Self-Study notes (Audit Antidote)

Chapter 1

Nature, objective and scope of audit

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

1. Analysis of definition:

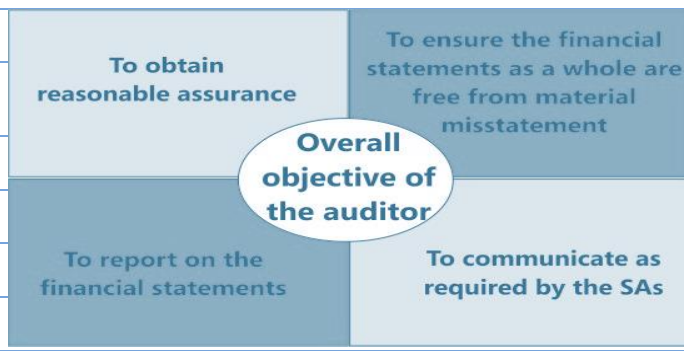
(a) Audit is Independent examination of financial information.

(b) Of an entity - Entity may be profit oriented or may be non-profit oriented (E.g., NGOs')

(c) Objective of the audit is to express an opinion on the financial statements.

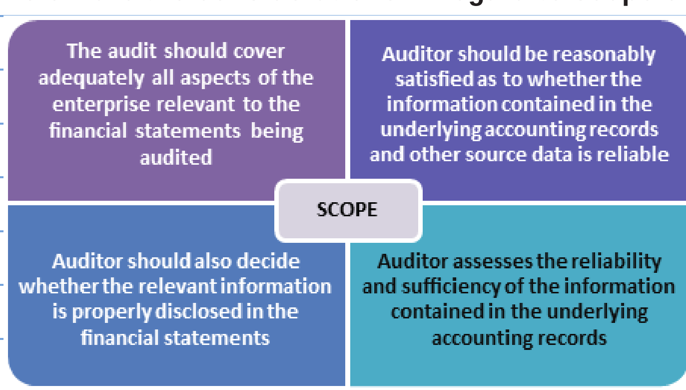
2. Objective of audit:

As per SA-200 "Overall Objectives of the Independent Auditor", in conducting an audit of financial statements, the overall objectives of the auditor are:



3. Scope of audit:

Below are the considerations in regard to scope of audit-

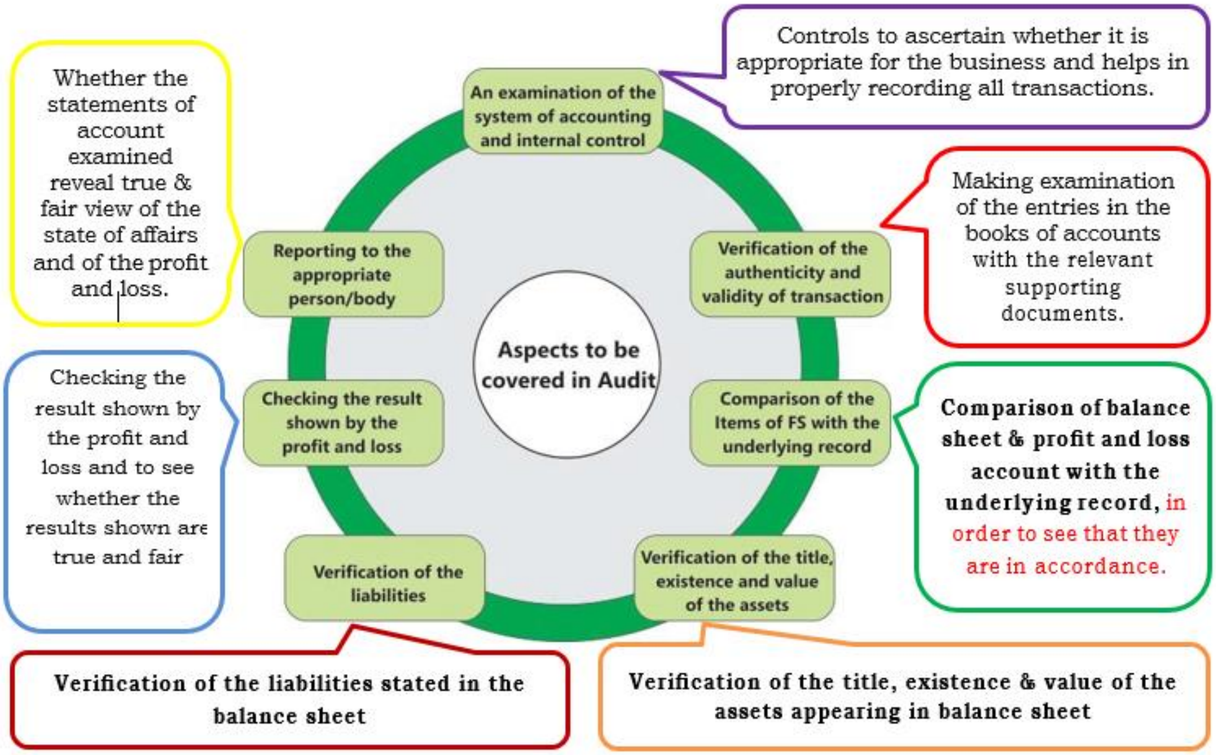


The auditor determines whether relevant information is properly disclosed in financial statements.

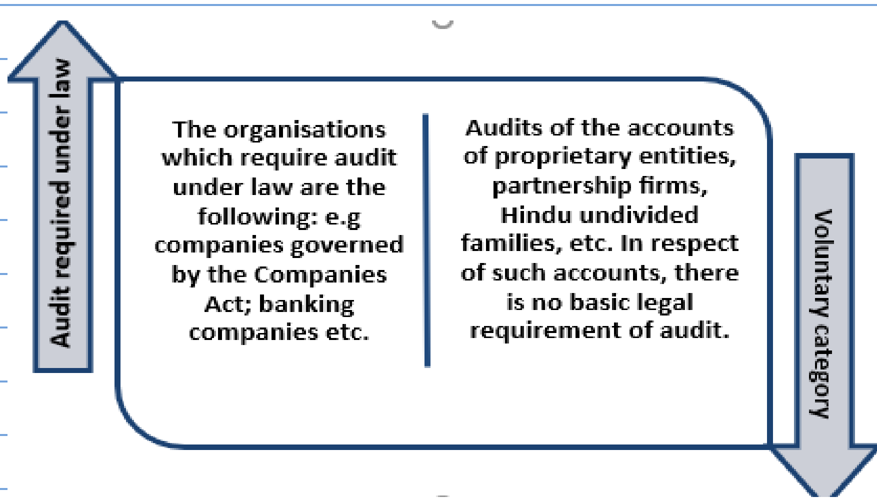
Constraints on scope of audit of FS that impair auditor's ability to express opinion on FS should be set out in his report.

The auditor is not expected to perform duties which fall outside the scope of his competence.

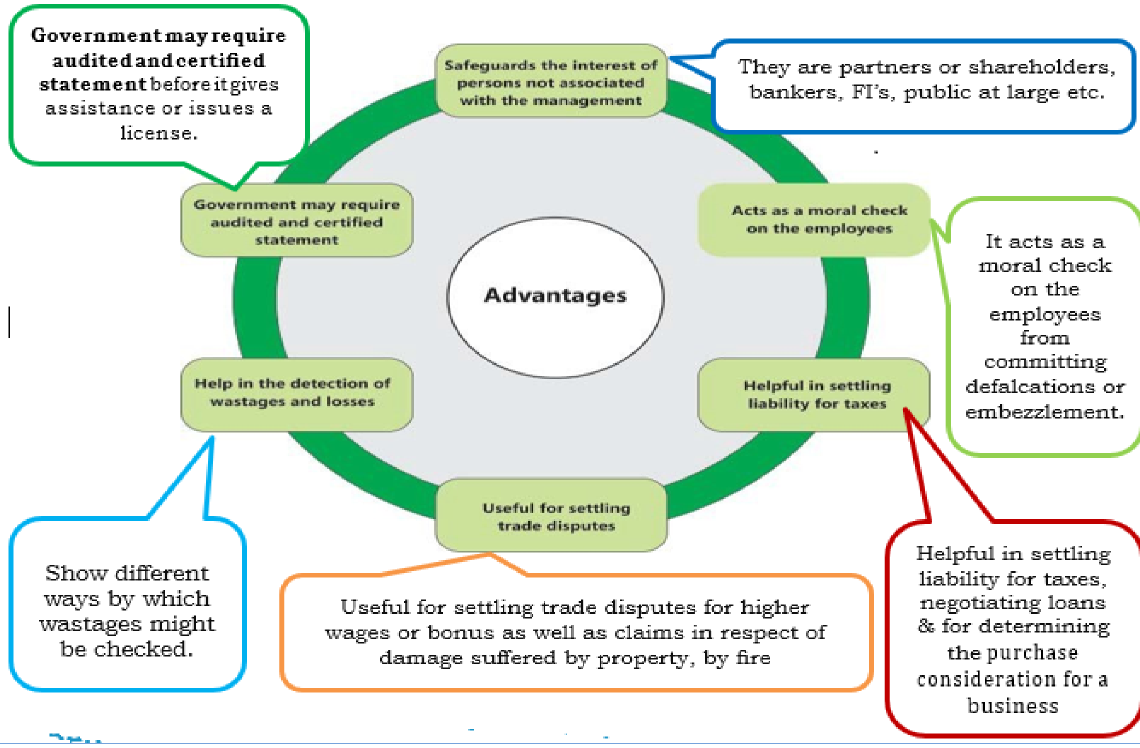
3.1 Aspect to be covered in Audit



4. Types of audit:



5. Benefits of audit:



6. Inherent Limitations of internal controls:

As per SA 200 "Overall Objectives of Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing-

"There are various inherent limitations to internal controls because of which auditor is not expected to, & cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error.

Nature of Financial Reporting

The preparation of financial statements involves judgment by management in applying requirements of the entity's applicable financial reporting framework.

Many financial statement items involve subjective decisions. There may be range of acceptable interpretations.

Timeliness of Financial Reporting and the Balance between Benefit and Cost

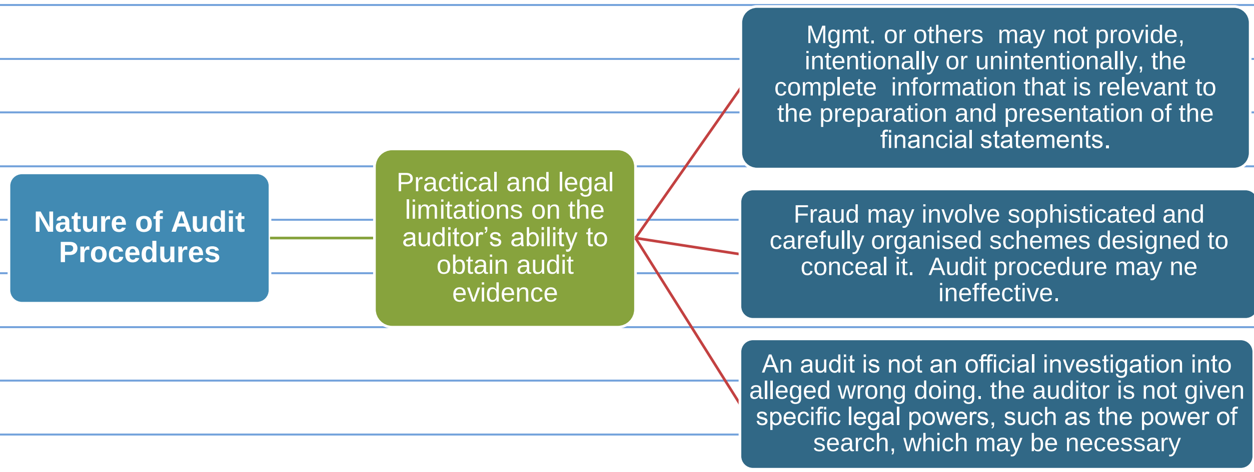
Appropriate planning assists in making sufficient time and resources available for the conduct of the audit.

There is a balance to be struck between the reliability of information and its cost

Other Matters that Affect the Limitations of an Audit

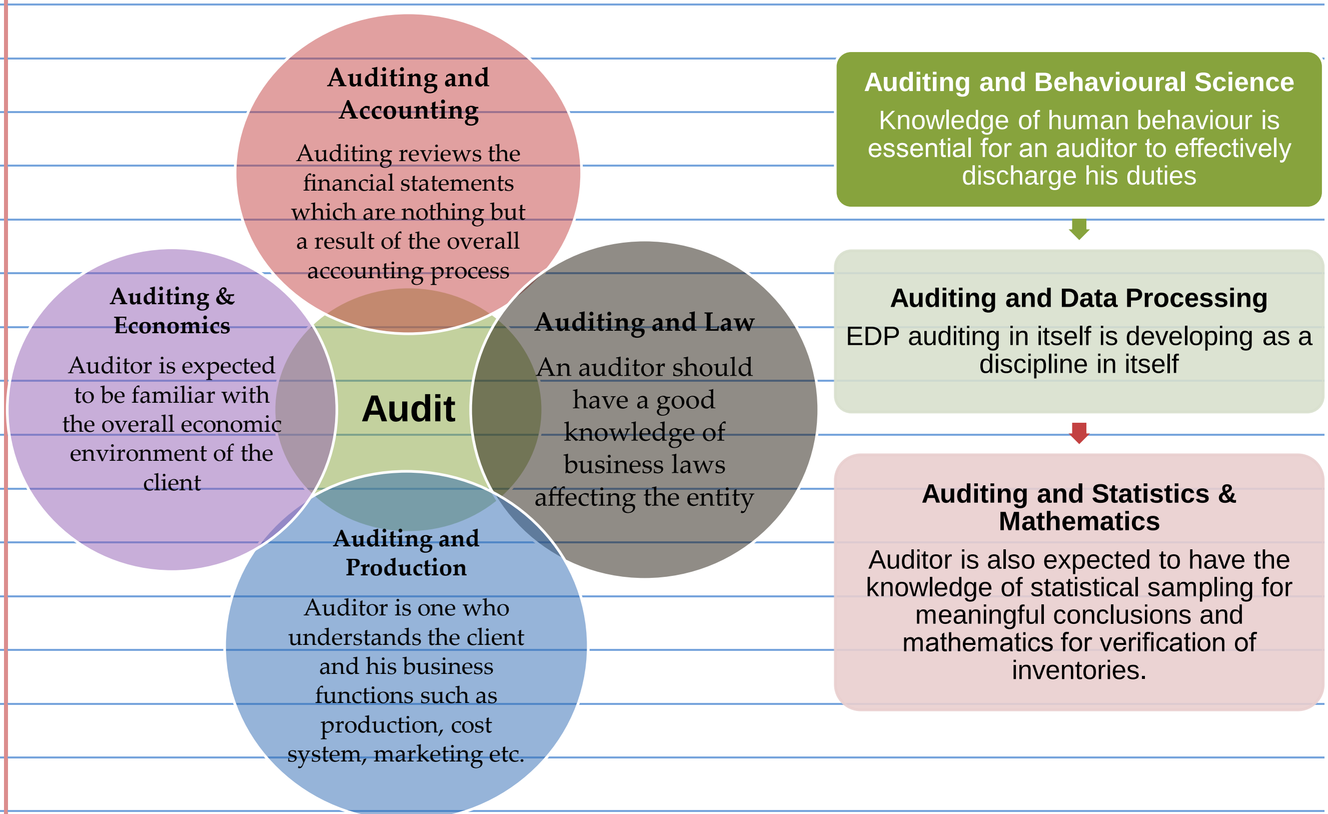
Limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

***Fraud involving senior mgmt.**
***Non compliance occurence.**
***Non favorable Future events.**



7. Relationship of auditing with other disciplines:

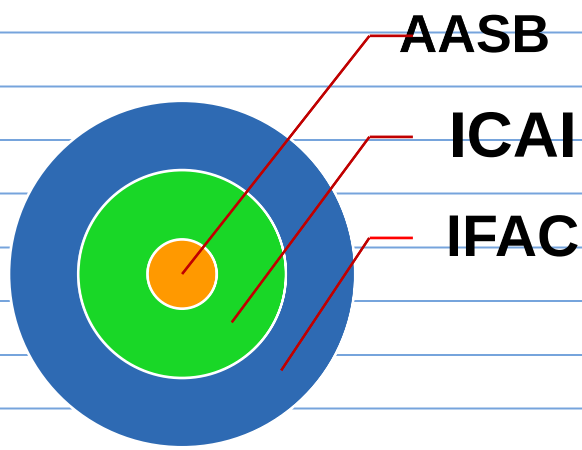
It is quite logical & natural that function of audit can be performed if & only if person possesses a good knowledge about the fields in respect of which he is conducting such a review-



8. Standard setting process:

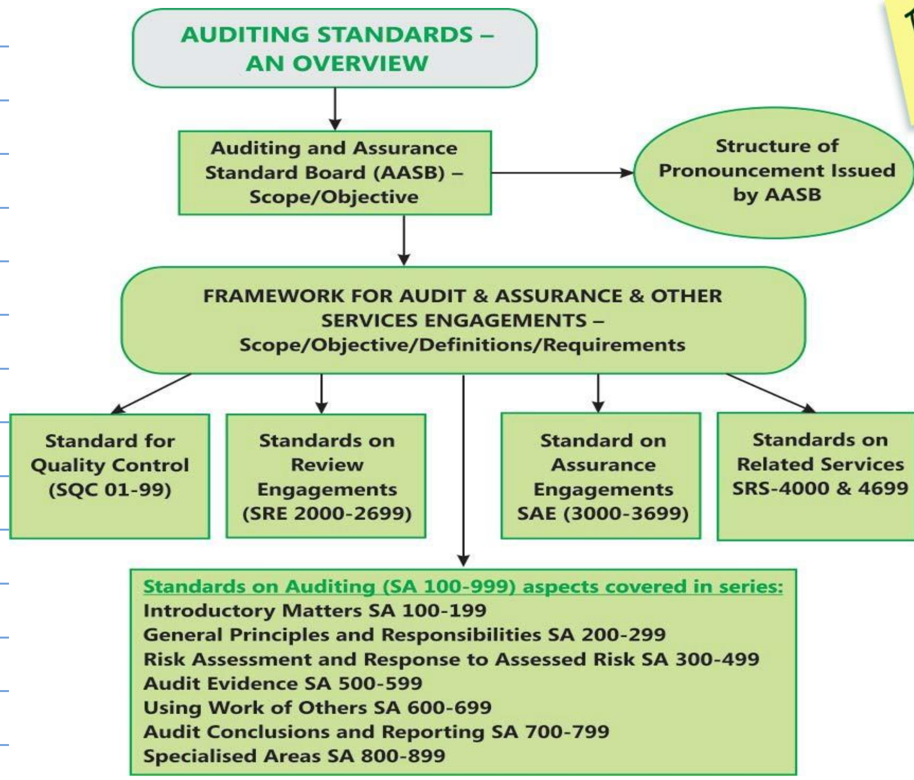
IFAC Board has established the International Auditing and Assurance Standards Board (IAASB) develop and issue, in the public interest and under its own authority, high quality auditing for use around the world. IAASB achieves the objectives by-

8.1. Role of Auditing and assurance standard board-



The ICAI constituted the Auditing Practices Committee (APC) in 1982.

Main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute.



SAs	apply in the audit of historical financial information.
SREs	apply in the review of historical financial information.
SAEs	apply in assurance engagements, dealing with subject matters other than historical financial information.
SRSs	apply to engagements to apply agreed upon procedures to information and other related services engagements such as compilation engagements.

9. Qualities Of an auditor:

According to Dicksee- "Qualities of good auditors are tact, caution, firmness, good temper, integrity, discretion, industry, judgment, patience, clear headedness and reliability".

Below are the some of the personal & professional traits that auditor should possess:

Code to remember: D.K. T.A.U. (DK का ताऊ)

1. He must have the highest degree of integrity backed by adequate independence.
2. He must have a thorough knowledge of the general principles of law which govern matters.
3. He must pursue an intensive programme of theoretical education in subjects like financial management accounting, general management, business and corporate laws etc.
4. The auditor should be equipped with an understanding of the special features peculiar to a particular business.
5. An exhaustive knowledge of accounting in all its branches.

Lord Justice Lindley – "An auditor must be honest that is, he must not certify what he does not believe to be true and must take reasonable care & skill before he believes that what he certifies To be true.

10. Element of a system of quality control:

The firm's system of quality control should include policies and procedures, which includes:

Leadership responsibilities for quality within the firm

- Engagement partner shall take responsibility for overall quality.
- Performing work that complies with professional standards.
- Complying with the firm's quality control policies and procedures & issuing appropiate auditor's reports in given circumstances.

Ethical Equipments

- The auditor shall comply with relevant ethical requirements, including those pertaining to financial statement audit engagements.
- The Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements

Acceptance & continuance of client relationships

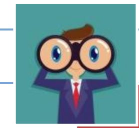
- Engagement partner shall be satisfied that appropriate procedure regarding acceptance & continuance of client relationships & audit engagements have been followed.
- SQC 1 requires firm to obtain information before accepting an engagement

Human Resources

- The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities
- Issues - Recruitmemt, competence, promotions, etc are addressed.

Engagement Performance

- Firm should establish policies & procedures designed to provide it a reasonable assurance that engagements are performed in line with professional standards & regulatory requirements.
- Frm seeks to establish consistency in the quality of engagement performance



Monitoring

- Policies & procedures relating to system of quality control are relevant, adequate, & complied with.
- Monitoring compliance assures , adherence to professional standards, controls are designend as required, and reports that are issued by firm is appropiate or not.

Below are some of the definitions and explanations needed to be studied under this chapter:

10.1. Leadership responsibilities for quality within the firm→

As per SA 220 "Quality Control for an audit of Financial Statements", the engagement partner

take responsibility for overall quality on each audit engagement to which that partner is assigned.

The Engagement partner and his team emphasis on-

(a) On quality of performing work that complies with applicable standards.

(b) Complying with firm's quality control policies and procedures as applicable.

(c) Issuing auditor's reports that are appropriate in the circumstances

(d) Engagement team's ability to raise concerns without fear of reprisals

Engagement Partner - Refers to the partner or other person in the firm who is responsible for the audit engagement; and its performance, and

For the auditor's report that is issued on behalf of firm, and;

Who, has the appropriate authority from a professional, legal/regulatory body !

10.2. Ethical Requirements Relating to an Audit of Financial Statements →

Auditor shall comply with relevant ethical requirements, including those pertaining to independence relating to financial statement audit engagements. IESBA Code related to an audit of financial Statements. Following are the fundamental principles of professional ethics relevant to the auditor-

- Integrity
- Objectivity.
- Professional behavior
-

- **Confidentiality**
- **Professional competence & due care,**

The code describes independence as- **Independence of Mind** & **Independencein Appearance**

Standard on Quality Control (SQC) 1
Sets out the responsibilities of the firm for establishing policies and procedures regarding compliance with relevant ethical requirements

SA 220
Sets out the engagement partner's responsibilities with respect to relevant ethical requirements

10.2.1. Independence of Auditors-

Independence implies that judgment of a person is not subordinate to wishes or direction of another person who might have engaged him. There are two interlinked perspectives of independence of auditors. International Federation of Accountants (IFAC) defines the term as follows-

Independence of mind –
1. **State of mind that permits the provision of an opinion without being affected by influences.**
2. **Allowing an individual to act with integrity, and exercise objectivity and and professional skepticism.**

Independence in appearance –
1. **Avoidance of facts and circumstances that are significant;**
2. **Third party would reasonably conclude an auditor's integrity, objectivity or professional skepticism had been compromised.**

10.2.2. Threats to Independence -

Following are 5 types of threats as identified by IFAC-

Code to Remember: F.A.I².R.

1. **Familiarity Threats:**

(a) They occur when auditors form relationships with the client where they end up being too sympathetic to the client's interest,

(b) This can occur in many ways: -

- Close relative of the audit team working in a senior position in the client company.
- Former partner of the audit firm being a director or senior employee of client.

(c) Familiarity- मेल-जोल. So मेल-जोल से बढ़ा threat.

2. **Advocacy Threats: (वकालत)**

(a) They which occur **when the auditor promotes, or is perceived to promote**, a client's opinion,

(b) Example 1. **When an auditor deals with shares or securities of the audited company**

2. **Becomes the client's advocate in litigation and third-party dispute**.

3. **Intimidation Threats:**

(a) Occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism.

(b) These could happen because of threat of replacement over disagreements with application of accounting principles, or pressure to disproportionately reduce work.

4. **Self-Interest threats:**

(a) Occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client.

(b) Examples-

- **Direct financial interest or materially significant indirect financial interest in a client.**
- **Close business relationship with an audit client**
- **Potential employment with the client**

5. **Self-Review threats:**

(a) Occur when during a review of any judgment or conclusion reached in a previous audit or non audit engagement. These includes-

- **Management audit, internal audit etc.**
- **Investment advisory service, design and implementation of information technology.**

10.2.3. Safeguard to Independence -

The following are the guiding principles in this regard-

1. It is essential that auditors should always be and appears to be **independent of the entities**.
2. Key fundamental principles i.e. integrity, objectivity & professional skepticism, which necessarily require the auditor to be independent.
3. Before taking on any work, an auditor must conscientiously consider whether it **involves threats** to his independence.

4. In case of possibility of such threats, auditor **should either desists the task or implant safeguards** to eliminate such threats.
5. If the auditor is **unable to fully implement** credible and adequate safeguards, **then he must not accept the work.**

10.2.4. Professional Skepticism -

Professional skepticism refers to an attitude that includes a questioning mind, being alert to the conditions which may indicate possible misstatement due to error or fraud, and critical assessment of audit evidence. Professional skepticism includes-

The auditor shall plan and perform an audit with professional skepticism recognizing that may exist that cause the financial statements to be materially misstated-

Professional skepticism includes being alert to, for example-

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest need for audit procedures in addition to those required by the SAs.
- Maintaining professional skepticism throughout audit, is necessary if auditor need to reduce risks of overlooking unusual circumstances, over generalizing when drawing conclusions from audit observations.

Professional skepticism is necessary to critical assessment of audit evidence. It includes consideration sufficiency and appropriateness of audit evidence obtained in the light of the circumstances.

Illustration1-

Mr. H is an audit team member of a Partnership Firm of CA - WY and Associates. Mr. H was of the opinion that Professional Skepticism is required only at planning stage of an audit because circumstances which are unusual in nature exist at the beginning of an audit only. Explain whether Professional Skepticism is only required at planning stage of an audit.

Solution 1-

Professional Skepticism is not only required at planning stage of audit, rather it is required during the entire process of an audit because situations & circumstances that are not usual in nature exist during the entire process of an audit.

10.3. Engagement performance→

The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory & legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances.

10.4. Monitoring→

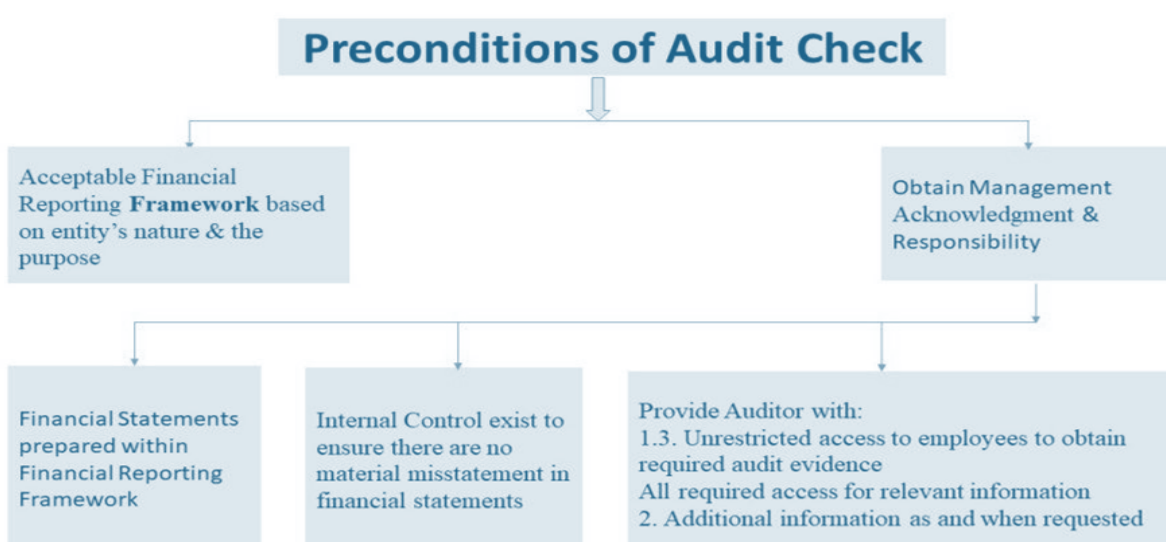
The firm should establish policies and procedures designed to provide it with reasonable assurance the policies and procedures relating to the system of quality control are relevant, adequate and complied with in practice. **The purpose of monitoring compliance with quality control policies & procedures is to provide an evaluation of-**

11. Precondition of audit:

In SA 210, precondition means the use by management-

(a) Of an acceptable financial reporting framework in preparation of financial statements and;

(b) Agreement of management and, where appropriate, those charged with governance to the premises on which an audit is conducted.



12. Agreement on audit engagement terms: (सभी सहमत हैं)

Where the **law doesn't provide** audit of the accounts, it is **matter of contract between client** and **auditor**. It is, therefore important, **both** for the auditor and client, that each party **should be clear about the nature of the engagement**. It must be reduced to writing and should exactly specify the scope of the work. In case of partnership-

- **The appointment of auditor is normally governed by the partnership deed.**
- **The accountant should first get a clear idea of nature of the service required & then ensure, with reference to the terms of partnership agreement that his appointment is valid.**

The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include-

Code to remember: **C.R.O.M.A.** (Audit engagement letter = Croma's one stop solution)

(सभी चीजें यहां पाई जाती हैं, so croma [Engagement letter में सभी शामिल हैं]

1. **C**ontent and form of any reports to be issued by auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.
2. **R**esponsibilities of the auditor
3. **O**bjective and scope of the audit of the financial statements
4. **M**anagement's responsibilities.
5. **A**pplicable financial reporting framework for the preparation of the financial statements

13. Recurring Audits:

On recurring audits, the auditor shall assess whether circumstances **require terms of the audit engagement to be revised** and whether there is a need to remind the entity of the existing terms of The audit engagement

Following factors may make it appropriate to revise the terms of audit engagement or to remind the entity of existing terms-

- Any indication that the entity misunderstands the objective and scope of the audit.

- Revised or special terms of audit engagement - **A recent change of senior management**

- A significant change in ownership - **A significant change in nature or size of the entity's** [illegible]

- Any change in legal or regulatory requirements

Illustration 2-

R & Co, a firm of Chartered Accountants have not revised the terms of engagements & obtained confirmation from clients for last 5 years despite changes in business & professional environment. Elucidate circumstances that may warrant the revision in terms of engagement.

Solution 2-

As per SA 210 on "Agreeing the Terms of Audit Engagements", the auditor may decide not to send a new audit engagement letter or other written agreement each period. However, factors that may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms are discussed above.

14. Limitation on scope prior to audit engagement acceptance:

If management or those charged with governance impose a limitation on scope of auditor's work-

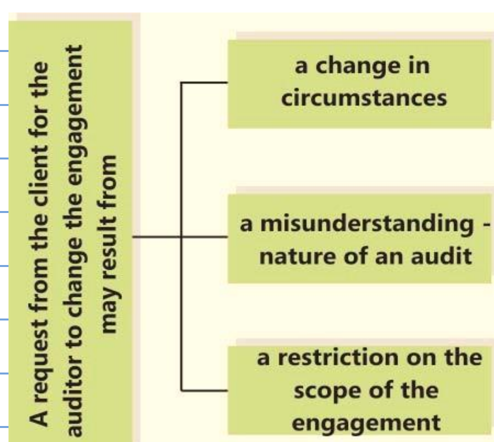
(a) In the **terms of a proposed audit engagement;**

(b) Such that the auditor believes the **limitation will result in the auditor** disclaiming an opinion on the financial matters.

(c) Auditor **shall not accept such a limited engagement** as an audit engagement.

15. Acceptance of a change in engagement-

An auditor who, before completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so. A request from the client for the auditor to change the engagement may result from-



Below points need to be considered for any changes in the engagement: -

1. The auditor would consider carefully the reason given for the request and also implication of restriction on scope of the engagement.
2. If auditor is of the opinion that such changes are justifiable and if the audit work performed complied with the SAs applicable to the changed engagement, the report issued would be appropriate for the revised terms of engagement.
3. If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, auditor shall-
   - **Withdraw from the audit engagement where possible under applicable law/regulations.**
   - **Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties.**

Illustration 3-

M/s Suresh chandra & Co. has been appointed as an auditor of SC Ltd. for the financial year 2014-15. CA. Suresh, one of the partners of M/s Suresh chandra & Co., completed entire routine audit work by 29th May, 2015. Unfortunately, on very next morning, while going towards office of SC Ltd. to sign final audit report, he met with a road accident & died. CA Chandra, another partner of M/s Suresh chandra & Co., therefore, signed the accounts of SC Ltd., without reviewing work performed by CA. **Required** - State with reasons whether CA. Chandra is right in expressing an opinion on the statements the audit of which is performed by another auditor.

Solution 3- **(Soliton is divided in to 3 parts)**

Provision-

Relying on Work Performed by another auditor, a per SA 220 "Quality Control for an Audit of Financial Statements", an engagement partner taking over an audit during the engagement may apply the review procedures

Further, one of the basic principles, which govern the auditor's professional responsibilities and which should be complied with **wherever an audit is carried** that **when auditor delegates** work to assistants or uses work performed by other auditor & experts, **he will continue to be responsible for forming and expressing his opinion on the financial information**. However, **he will be entitled** to **rely on work performed by others**, provided **he exercises adequate skil**l and care and is not aware of any reason to believe that he should not have so relied.

Facts-

In the given case, all the auditing procedures before the moment of signing of final report have been performed by CA. Suresh. Report could not be signed by him due to his unfortunate death. Later on, CA. Chandra signed the report relying on the work performed by CA. Suresh.

Conclusion-

Here, CA. Chandra is allowed to sign the audit report, though, will be responsible for expressing the opinion. He may rely on the work performed by CA. Suresh provided he further exercises adequate skill and due care and review the work performed by him.

TEST YOUR KNOWLEDGE

1. Correct and incorrect-

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

a) **Basic objective of audit does not change with reference to nature, size or form of an entity.**

A a) **CORRECT :** An audit is an **independent examination** of financial information of any entity whether profit oriented or not, and irrespective of its size or legal form, when such an examination is being conducted with a view to expressing an opinion thereon. It is clear that the basic objective of the auditing, i.e., **expression of opinion on financial statements does not change** with reference to nature, size or form of an entity.

b) **The purpose of an audit is to enhance the degree of confidence of intended users in financial Statements.**

A b) **CORRECT :** As per SA 200 "Overall Objectives of the Independent Auditor and the conduct of an Audit in Accordance with Standards on Auditing", the purpose of an audit is to enhance the **degree of confidence of intended** users in financial statements. This is achieved by expression of an **opinion by auditor** on whether the financial statements are **prepared in accordance with an applicable financial reporting** framework.

c) **The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that financial statements are free from material misstatement due to fraud or error.**

A c) **CORRECT :** As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the auditor is not expected to, and cannot reduce audit risk to zero and cannot therefore obtain absolute assurance that financial statements free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.

d) **The audit engagement letter is sent by the client to auditor**

A d) **INCORRECT :** As per SA 210 "Agreeing the Terms of Audit Engagements", Audit engagement letter is sent by the auditor to his client.

e) **Specific disclosure is required of the fundamental accounting assumptions followed in the statements.**

A e) **INCORRECT :** As per AS 1, "Disclosure of Accounting Policies", specific disclosure of the fundamental accounting assumption is required if they are not followed in the financial statement.

f) **An Auditor is considered to lack independence if the partner of audit firm deals with shares & securities of the audited entity**

A f) **CORRECT:** **As per section 141 (3)(d),**

A person shall not be eligible for appointment as an auditor of-

- A company namely;
- A person, or his relative or partner is holding any security of or interest in the company **OR**
- its subsidiary, or of its holding or associate company or a subsidiary of such holding company.

From the above it can be concluded that-

- If partner deals with shares and securities of the audited entity. He would lack independence;
- Also, the Code of Ethics for Professional Accountants, prepared by IFAC, identifies 5 threats;

g) **The Audit Engagement documentations should ordinarily be retained by auditor for minimum of 6 years from date of the auditor's report or the date of the group auditor's report, whichever is later.**

A g) **INCORRECT:** SQC 1 requires firms to **establish policies and procedures** for the retention of the engagement documentation. The **retention period for audit engagements** ordinarily is **no shorter than 7 years** from the date of auditor's report or, if later, the date of the group auditor's report.

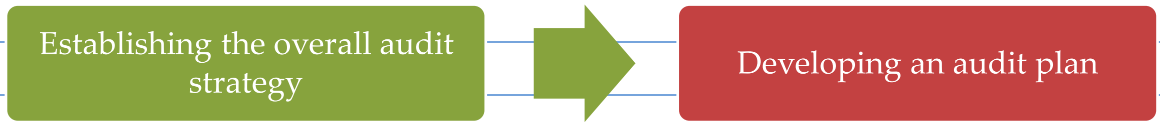
h) Mr. S, one of the new team members of the auditor of Extremely Effective Limited was of the view that for the purpose of conducting an audit, only knowledge of direct tax is required whereas no knowledge of indirect tax is required

A h) **INCORRECT:** The viewpoint of Mr. S is incorrect because for the purpose of conducting audit, proper knowledge of both direct tax as well as indirect tax is required.

Chapter 2

Audit Strategy, audit planning & audit programme

1. **Planning an audit involves-**



2. **Audit plan to conduct an effective audit-**

"The auditor <u>should plan his work</u> to enable him to conduct an effective audit in an efficient and timely manner. <u>Plans should be based on knowledge of the client's business</u>". Below are coverage **areas-**