **Procedure if fraud is identified:**

SUSPICION

CONFIRM DISPELLED

↓

- Communicate to management, members
- Ascertain about any disclosure required in F/s or not

↓

If management restricts auditor from doing anything, he may withdraw.

SA 250: Consideration of laws and regulations in an audit of financial statement

- **Management responsibility to comply with laws**
  - Its management's responsibility to comply with law and prevent non compliance
  - Can do this by proper Internal controls, maintaining registers, Internal audit functions & Audit committee

- **Auditor respond to non compliance**

i) Evaluate possible effects on F/s
  - obtain reasons for non compliance
  - potential financial consequences & its impact on F/s

ii) Documenting and discussion with management
  - On non compliance, document there in form of records
  - If appropriate information not obtained from management then take legal advice
  - Consider its impact on f/s & issue appropriate audit report

- **Auditor's responsibility:**
  - Must plan, perform and evaluate to have reasonable assurance about compliance with laws.

- **Audit report on non compliance**

a) to management
   - communicate to BOD, management; if such authority is absent, take legal advice

b) to users
   - in case of material impact on F/s, give qualified or adverse opinion
   - unable to obtain information, give qualified or disclaimer of opinion

- **Audit procedure**

Compliance	Non Compliance
- obtain understanding of legal framework	- obtain written representation from management
- inquire about F/s	- read minutes of board
- Inspect	- Enquire with management
- take evidence about compliance With such law	- perform substantive test

- **Auditor's withdrawal**
   - client does not take remedial action
   - when top management is extremely involved in any kind of material misstatement
   - take legal advice
   - advice incoming auditor about reason for withdrawal

SA 620 Using the work of an Expert

- Object:
  - Establish auditors responsibility & procedures to be considered using work of an expert

- Reasonableness:

Common Sense

Ex:

Independent auditor gives independent opinion → Co.

↑ External audit evidence ↑ External & Internal audit evidence

Expert

   - based on comfort, auditor can give opinion
   - if independent auditor wants to meet expert and management is stopping him, then limitations of scope & based on its impact on F/s auditor bases his qualified opinion or disclaimer of opinion.

- Areas in which expert work is required

- Valuation of asset
- Legal opinion
- Actuarial advice
- Measurement of work done on long term contracts

- If company is not satisfied with one expert advice, then industry expert advice / opinion can be taken after due professional care
  ↓
  - is he an expert
  - facts of case
  - reasonableness of opinion

➢ Need to use expert work (factors):
- Materiality
- Complexity of information
- Whether there are alternative source of audit evidence

➢ Qualities of an expert
- Qualified, experienced.
- Independent
- Un biased

➢ Reasonableness of opinion:

If Auditor

Finds it reasonable ↓ No need to mention in audit report

Un reasonable ↓ Take expert consent in writing and in other Matter para, auditor will give judgment (referring Expert name)

SA 500: Audit Evidence (on or after April 01, 2009)

➢ Audit evidence: information obtained by auditor in arriving at conclusions, based on which audit opinion is formed

➢ Audit objectives: design & perform audit procedures to enable auditor to obtain appropriate audit evidence to draw reasonable conclusion on which auditors opinion is based

➢ Sufficient: quantum of audit evidence obtained

➢ Appropriate: relevance of reliability

- Persuasiveness is for more important than conclusiveness because:

a) cost of obtaining evidence may may exceed usefulness of obtained
b) audit gives reasonable not absolute assurance about management.

- Techniques of obtaining evidence
  - *Inspection*: examination of books and documentary evidence. Ex: lease, investment agreement
  - *Observation*: looking at a process or procedure being performed by others
  - *External confirmation*: audit evidence obtained in written from third party
  - *Recalculations*, Re performance:
  - *Inquiry*: seeking information of knowledgeable person, within or outside entity
  - Design & perform audit procedure:
    - Relevance
    - Reliability: evidence from independent external source are more reliable than that of internal source
  - Using management expert: if information is provided using work of management expert, then
    - Evaluate competence, capabilities of expert & discuss it with who are familiar with that expert.
    - Understand work of that expert
    - Evaluate appropriateness of that expert work as audit evidence
  - Information produced by entity
  - Analytical procedures: consists of evaluation of financial information made by study of relationship of both financial & non financial data

Audit procedures comprise

a. Compliance procedures
   a. Test of compliance with laws and regulations
   b. Test of controls
b. Substantive procedures
   a. Substantive analytical procedure
   b. Test of details

SA 260: Communication with those charged with governance (revised)

- **Communication is between:**

Auditor → Top Management → Those charged with governance

- **What are matters of governance interest?**

Matters which have come to the knowledge of the auditor through audit procedures during the course of audit and are important for those charged with governance to discharge their function

- **How to communicate?**

In writing, even if communicating orally, still has to be noted in writing.

- **When to communicate?**

Material weakness in internal control system	As soon as possible
Regarding independence	Whenever threat to independence is perceived (in writing)
Auditor's views on qualitative aspects of entity's accounting practices matters	Concluding discussions

- **What to communicate?**

Issue→ why is it an issue→ Impact on F/s→ Impact on audit report→ management response→ Auditor's conclusion **<u>(letter of weakness/ management letter)</u>**

- **Matters to governance:**
  - Fraud and error
  - Draw from engagement
  - Unusual transactions
  - Overall scope of audit
  - Internal control weakness
  - Non compliance of law
  - Material discrepancies

- **After communicating response**

Resolved problems → "Document It"

Problem remains → Assess the impact & based on it, form suitable audit opinion

- **POINTS TO REMEMBER**
  - Documentation may be in form of **<u>MINUTES</u>** of discussion between auditor & management
  - Communicating results in **<u>Modified report</u>** charged with governance, is no substitute to communication with shareholders through audit report.

SA 265: Communicating deficiencies in internal control to those charged with governance of management

- **Auditors objective:**
  - to communicate deficiencies to governance in internal control

- **Deficiency**
  - control is designed in such a way that it is unable to prevent misstatement in F/s
  - Note: matters to be included in written letter are deficiencies and explanation of their potential effects

- **Requirements of SA 265**
  - Identify deficiencies
  - Recognize significant deficiencies
  - Communication of significant deficiencies – in writing (letter of weakness) on timely basis

- **Examples of deficiencies in internal control**
  - misstatement detected by auditors procedure that were not …..
  - disclosure of material misstatement due to error or fraud
  - evidence of management in ability to over see the preparation of F/s

Note: **SA 260**	**SA 265**
- all matters of governance interest are addressed	- Only Internal control weakness is addressed
- at later stage of audit	- after early stage i.e after completion of test of controls

SA 299 Responsibility of joint auditors

- **Joint Auditors:** Audit of F/s of business by more than one auditor

- **Conduct of joint audit**

  Division of work
  ↓
  Co ordination
  ↓
  Fixing responsibility

  - **Division of work:**
    - By mutual consent, work to be divided for specific area, time & period
    - Important audit areas to be audited together
    - Proper documentation

  - **Co ordination**

a) During the course of audit, if an auditor come across matter relevant for other Joint auditor, so he must tell him
b) He must communicate in writing
c) Must communicate:
   - before finalization of audit
   - if told after audit report, then other joint auditor will not be responsible.

- **Joint Auditors are jointly responsible for:**
  - Work carried by all
  - Decision taken by all regarding nature, timing, extent
  - Audit report comply with relevant statute
  - F/s of entity comply with disclosure requirement
  - Matters brought to notice of joint auditor by one of them, but all of them agree on it

- **Joint auditor individually responsible for:**
  - review of audit report of branches
  - carry out part of audit work assigned
  - ensuring comply of laws & disclosures to be made and present a true & fair report on F/s of branch

- **Reporting responsibilities**
  - if **agree** on matters give **single report**
  - if **dis agreement** of any matter- prepare **separate report** and express each one of his opinion
  - majority plays no role- so in case of dis agreement, separate audit report can be issued.

SA 300: Planning an audit of financial statements (revised)

- **Why we plan an audit**

So that audit will be performed in an Efficient manner.

- **BENEFITS:**

  - Attention to important areas
  - Prompt identification of problems
  - Proper supervision, review of work
  - Co ordination

Size → Complexity → Previous experience → Changes in circumstances

- Note: auditor shall document overall audit strategy in memorandum including scope, time and conduct of audit

➢ **Elements of planning**

a) Develop overall strategy
- Ascertain knowledge about client business
- Understand control & plan assess control risk
- Assign proper team
- Review mechanism
- Using work of an expert
- Any up gradation/ revisions
- Communication with team

  Delegation Training
- Plan audit procedure
- Identify inherent risk

➢ **Preliminary engagement activities:**
- Carry out audit procedure as per SA 220
- Client relationship
- SA 210 ‘ Terms of audit engagement’

➢ **In case of new initial audit engagement**
- Accepting client relationship
- Communicate with predecessor auditor, if auditor has changed.

SA 520 Analytical Procedures

- Meaning: analysis of significant trends & ratios & investigation of fluctuations.

Analytical procedures

- Planning analytical procedures/ Preliminary analytical procedure
- Execution/ Substantive analytical procedure
- final analytical procedure

Analytical procedures

- Comparison of client information
  ↓
  - -similar period with prior period
  - -with client determined expected result
  - -with auditor expected results
  - -with industry data
- Study of relationship between financial & Non financial data
  ↓
  - - cost of sales & sales
  - - payroll costs & no of staff

- Planning analytical procedure:
  - To understand the business & identify area of potential risk
  - Uses financial & non financial information

- Substantive analytical procedure:
  - Obtain extra evidence
  - Develop an independent expectation
  - Define tolerable level of deviation
  - Compare with extra evidence with actuals & compute difference
  - If difference is beyond expectation then ↑ level of work

- Final stage analytical procedure:
  - Confirm that critical area have been addressed properly during audit
    ↓
    Sufficient appropriate audit evidence
  - Here he analyses about reasonableness of audited F/s

- Types of analysis by analytical procedures :
  - **Trend analysis:** comparing financial information with prior period
  - **Data analysis:** compare financial information with anticipated results
  - **Inter firm analysis:** comparing ratio with other firm of same size
  - **Financial ratio analysis:** eg gross profit, turn over ratios

SA 530: Audit Sampling (revised)

Objective: To draw conclusion about the population from which the sample is selected

- Audit Sampling:
  - Application of audit procedures less than 100% of items
  - May be statistical or non statistical
  - Require skill on part of auditor
  - Auditor should choose sample which is true representative of population

- Sampling Risk
  - Risk sample so selected is not representative of population
  - Auditor conclusion based upon sample may be different from conclusion that would been if complete population were subjected to same audit procedure
  - If auditor is ready to accept less risk then large size of sample should be taken.

    - STRATIFICATION: process of dividing population into sub populations, each group of sampling having similar characteristics
    - EXPECTED ERROR: deviation rate expected by auditor on basis of prior experience

Error type	**In case of test of controls**	**In case of test of details**	**Effect of this erroneous conclusion**
Type 1	Risk that controls of sample are **more effective** than those of entire population are.	That a material misstatement **doesn't exist in sample**, when in fact it does exist in population	This affects **audit effectiveness**, and is more likely to lead to an inappropriate audit opinion
Type II	That controls of sample tested are **less effective** than they those of entire population.	That a **material** misstatement **exist in sample**, when in fact it is not material at the level of entire population	This affect **audit efficiency**, as it would lead to additional work to establish that initial conclusions were incorrect. This would waste auditor's time in verifying less risky items, which could have been used for more risky areas

Steps in sample selection

Design & select audit sample

↓

Perform audit procedures

↓

Investigate & cause of deviations

↓

Projecting misstatement

↓

Evaluate the sample result

- Steps for audit sampling

Designing of sample

↓

Determining sample size

↓

Selection of items to sample

↓

Performing audit procedures on selected sample

↓

Analysis of nature, causes of deviations & misstatements

↓

Projecting misstatement

↓

Evaluating results of sample

- Methods of Sampling

i) **Random Sample:** use of random number table. Each sampling unit has equal probability of being selected.

ii) **Systematic Sample:** having fixed interval between any consecutive units selected. can be used only when population is not structured.

iii) **Haphazard Selections:** No intention to exclude/ include a particular item. Its equivalent to random sample.

iv) **Block selection:** involves selection of blocks with in population. Cannot be used for audit sampling because population is structured.

SA 315: Identifying & Assessing the risk of material misstatement through understanding the entity & its environment

- Assertions: Representations by management that are embodied in F/s to find potential misstatement
- Risk assessment procedures:
  - understand entity including internal controls
  - assess material misstatements at F/S & assertion levels
- Significant risk: Assessed risk of material misstatement requires special audit consideration

- RISK ASSESSMENT PROCEDURES:

Enquires of management
↓
Use of analytical procedures
↓
Observations & Inspection
↓
Information obtained in prior period
↓
Discuss with engagement team

- Obtain client business knowledge:

Industry factor	Regulatory factor	External factor
i) Competitor	Taxation	Interest rates
ii) Technology	Govt policies	Inflation

- Nature of entity:

Business operations	Investment	financial reporting
- joint venture	- capital investment	- accounting principles
- transactions with Related parties		- revenue recognition practices

Note: if during audit, assessment of risk at certain level changes, auditor shall revise risk assessment & modify further planned audit procedures

- Understand client business & clients internal controls

- SA 315: Identify & access risk of material misstatement by:
  - Assessment of risk of material misstatement at F/s level

- Assessment of material misstatement at assertion level
- Entity selection & application of accounting policies
- Objective, strategies & related business risk
- Measurement & review of entity financial performance.

- Components of Internal controls:

  - Risk assessment
  - Information and communication
  - Control activities
  - Monitoring of controls

SA 330: Auditor's responses to assessed risk

Objective: To obtain sufficient appropriate audit evidence about assessed risk of material misstatement & design, implement responses to those risks.

➢ Test of controls (TOC)

I. When to be used:
- controls are effective
- standard procedure + test of control used together

II. Extent of test of controls
- if more persuasive audit evidence, he may ↑ TOC
- to test operating effectiveness

III. Testing of indirect control
- determine whether controls depend upon other control

IV. Timing of test of control
- auditor shall test TOC where he relies on control over period of time

V. Aspect of test of control

a) Audit evidence obtained during interim period:
- obtain audit evidence changes to control subsequent to interim period

b) Audit evidence obtained in previous audit:
- ↑ or ↓ audit evidence to be obtained in current period about operating effectiveness of controls.

➢ **Auditors overall response to assessed risk:**
- high degree of professional skepticism
- assign experienced staff
- more supervision
- emphasis on substantive procedure
- changes to nature, timing & extent

- **Audit procedures responsive to assessed risk of material misstatement at assertion level:**
    - to address the material misstatement and F/s level
    - consider reason for assessment given to risk including inherent risk & control risk
    - higher the assessment of risk, more persuasive audit evidence

- **Sufficiency and appropriateness of audit evidence:**
- Evaluate whether : assessment of risk of material misstatement at assertion level remains appropriate
    - appropriate audit evidence been obtained
    - if audit evidence not obtained express qualified opinion or disclaimer of opinion
- Conclude whether: sufficient audit evidence been obtained, if not express qualified or disclaimer of opinion
    - **Note:**

Audit Risk Assessment

Identifying & assessing risk Of material misstatement (Sec 315)	**Responding to such risk using appropriate audit procedures. Nature, timing extent of audit procedure (sec 330)**

SA 402: Audit consideration relating to entity using a service organization

Notes already dictated in the class

SA 320: materiality in planning and performing an Audit.

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements
- Materiality is fact determined by auditors' professional judgment
- Materiality is considered at:
    - Planning stage – It is an initial calculation which gives an initial perspective to auditor about the areas to focus on
    - Performance stage – Materiality level determined at Planning stage is revisited as the audit progresses. This enables updation of materiality level originally determined
    - Opinion stage – this is to check whether the aggregate impact of unadjusted differences in financial statements is material (covered in detail in SA 450)

- Materiality and Audit risk:
  - Identify risk of material misstatement
  - Determine nature, timing and extent of audit procedures.
  - Evaluate effect of un corrected misstatement.
- Materiality level: a level beyond which material misstatement affects the decision making of users
  Materiality ↑ = audit work ↓ → Inverse relationship
  Risk ↑ = audit work ↑ → Direct relationship

  Both are interdependent.

- Revision of materiality as audit progress:
  - On becoming aware of information during audit, auditor should revise the materiality for F/s
  - If the auditor concludes that a lower materiality for the financial statements as a whole than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate

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

Auditor is assumed to have considered the following to ascertain that materiality level

- reasonable diligence in the light of knowledge of business
- Understand FS and levels of materiality
- Recognizes uncertainties
- reasonable economic decisions

This shall be documented

SA 450: Evaluation of misstatement identified during the audit

- The auditor shall ***accumulate material misstatements*** identified during the audit
- Misstatement can be considered material
  - on individual basis or
  - on aggregate basis
- If misstatements are found, then he should:
  - Communicate on timely basis, all material misstatement to management.

- Auditor can request management to correct those entries
- If management disagrees, auditor must try to understand management reason for not making corrections.

- If misstatements are found then auditor shall perform additional audit procedures to determine whether misstatements remain.

- If management disagrees to rectify material misstatements, modified report will be given by auditor.

SA 580 : Written representation

- Scope: Auditors responsibility to obtain written representation from management
- A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records [Management includes ‘Those charged with Governance’]
- Written representation should affirm the following (inclusive list):
  - Whether there are any frauds noticed by management?
  - Whether there are any changes in internal control framework?
  - Whether there are any non compliances with laws and regulations?
  - List of contingent liabilities if any
  - Confirmation that all requisite information is provided to auditor

- The date of representation shall be as near as practicable to, but not after, the date of the auditor’s report on the financial statements
- The written representations shall be for all financial statements and periods referred to in the Auditor’s Report
- It shall be addressed to the auditor

Auditors’ duties in special situations

Situation	Auditors’ Duties
Doubt as to reliability of written representations	• If the auditor has **concerns about the competence,** integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, he shall **determine the effect** that such concerns may have **on the reliability of representations (Oral / Written) and audit evidence in general** • If written **representations are inconsistent with other audit evidence**, the auditor shall perform audit procedures to attempt to **resolve them.**

	• **If such inconsistencies remain unresolved,** he shall **determine the effect** that such concerns may have **on the reliability of representations (Oral / Written) and audit evidence in general** • If auditor opines that audit evidence is **unreliable**, he shall determine its impact on the Auditor's report
Disclaimer of Opinion	The auditor shall disclaim an opinion on the financial statements in accordance with SA 700 if • He concludes that there is sufficient doubt about the integrity of management such that the written representations required are not reliable OR • Management doesn't provide the written representations

	Terms of engagement SA210	**Management letter or letter of weakness SA 260/265**	**Management representation letter of representation/ written representation**
From	Auditor	Auditor	Those charged with governance
To	Those charged with governance	Those charged with governance	Auditor
When	Beginning of audit, at time of acceptance	265 – is after completion of TOC 260 – after completing audit but before concluding on audit opinion	When ever auditor finds necessity written representation should be given by management to auditor
Why	Communicating acceptance, reporting format, scope, responsibility	Communication to management for obtaining their responses about weakness noticed during the audit	That management has disclosed, discharged their responsibilities properly towards members & auditors

- Written representation is generally considered an additional or secondary or supportive document (not primary)
  - In certain exceptional cases management written representation becomes primary audit evidence (Eg. List of related parties , Intention of management regarding investments etc.,)
  - So, auditor should carry out all his audit procedures not withstanding fact that written representation is obtained.

SA 540 Auditing Accounting estimates including fair value accounting estimates & related disclosure

- Accounting estimates:
  - closest approximations
  - best available information
  - at a given point of time
  - in the absence of precise means of measurement

- Exceptional cases are not examples of estimates
- Estimate should be made by management
- Auditing accounting estimates: evaluating reasonableness in accounting estimates
- Accounting Estimates

Fair value accounting estimates | other accounting estimates

↓

Value of current transaction or F/s based on current condition prevalent at measurement date, like estimated market price for particular asset or liability.

- Audit procedure over accounting estimates

Do risk assessment procedure to identify material misstatement ↓ Response to risk determining nature, timing, extent of audit procedures ↓ Evaluate reasonableness of estimates ↓ Verify whether management disclosed or not in FS about estimates.

How to ascertain reasonableness of accounting estimates?

- past experience
- If it is formula based – review formula
- Consistency
- Disclosure of deviations in FS, if any

- When estimation is not close to actual, its called **estimation risk.**

- Audit procedure for assessment of risk of material misstatement for accounting estimates:

1) Obtain sufficient appropriate audit evidence regarding reasonableness
2) Adopt one or more of the following
3) Evaluate accuracy, completeness

4) Evaluate assumptions on which estimates are based
5) External evidence are more reliable than internal
6) Use "work of expert" in case of complex calculations
7) Compare estimate for prior periods with actual results of these period to judge general reliability
8) Ensure that material estimates are approved by appropriate level of management

- Documentation of all audit work done by auditor.

- Evaluate result of audit procedures:

After performing audit procedure, he finally assesses reasonableness of estimate

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If there is difference between auditors estimate & estimate amount in F/s

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Consider whether it requires

↓

If material difference, requiring adjustment then request management to revise the same

Amount is adjusted → ↓ OK

management refuses → ↓ consider its impact on F/s in audit report and Give either qualified/ Adverse opinion

SA 550: Related parties (on or after April 1,2010)

Related Parties- A person or entity has control or significant influence on the other.

Verification of related party transactions:

Step 1: Understand related party relationship

To recognize FRF   To conclude F/s are true & fair

Step 2: Financial reporting framework for related party disclosure comply with AS 18

Step 3: Perform audit procedure to validate the following

For adequate disclosure of related parties

Disclosure of material transactions with related parties

To assess the reliability of mgt. representations

- Control relationship come into existence by virtue of:
  - composition of BOD
  - virtue of share holding

- Auditor can identify related parties by following ways:

- Review working papers for prior years for names of related parties
- BOD, Review MOA, AOA & minutes
- Obtain list of share holders from share register
- Review joint venture
- Review income tax returns and material investment transactions
- Management representations, inquire affiliation of directors

➢ Auditor can identify transactions with related parties:
  - By considering records of related party transactions
  - Assess reliability of management representations & disclosure through:
    a) Unusual transactions
    b) Examine confirmation of leases, receivables, payables etc
    c) Reviewing ITR, transactions not given accounting recognition
    d) Transactions having abnormal terms of trade
    e) Transactions lacking apparent logic
    f) Where substance differ from form

➢ Auditor after identifying related parties and after performing audit risk assessment procedures:
  - possible fraud/ errors
  - inquire about unusual transactions
  - maintaining professional skepticism in reviewing records
  - understand management related parties and related parties transactions, control and authorization of related party transactions.

➢ Auditor has to examine that all transactions have been properly recorded & disclosed and perform additional procedures if required.

- Risk related to related parties

Transactions may not be conducted under normal terms

Information systems may be in effective

➢ Management representations
Auditor should obtain management representation letter regarding:
a) Completeness of information provided regarding identification of relate parties
b) Adequacy of related party disclosures in F/s

- Audit conclusions and reporting

a) if unable to obtain sufficient appropriate audit evidence related to related parties

Qualified opinion Disclaimer of opinion

b) if he concludes that their disclosure in F/s are not adequate then express qualified opinion

- In documentation mention nature of related party relationship, related party transactions and nature of related party.

SA 505 External Confirmation

- External Confirmation: Audit evidence obtained as direct written response to the auditor from the third party
- Positive Confirmation: a request by confirming party to respond directly to auditor whether party agrees or disagrees with the info
- Negative Confirmation: respondent to reply only in event of disagreement with the information provided in the request

↓

Can be used when

- inherent and control risk is low
- substantial no of errors not expected
- large no of small evidences are involved

- Timing of confirmation:
  - at balance sheet date
  - at any other date close to balance sheet date

- Process of external confirmation:

a) Selecting the items for which confirmation is required
  - GENERALLY, high risk items are selected
  - But, auditor also selects zero balance or low value items to as a matter of professional skepticism

b) Designing the form of confirmation request
  - assertions being addressed
  - identified material misstatements and frauds
  - lay out and presentation of request

c) Communicating the confirmation request to third party

d) Obtaining response from third party

e) Evaluating the information or absence of confirmation

- External confirmation procedure result:

a) Doubtful about validity of evidence → perform additional audit procedures to resolve

b) Concludes that evidence not reliable → revise assessment of material misstatement at assertion level and modify planned audit procedures
c) Non responses → perform alternative audit process like subsequent period transactions, verifications
d) Response to positive confirmation is required to obtain audit evidence→ if auditor do not get +ve confirmation & he opines that more audit evidence is required he shall determine implication for the audit and auditors opinion in accordance with applicable standards.
e) Exceptions→ investigate exceptions to determine whether or not they are indicative of misstatements

- If management refuses to send confirmation request then:
  Consider validity of grants for such request along reason

If he agrees	if he disagrees
Not to seek external confirmation for particular matter. Apply alternative procedure to obtain audit evidence.	then there is limitation on scope of auditors work & based on impact on F/S give opinion

SA 570 Going Concern (Revised)

Going Concern: An entity is said to be going concern if it is likely to continue in existence of <u>foreseeable future</u> (period >= 1 yr from B/s date)

- Going concern Questionability indicators:

a) discontinuance of dividends
b) Net liability
c) Adverse key financial ratios
d) In ability to pay creditors

➢ Risk assessment procedures done by auditor:

- Conditions creating doubt whether business will continue
- Determine did management already performed a preliminary assessment

Yes	No
- discuss assessment with management - conditions creating doubt on entity's ability to continue - if so, understand management's plan to address them	- discuss with management basis for intended use of going concern assumptions - inquire with management whether conditions creating doubt on entity to continue as going concern or not

<u>Audit Procedure and conclusion and reporting:</u>
Summary - Kinds of audit report and going concern assumption

Appropriateness of going Concern assumption	*Adequacy of disclosure*	*Kind of audit opinion*
Appropriate	Not required since it is appropriate	Unqualified
Questionable, but resolved by the management explanation	Yes No	Emphasis of matter Qualified or adverse opinion
Doubt remains	No	Qualified or adverse report
Inappropriate	NIL	Adverse report

SA 560: Subsequent events (revised)

- Subsequent events
  - Events occurring between date of F/s & date of auditors report
  - Facts became known to auditor after date of auditor's report ***(included after revision of standard)***

- Events occurring between date of F/s & date of auditors report
  - Step1: Identify subsequent events

    i) Perform audit procedures to obtain evidence

    ii) If previously audited

    ↓

    Satisfactory conclusion

    ↓

    Additional audit procedure not required
  -
  - Step 2: Specific procedures

    Understand procedure | Inquire with management | Reading minutes of GM taken place <u>after B/s date</u> | Reading latest interim F/s <u>if any</u>
  - Step 3: F/s review
  - Step 4: written representation about identification & treatment of subsequent events
- Auditors scope

  Financial reporting frame work

  ↓

  Identifies Evidence

  Existing at the date of F/s & That arises after the date of F/s

- F/s are *prepared by the management
- *Reviewed by audit committee
- *Approved by BOD
- Such approved F/s are *authenticated by auditor with audit report
- Such audited financials are *adopted by members in the AGM

➢ *Facts known to auditor after date of auditor's report but before the F/s given to third party:

a) Discuss with management (those charged with governance)
↓
Determine whether F/S need amendment
↓
If so, inquire how management addresses the matter in F/s

b) If management amends F/s, carry out audit procedures on specific required area & provide audit report on amended F/s

c) F/s which are approved by BOD can be revised, provided revised F/s must be again approved

d) Dual dating: Besides old date ,add date of revised report

e) Adding new para: amended audit report includes a statement in EOM or other matters

➢ *Facts known to auditor after F/s issued to third parties:

i) Same as above earlier

ii) If management amend F/s:
- carry out audit procedures
- parties already issued F/s are informed about changes
- Dual dating
- When dual dating para changes, amend audit report or issue new audit report

iii) In new or amended audit report add para EOM/ other matters discussing reasons for amendment

iv) If management do not take steps to inform users about changes took place in earlier F/s, then auditor shall take appropriate actions

Audit Report

Not given to entity	Given to entity	F/s are subsequently given to third parties
↓	↓	↓
Modified opinion	Inform T.C.W.G Not to give F/s to Third parties	auditor shall take necessary steps

- Points to remember:
  - BOD can revise F/s any number of times but procedure of companies act should comply whenever F/s are subject to revisions and re opening
  - Auditor cant insist management to revise and cannot prevent management from revising.

SA 600: Using the work of another auditor

- **Objective:** To discuss audit procedures to be applied by principle auditor, when he uses the work of another auditor
- Applicable: to component auditor
- Not applicable:
  - Joint auditor
  - Predecessor auditor
  - Financial information of component auditor is immaterial
- Principal auditor: Responsible for reporting on F/s of an entity who has one or more component
- Component auditor: any branch, division, joint venture, whose Financial information is used in F/s of entity
- Documentations by principal auditor:
  a) Components audited by other auditor
  b) Audit procedures adopted & evidence obtained
  c) Conclusion that particular component is not material
  d) Manner of dealing with modification in another auditors report
- Co ordination: Sufficient liaison between principal auditor & component auditor:
  - Immediately communicate any matter which come to their attention
  - Principal auditor, when finds necessary may obtain from component auditor information required for the purpose of audit
- How principal auditor can use the work of another auditor:
  - Principal auditor should first evaluate how the work of component auditor will affect the audit
  - Acceptance of principal auditor by considering: i) degree of knowledge of business component ii) risk of material misstatement in F/s of components audited by other auditor
  - Principal auditor is entitled to rely on work of component auditor, provided he exercises <u>due skill & care & there is nothing to doubt</u>
  - Principal auditor should advise component auditor regarding
  i) use to be made of his work & report
  ii) significant <u>accounting, auditing, reporting requirements</u>
  iii) <u>areas</u> requiring special consideration
  - Principal auditor should consider <u>his findings, audit procedures</u> & discuss with other auditor
  - Principal auditor may require <u>supplement tests</u> to be performed by: a) another auditor b) Himself
- Principal auditor should qualify / Disclaim his audit report if:
  1. He can't use another auditors work & Procedures and
  2. He is not able to perform sufficient additional procedures

- Division of responsibility: principal auditor is usually not responsible in respect of work entrusted to other auditor.
- Introductory & scope paragraph of audit report should clearly indicate this fact & also mention financial information audited by other auditor

SA510: Initial Engagement opening balance (revised)

- Initial Engagement: An engagement in which F/s for previous period whether or not audited
- Opening balances: closing balance of preceding period brought forward to current period
- Predecessor auditor: auditor from different audit firm, who audited F/s of entity in prior period & replaced by current auditor
- Auditors duty for opening balances: read most recent F/s & predecessor audit report on information regarding opening balances, disclosure
- Procedures: closing balance correctly brought forward:
    - not containing any material misstatement
    - accounting policy consistently applied
- Misstatement: in opening balance & affecting materially current period F/s, then auditor should perform additional audit procedure &
    - if auditor concludes that material misstatement exists in current F/s then communicate to T.C.W.G

    - Prior period F/s audited by predecessor auditor

↓

Current year auditor can rely on audited F/s + Audit report of last year

Exception: when during the performance of audit procedures for current period, possibility of material misstatement in opening balance is indicated.

- Modified opinion in predecessor report
    - If we did the audit of last year, we would be knowing the risk

↓

Last year F/s, Audit report

↓

Modified opinion

↓

This can have impact on current year

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From risk assessment point

Last year audited by predecessor (SA 315) | last year audited by same person (SA 315) already completed LY

- Following audit procedure may be applied if F/s are un audited:

a) Current assets & liabilities:
   - evidence about opening balance can be obtained for current period audit
   - check assertions

b) Inventories:
   - current period audit procedure on closing balance provide audit evidence for stock at beginning of period
   - check physical inventory to reconcile it with opening balances
   - perform audit procedures on gross profit & cut off

c) Non current assets/ liabilities:
   - in cases of property, plant examine accounting records
   - confirmation with third parties
   - carry additional audit procedures.

➢ Audit conclusions and reporting:

- Situation 1:
  - Auditor unable to obtain sufficient audit evidence for opening balances

    ↓

    Qualified/ disclaimer of opinion

- Situation 2:
  - Opening balance contains material misstatements, whose effect

    Disclosed ↓ Not disclosed

    Qualified or adverse opinion

- Situation 3:
  - Auditor concludes current period accounting policies are not consistently applied or change in accounting policy is not disclosed

    ↓

    Qualified or adverse opinion

- Situation 4:
  - Last year audit report modified regarding F/s

    ↓
  - Brought forward of opening balances in current year

    ↓
  - Not resolved in current year

    ↓
  - It is material

    ↓
  - Communicate to management & based on response form an appropriate opinion

SA 710: Comparative Information

(Approach 1) (Approach 2)

Corresponding Figure ↔ Comparative Financial statements

Auditors opinion on F/s refers To current period only

Auditor opinion refer to each period for which F/s are presented

Comparative financial Information
Information regarding amounts and disclosures relating
to prior accounting periods presented in F?S of current Financial year.

<u>Audit Procedures:</u>

ii) Check comparative information agreed with the amounts.
iii) Accounting policies are followed consistently, if any change, the same is disclosed.
iv) Current year auditor became aware of material misstatement in comparative information, he shall increase extent of procedures to obtain sufficient appropriate audit evidence.
v) Obtains written representation from management that all comparative information is presented appropriately.
vi) Previous period F/s are audited:

- By different auditor:
  In current year audit report, in other matter paragraph, mention:
  - fact that it was audited by other auditor
  - opinion expressed by predecessor
  - if opinion was modified, the reason
  - date of such opinion
- Predecessor issued modified report

Matter remains un resolved

Then, current year auditor shall modify the auditors opinion on the current period F/S

- Modification Para
  - Case I
    Current year Figures & corresponding figures

Previous period Modification Current period modification

Material misstatement came into
Current period as opening balance, so current period balance mis stated
& not rectified, therefore impact on this i.e. on current period is material.

- Case II
  Explain audit opinion has been modified because of effects/ unresolved matter.

- If previous period F/s are not audited:

Then current year auditor shall:

- State in other matters that corresponding figures are un audited
- Request management to disclose fact in current year F/s
- Obtain evidence that opening balance do not contain misstatements

❖ In case of comparative F/S approach:

i) auditor shall refer to each period

ii) prior period F/s:

↓

current year audit ,

If auditor opinion on prior period of F/s differs from auditors previously expressed

↓

Disclose the substantive reason for different opinion in other matter para

SA 610 : Using the work of an Internal Auditor

External auditor's objective: To what extent to use specific work of Internal Auditor

SA does not deal with:

a) where Internal auditor provides direct assistance to external auditor
b) Not permissible for Internal Auditor to give access of working papers to third parties

- Statutory auditor using work of Internal Auditor:

Determine adequacy & planned effect

↓

Works adequate for audit

↓

If yes plan impact of internal audit work on nature, timing and extent of audit procedures

- How to determine adequacy:

a) By technical competence
b) Whether Internal auditor exercised due professional care
c) Communication between Internal Auditor & Statutory Auditor

- Scope of Internal audit function

- Monitoring of Internal control effectiveness
- Examination of financial information
- Review of compliance with laws
- Whether management has discharged their responsibilities

- External auditor using specific work of Internal auditor:
    - Internal audit practical training and proficiency
    - Review, supervision and documentation of internal audit work
    - Adequate evidence gathered by internal auditor
    - Conclusion by internal auditor reached are appropriate
    - Whether exceptional items disclosed by Internal auditor resolved

- Factors to determine planned effect:
    - Nature and scope of specific work performed
    - Assessed risk of management
    - Degree of subjectivity involved in evaluating audit evidence

- Internal Audit and External audit

	Internal	External
Appointed By:	Management	Members
Objective	To ensure designing and operating effectiveness	To express opinion on Financial statements

- Technical Competence
    - Whether internal auditors are members of relevant professional bodies
    - Compliance with the mandatory SA
    - Whether internal auditor has adequate technical training

- Due Professional Care
    - Whether activities of internal audit functions are planned, supervised and reviewed
    - Existence and adequacy of audit manuals

- Matter to be agreed between Internal & External Auditor
    - Timing of such work
    - Extent of audit coverage
    - Proposed methods of item selection
    - Documentation of work performed