

ONE MASTER CHART FOR LEARNING SA WITH AAS

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Standard on Auditing (SA) 200*(Revised)

Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing

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Limited Revisions Consequential to issuance of the Standard on Auditing (SA) 200 (Revised), Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing	

Standard on Auditing (SA) 200 Revised, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services†", which sets out the authority of SAs.

* The date this Revised Standard on Auditing (SA) 200 comes into effect, SA 200, "Basic Principles Governing an Audit", issued by ICAI in April, 1985 and SA 200A, "Objective and Scope of an Audit of Financial Statements", issued by ICAI in April, 1985 shall stand withdrawn.

† Published in the July, 2007 issue of the Journal.

Overall Objectives of the Independent Auditor and the Conduct of an Audit

Introduction

Scope of this SA

1. This Standard on Auditing (SA) establishes the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with SAs. Specifically, it sets out the overall objectives of the independent auditor, and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives. It also explains the scope, authority and structure of the SAs, and includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the SAs. The independent auditor is referred to as "the auditor" hereafter.
2. SAs are written in the context of an audit of financial statements by an auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information.

An Audit of Financial Statements

3. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with SAs and relevant ethical requirements enables the auditor to form that opinion. (Ref: Para. A1)
4. The financial statements subject to audit are those of the entity, prepared and presented by management of the entity with oversight from those charged with governance. SAs do not impose responsibilities on management or those charged with governance and do not override laws and regulations that govern their responsibilities. However, an audit in accordance with SAs is conducted on the premise that management and, where appropriate, those charged with governance have responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of those responsibilities. (Ref: Para. A2-A11)
5. As the basis for the auditor's opinion, SAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. (Ref: Para. A28-A52)
6. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements¹. In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgments about materiality are made in the light of surrounding circumstances, and are affected by the auditor's perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or a combination of both. The auditor's opinion deals with the financial statements as a whole and

¹ SA 320 (Revised), "Materiality in Planning and Performing an Audit" and SA 450, "Evaluation of Misstatements Identified during the Audit".

therefore the auditor is not responsible for the detection of misstatements that are not material to the financial statements as a whole.

7. The SAs contain objectives, requirements and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. The SAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things:

- ◆ Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.
- ◆ Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
- ◆ Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.

8. The form of opinion expressed by the auditor will depend upon the applicable financial reporting framework and any applicable laws or regulations. (Ref: Para. A12-A13)

9. The auditor may also have certain other communication and reporting responsibilities to users, management, those charged with governance, or parties outside the entity, in relation to matters arising from the audit. These may be established by the SAs or by applicable laws or regulations².

Effective Date

10. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Overall Objectives of the Auditor

11. In conducting an audit of financial statements, the overall objectives of the auditor are:

- (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
- (b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

12. In all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, the SAs require that the auditor disclaim an opinion or withdraw from the engagement, where withdrawal is legally permitted.

Definitions

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

- (a) Applicable financial reporting framework – The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation and presentation of the financial statements that is

² See, for example, SA 260 (Revised), "Communication with Those Charged with Governance"; and paragraph 43 of SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".

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acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

The term “fair presentation framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

- (i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
- (ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term “compliance framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.

- (b) Audit evidence – Information used by the auditor in arriving at the conclusions on which the auditor’s opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. For purposes of the SAs:
 - (i) Sufficiency of audit evidence is the measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor’s assessment of the risks of material misstatement and also by the quality of such audit evidence.
 - (ii) Appropriateness of audit evidence is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor’s opinion is based.
- (c) Audit risk – The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.
- (d) Auditor – “Auditor” is used to refer to the person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm. Where an SA expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term “engagement partner” rather than “auditor” is used. “Engagement partner” and “firm” are to be read as referring to their public sector equivalents where relevant.
- (e) Detection risk – The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.
- (f) Financial statements – A structured representation of historical financial information, including related notes, intended to communicate an entity’s economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The term “financial statements” ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but can also refer to a single financial statement.
- (g) Historical financial information – Information expressed in financial terms in relation to a particular entity, derived primarily from that entity’s accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

- (h) Management – The person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.
- (i) Misstatement – A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

When the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

- (j) Premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted – That management and, where appropriate, those charged with governance have the following responsibilities that are fundamental to the conduct of an audit in accordance with SAs. That is, responsibility:
 - (i) For the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework; this includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; and
 - (ii) To provide the auditor with:
 - a. All information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements;
 - b. Any additional information that the auditor may request from management and, where appropriate, those charged with governance; and
 - c. Unrestricted access to those within the entity from whom the auditor determines it necessary to obtain audit evidence.

In the case of a fair presentation framework, the responsibility is for the preparation and fair presentation of the financial statements in accordance with the financial reporting framework; or the preparation of financial statements that give a true and fair view in accordance with the financial reporting framework. This applies to all references to "preparation and presentation of the financial statements" in the SAs.

The "premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted" may also be referred to as the "premise".

- (k) Professional judgment – The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.
- (l) Professional skepticism – An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.
- (m) Reasonable assurance – In the context of an audit of financial statements, a high, but not absolute, level of assurance.

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- (n) Risk of material misstatement – The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:
 - (i) Inherent risk – The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
 - (ii) Control risk – The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.
- (o) Those charged with governance – The person(s) or organisation(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.

Requirements

Ethical Requirements Relating to an Audit of Financial Statements

14. The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. (Ref: Para. A14-A17)

Professional Skepticism

15. The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. (Ref: Para. A18-A22)

Professional Judgment

16. The auditor shall exercise professional judgment in planning and performing an audit of financial statements. (Ref: Para. A23-A27)

Sufficient Appropriate Audit Evidence and Audit Risk

17. To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. (Ref: Para. A28-A52)

Conduct of an Audit in Accordance with SAs

Complying with SAs Relevant to the Audit

18. The auditor shall comply with all SAs relevant to the audit. An SA is relevant to the audit when the SA is in effect and the circumstances addressed by the SA exist. (Ref: Para. A53-A56)

19. The auditor shall have an understanding of the entire text of an SA, including its application and other explanatory material, to understand its objectives and to apply its requirements properly. (Ref: Para. A57-A65)

20. The auditor shall not represent compliance with SAs in the auditor's report unless the auditor has complied with the requirements of this SA and all other SAs relevant to the audit.

Objectives Stated in Individual SAs

21. To achieve the overall objectives of the auditor, the auditor shall use the objectives stated in relevant SAs in planning and performing the audit, having regard to the interrelationships among the SAs, to: (Ref: Para. A66-A68)

- (a) Determine whether any audit procedures in addition to those required by the SAs are necessary in pursuance of the objectives stated in the SAs; and (Ref: Para. A69)
- (b) Evaluate whether sufficient appropriate audit evidence has been obtained. (Ref: Para. A70)

Complying with Relevant Requirements

22. Subject to paragraph 23, the auditor shall comply with each requirement of an SA unless, in the circumstances of the audit:

- (a) The entire SA is not relevant; or
- (b) The requirement is not relevant because it is conditional and the condition does not exist. (Ref: Para. A71-A72)

23. In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in an SA. In such circumstances, the auditor shall perform alternative audit procedures to achieve the aim of that requirement. The need for the auditor to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the aim of the requirement. (Ref: Para. A73)

Failure to Achieve an Objective

24. If an objective in a relevant SA cannot be achieved, the auditor shall evaluate whether this prevents the auditor from achieving the overall objectives of the auditor and thereby requires the auditor, in accordance with the SAs, to modify the auditor's opinion or withdraw from the engagement. Failure to achieve an objective represents a significant matter requiring documentation in accordance with SA 230 (Revised)³. (Ref: Para. A74-A75)

Application and Other Explanatory Material

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Scope of the Audit (Ref: Para. 3)

A1. The auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. In some cases,

³ SA 230 (Revised), "Audit Documentation", paragraph 8(c).

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however, the applicable laws and regulations may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. While the SAs include requirements and guidance in relation to such matters to the extent that they are relevant to forming an opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions.

Preparation of the Financial Statements (Ref: Para. 4)

A2. An audit in accordance with SAs is conducted on the premise that management and, where appropriate, those charged with governance have responsibility:

- (a) For the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework; this includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; and
- (b) To provide the auditor with:
 - (i) All information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements;
 - (ii) Any additional information that the auditor may request from management and, where appropriate, those charged with governance; and
 - (iii) Unrestricted access to those within the entity from whom the auditor determines it necessary to obtain audit evidence.

A3. As part of their responsibility for the preparation and presentation of the financial statements, management and, where appropriate, those charged with governance are responsible for:

- ◆ The identification of the applicable financial reporting framework, in the context of any relevant laws or regulations.
- ◆ The preparation and presentation of the financial statements in accordance with that framework.
- ◆ An adequate description of that framework in the financial statements.

The preparation of the financial statements requires management to exercise judgment in making accounting estimates that are reasonable in the circumstances, as well as to select and apply appropriate accounting policies. These judgments are made in the context of the applicable financial reporting framework.

A4. The financial statements may be prepared in accordance with a financial reporting framework designed to meet:

- ◆ The common financial information needs of a wide range of users (i.e., “general purpose financial statements”); or
- ◆ The financial information needs of specific users (i.e., “special purpose financial statements”).

A5. The applicable financial reporting framework often encompasses financial reporting standards established by an authorised or recognised standards setting organisation, or legislative or regulatory requirements. In some cases, the financial reporting framework may encompass both financial reporting standards established by an authorised or recognised standards setting organisation and legislative or regulatory requirements. Other sources may provide direction on the application of the applicable financial reporting framework. In some cases, the applicable financial reporting framework may encompass such other sources, or may even consist only of such sources. Such other sources may include:

- ◆ The legal and ethical environment, including statutes, regulations, court decisions, and professional ethical obligations in relation to accounting matters;
- ◆ Published accounting interpretations of varying authority issued by standards setting, professional or regulatory organisations;
- ◆ Published views of varying authority on emerging accounting issues issued by standards setting, professional or regulatory organisations;
- ◆ General and industry practices widely recognised and prevalent; and
- ◆ Accounting literature.

Where conflicts exist between the financial reporting framework and the sources from which direction on its application may be obtained, or among the sources that encompass the financial reporting framework, the source with the highest authority prevails.

A6. The requirements of the applicable financial reporting framework determine the form and content of the financial statements. Although the framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficient broad principles that can serve as a basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework.

A7. Some financial reporting frameworks are fair presentation frameworks, while others are compliance frameworks. Financial reporting frameworks that encompass primarily the financial reporting standards established by an organisation that is authorised or recognised to promulgate standards to be used by entities for preparing and presenting general purpose financial statements are often designed to achieve fair presentation.

A8. The requirements of the applicable financial reporting framework also determine what constitutes a complete set of financial statements. In the case of many frameworks, financial statements are intended to provide information about the state of affairs, results of operations and cash flows of an entity. For such frameworks, a complete set of financial statements would include a balance sheet; statement of profit and loss; a cash flow statement; and related notes. For some other financial reporting frameworks, a single financial statement and the related notes might constitute a complete set of financial statements:

- ◆ For example, normally, in government departments and local bodies, the primary financial statement is a statement of cash receipts and payments.
- ◆ Other examples of a single financial statement, each of which would include related notes, are:
 - Balance sheet.
 - Statement of profit & loss.
 - Statement of cash flows.
 - Statement of operations by product lines.

A9. SA 210 (Revised) establishes requirements and provides guidance on determining the acceptability of the applicable financial reporting framework⁴. SA 800 deals with special considerations when financial statements are

⁴ SA 210 (Revised), "Agreeing the Terms of Audit Engagements", paragraph 6(a).

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A10. Because of the significance of the premise to the conduct of an audit, the auditor is required to obtain agreement from management and, where appropriate, those charged with governance that they acknowledge and understand their responsibilities set out in paragraph A2 as a precondition for accepting the audit engagement⁶. The auditor is also required to obtain written representations about whether management and, where appropriate, those charged with governance have fulfilled those responsibilities⁷.

Considerations Specific to Central/State Governments and Related Government Entities

A11. The mandates for audits of the financial statements of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), may be broader than those of other entities. As a result, the premise, relating to management's responsibilities, on which an audit of the financial statements of such an entity is conducted may include additional responsibilities, such as, the responsibility for the execution of transactions and events in accordance with legislation or proper authority.

Form of the Auditor's Opinion (Ref: Para. 8)

A12. The opinion expressed by the auditor is on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. The form of the auditor's opinion, however, will depend upon the applicable financial reporting framework and any applicable laws or regulations. Most financial reporting frameworks include requirements relating to the presentation of the financial statements; for such frameworks, preparation of the financial statements in accordance with the applicable financial reporting framework includes presentation.

A13. Where the financial reporting framework is a fair presentation framework, as is generally the case for general purpose financial statements, the opinion required by the SAs is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view. Where the financial reporting framework is a compliance framework, the opinion required is on whether the financial statements are prepared, in all material respects, in accordance with the framework. Unless specifically stated otherwise, references in the SAs to the auditor's opinion cover both forms of opinion.

Ethical Requirements Relating to an Audit of Financial Statements (Ref: Para. 14)

A14. The auditor is subject to relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics issued by the Institute of Chartered Accountants of India.

A15. The Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements and provides a conceptual framework for applying those principles;

- (a) Integrity;
- (b) Objectivity;
- (c) Professional competence and due care;

⁵ SA 800, "Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks", paragraph 8.

⁶ SA 210 (Revised), paragraph 6(b).

⁷ SA 580 (Revised), "Written Representations", paragraphs 10-11.

- (d) Confidentiality; and
- (e) Professional behavior.

A16. In the case of an audit engagement it is in the public interest and, therefore, required by the Code of Ethics, that the auditor be independent of the entity subject to the audit. The Code describes independence as comprising both independence of mind and independence in appearance. The auditor's independence from the entity safeguards the auditor's ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor's ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.

A17. Standard on Quality Control (SQC) 1 sets out the responsibilities of the firm for establishing policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements, including those pertaining to independence⁸. Revised SA 220 sets out the engagement partner's responsibilities with respect to relevant ethical requirements. These include evaluating whether members of the engagement team have complied with relevant ethical requirements, determining the appropriate action if matters come to the engagement partner's attention that indicate that members of the engagement team have not complied with relevant ethical requirements, and forming a conclusion on compliance with independence requirements that apply to the audit engagement⁹. Revised SA 220 recognises that the engagement team is entitled to rely on a firm's systems in meeting its responsibilities with respect to quality control procedures applicable to the individual audit engagement, unless information provided by the firm or other parties suggests otherwise.

Professional Skepticism (Ref: Para. 15)

A18. 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 the need for audit procedures in addition to those required by the SAs.

A19. Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of:

- ◆ Overlooking unusual circumstances.
- ◆ Over generalising when drawing conclusions from audit observations.
- ◆ Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

A20. Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and

⁸ Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements".

⁹ SA 220 (Revised), "Quality Control for an Audit of Financial Statements".

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appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

A21. The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence¹⁰. In cases of doubt about the reliability of information or indications of possible fraud (for example, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document may have been falsified), the SAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter¹¹.

A22. The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less-than-persuasive audit evidence when obtaining reasonable assurance.

Professional Judgment (Ref: Para. 16)

A23. Professional judgment is essential to the proper conduct of an audit. This is because interpretation of relevant ethical requirements and the SAs and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances. Professional judgment is necessary in particular regarding decisions about:

- ◆ Materiality and audit risk.
- ◆ The nature, timing, and extent of audit procedures used to meet the requirements of the SAs and gather audit evidence.
- ◆ Evaluating whether sufficient appropriate audit evidence has been obtained, and whether more needs to be done to achieve the objectives of the SAs and thereby, the overall objectives of the auditor.
- ◆ The evaluation of management's judgments in applying the entity's applicable financial reporting framework.
- ◆ The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

A24. The distinguishing feature of the professional judgment expected of an auditor is that it is exercised by an auditor whose training, knowledge and experience have assisted in developing the necessary competencies to achieve reasonable judgments.

A25. The exercise of professional judgment in any particular case is based on the facts and circumstances that are known by the auditor. Consultation on difficult or contentious matters during the course of the audit, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm, such as that required by Revised SA 220¹², assist the auditor in making informed and reasonable judgments.

A26. Professional judgment can be evaluated based on whether the judgment reached reflects a competent application of auditing and accounting principles and is appropriate in the light of, and consistent with, the facts and circumstances that were known to the auditor up to the date of the auditor's report.

¹⁰ SA 500 (Revised), "Audit Evidence", paragraphs 7-9.

¹¹ SA 240 (Revised), paragraph 13; SA 500 (Revised), paragraph 11; and SA 505 (Revised), "External Confirmations", paragraphs 10-11, and 16.

¹² See footnote 9.

A27. Professional judgment needs to be exercised throughout the audit. It also needs to be appropriately documented. In this regard, the auditor is required to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in reaching conclusions on significant matters arising during the audit¹³. Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient appropriate audit evidence.

Sufficient Appropriate Audit Evidence and Audit Risk (Ref: Para. 5 and 17)

Sufficiency and Appropriateness of Audit Evidence

A28. Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit¹⁴) or a firm's quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared by an expert employed or engaged by the entity. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases, the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.

A29. The sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

A30. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

A31. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. SA 500 (Revised) and other relevant SAs establish additional requirements and provide further guidance applicable throughout the audit regarding the auditor's considerations in obtaining sufficient appropriate audit evidence.

Audit Risk

A32. Audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

A33. For purposes of the SAs, audit risk does not include the risk that the auditor might express an opinion that the

¹³ SA 230 (Revised), paragraph 8.

¹⁴ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 9.

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financial statements are materially misstated when they are not. This risk is ordinarily insignificant. Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

Risks of Material Misstatement

A34. The risks of material misstatement may exist at two levels:

- ◆ The overall financial statement level; and
- ◆ The assertion level for classes of transactions, account balances, and disclosures.

A35. Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

A36. Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk. Auditors use various approaches to accomplish the objective of assessing the risks of material misstatement. For example, the auditor may make use of a model that expresses the general relationship of the components of audit risk in mathematical terms to arrive at an acceptable level of detection risk. Some auditors find such a model to be useful when planning audit procedures.

A37. The risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.

A38. Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterised by a large number of business failures.

A39. Control risk is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The SAs provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed¹⁵.

A40. The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative

¹⁵ SA 330, "The Auditor's Responses to Assessed Risks", paragraphs 7-17.

terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

A41. SA 315 establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.

Detection Risk

A42. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.

A43. Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. Matters such as:

- ◆ adequate planning;
- ◆ proper assignment of personnel to the engagement team;
- ◆ the application of professional skepticism; and
- ◆ supervision and review of the audit work performed,

assist to enhance the effectiveness of an audit procedure and of its application and reduce the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results.

A44. SA 300 (Revised)¹⁶ and SA 330 establish requirements and provide guidance on planning an audit of financial statements and the auditor's responses to assessed risks. Detection risk, however, can only be reduced, not eliminated, because of the inherent limitations of an audit. Accordingly, some detection risk will always exist.

Inherent Limitations of an Audit

A45. The auditor is not expected to, and 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. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. The inherent limitations of an audit arise from:

- ◆ The nature of financial reporting;
- ◆ The nature of audit procedures; and
- ◆ The need for the audit to be conducted within a reasonable period of time and at a reasonable cost.

The Nature of Financial Reporting

A46. The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures. For example, this is often the case with respect to certain accounting estimates. Nevertheless, the SAs require the auditor to

¹⁶ SA 300 (Revised), "Planning an Audit of Financial Statements".

Overall Objectives of the Independent Auditor and the Conduct of an Audit give specific consideration to whether accounting estimates are reasonable in the context of the applicable financial reporting framework and related disclosures, and to the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments¹⁷.

The Nature of Audit Procedures

A47. There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

- ◆ There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor. Accordingly, the auditor cannot be certain of the completeness of information, even though the auditor has performed audit procedures to obtain assurance that all relevant information has been obtained.
- ◆ Fraud may involve sophisticated and carefully organised schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
- ◆ An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

Timeliness of Financial Reporting and the Balance between Benefit and Cost

A48. The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost. This is recognised in certain financial reporting frameworks (see, for example, the "Framework for the Preparation and Presentation of Financial Statements" issued by the Institute of Chartered Accountants of India (ICAI)). Therefore, there is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognising that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.

A49. Consequently, it is necessary for the auditor to:

- ◆ Plan the audit so that it will be performed in an effective manner;
- ◆ Direct audit effort to areas most expected to contain risks of material misstatement, whether due to fraud or error, with correspondingly less effort directed at other areas; and
- ◆ Use testing and other means of examining populations for misstatements.

A50. In light of the approaches described in paragraph A49, the SAs contain requirements for the planning and performance of the audit and require the auditor, among other things, to:

- ◆ Have a basis for the identification and assessment of risks of material misstatement at the financial statement and

¹⁷ SA 540 (Revised), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", and SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements", paragraph 12.

assertion levels by performing risk assessment procedures and related activities¹⁸; and

- ◆ Use testing and other means of examining populations in a manner that provides a reasonable basis for the auditor to draw conclusions about the population¹⁹.

Other Matters that Affect the Inherent Limitations of an Audit

A51. In the case of certain assertions or subject matters, the potential effects of the inherent limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- ◆ Fraud, particularly fraud involving senior management or collusion. See SA 240 (Revised) for further discussion.
- ◆ The existence and completeness of related party relationships and transactions. See SA 550 (Revised)²⁰ for further discussion.
- ◆ The occurrence of non-compliance with laws and regulations. See SA 250 (Revised)²¹ for further discussion.
- ◆ Future events or conditions that may cause an entity to cease to continue as a going concern. See SA 570 (Revised)²² for further discussion.

Relevant SAs identify specific audit procedures to assist in mitigating the effect of the inherent limitations.

A52. Because of the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with SAs. Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with SAs. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less-than-persuasive audit evidence. Whether the auditor has performed an audit in accordance with SAs is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor's report based on an evaluation of that evidence in light of the overall objectives of the auditor.

Conduct of an Audit in Accordance with SAs

Nature of the SAs (Ref: Para. 18)

A53. The SAs, taken together, provide the standards for the auditor's work in fulfilling the overall objectives of the auditor. The SAs deal with the general responsibilities of the auditor, as well as the auditor's further considerations relevant to the application of those responsibilities to specific topics.

A54. The scope, effective date and any specific limitation of the applicability of a specific SA is made clear in the SA. Unless otherwise stated in the SA, the auditor is permitted to apply an SA before the effective date specified therein.

A55. In performing an audit, the auditor may be required to comply with legal or regulatory requirements in addition to the SAs. The SAs do not override laws and regulations that govern an audit of financial statements. In the event that those laws and regulations differ from the SAs, an audit conducted only in accordance with laws and regulations will not automatically comply with SAs.

¹⁸ SA 315, paragraphs 5-10.

¹⁹ SA 330; SA 500 (Revised); SA 520 (Revised), "Analytical Procedures", and SA 530 (Revised), "Audit Sampling".

²⁰ SA 550 (Revised), "Related Parties".

²¹ SA 250 (Revised), "Consideration of Laws and Regulations in an Audit of Financial Statements".

²² SA 570 (Revised), "Going Concern".

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A56. The SAs are also relevant to engagements in case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions). The auditor's responsibilities of those entities, however, may be affected by the audit mandate, or by obligations on those entities arising from legislation, regulation, ministerial directives, government policy requirements, or resolutions of the legislature, which may encompass a broader scope than an audit of financial statements in accordance with the SAs. These additional responsibilities are not dealt with in the SAs. They may be dealt with in the relevant laws and regulations in which the entities are operating.

Contents of the SAs (Ref: Para. 19)

A57. In addition to objectives and requirements (requirements are expressed in the SAs using "shall"), an SA contains related guidance in the form of application and other explanatory material. It may also contain introductory material that provides context relevant to a proper understanding of the SA, and definitions. The entire text of an SA, therefore, is relevant to an understanding of the objectives stated in an SA and the proper application of the requirements of an SA.

A58. Where necessary, the application and other explanatory material provides further explanation of the requirements of an SA and guidance for carrying them out. In particular, it may:

- ◆ Explain more precisely what a requirement means or is intended to cover.
- ◆ Include examples of procedures that may be appropriate in the circumstances.

While such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements of an SA. The application and other explanatory material may also provide background information on matters addressed in an SA.

A59. Appendices form part of the application and other explanatory material. The purpose and intended use of an appendix are explained in the body of the related SA or within the title and introduction of the appendix itself.

A60. Introductory material may include, as needed, such matters as explanation of:

- ◆ The purpose and scope of the SA, including how the SA relates to other SAs.
- ◆ The subject matter of the SA.
- ◆ The respective responsibilities of the auditor and others in relation to the subject matter of the SA.
- ◆ The context in which the SA is set.

A61. An SA may include, in a separate section under the heading "Definitions", a description of the meanings attributed to certain terms for purposes of the SAs. These are provided to assist in the consistent application and interpretation of the SAs, and are not intended to override definitions that may be established for other purposes, whether in law, regulation or otherwise. Unless otherwise indicated, those terms will carry the same meanings throughout the SAs. The Glossary of Terms relating to Engagement and Quality Control Standards issued by the Auditing and Assurance Standards Board contains a complete listing of terms defined in the SAs. It also includes descriptions of other terms found in SAs to assist in common and consistent interpretation.

A62. When appropriate, additional considerations specific to audits of smaller entities and to certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), are included within the application and other explanatory material of an SA. These additional considerations assist in the application of the requirements of the SA in the audit of such entities. They do not, however, limit or reduce the responsibility of the auditor to apply and comply with the requirements of the SAs.

Considerations Specific to Smaller Entities

A63. For purposes of specifying additional considerations to audits of smaller entities, a “smaller entity” refers to an entity which typically possesses qualitative characteristics such as:

- (a) Concentration of ownership and management in a small number of individuals (often a single individual – either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and
- (b) One or more of the following:
 - (i) Straightforward or uncomplicated transactions;
 - (ii) Simple record-keeping;
 - (iii) Few lines of business and few products within business lines;
 - (iv) Few internal controls;
 - (v) Few levels of management with responsibility for a broad range of controls; or
 - (vi) Few personnel, many having a wide range of duties.

These qualitative characteristics are not exhaustive, they are not exclusive to smaller entities, and smaller entities do not necessarily display all of these characteristics.

A64. The considerations specific to smaller entities included in the SAs have been developed primarily with unlisted entities in mind. Some of the considerations, however, may be helpful in audits of smaller listed entities.

A65. The SAs refer to the proprietor of a smaller entity who is involved in running the entity on a day-to-day basis as the “owner-manager”.

Objectives Stated in Individual SAs (Ref: Para. 21)

A66. Each SA contains one or more objectives which provide a link between the requirements and the overall objectives of the auditor. The objectives in individual SAs serve to focus the auditor on the desired outcome of the SA, while being specific enough to assist the auditor in:

- ◆ Understanding what needs to be accomplished and, where necessary, the appropriate means of doing so; and
- ◆ Deciding whether more needs to be done to achieve them in the particular circumstances of the audit.

A67. Objectives are to be understood in the context of the overall objectives of the auditor stated in paragraph 11 of this SA. As with the overall objectives of the auditor, the ability to achieve an individual objective is equally subject to the inherent limitations of an audit.

A68. In using the objectives, the auditor is required to have regard to the interrelationships among the SAs. This is because, as indicated in paragraph A53, the SAs deal in some cases with general responsibilities and in others with the application of those responsibilities to specific topics. For example, this SA requires the auditor to adopt an attitude of professional skepticism; this is necessary in all aspects of planning and performing an audit but is not repeated as a requirement of each SA. At a more detailed level, SA 315 and SA 330 contain, among other things, objectives and requirements that deal with the auditor's responsibilities to identify and assess the risks of material misstatement and to design and perform further audit procedures to respond to those assessed risks, respectively; these objectives and

Overall Objectives of the Independent Auditor and the Conduct of an Audit requirements apply throughout the audit. An SA dealing with specific aspects of the audit (for example, SA 540 (Revised)) may expand on how the objectives and requirements of such SAs as SA 315 and SA 330 are to be applied in relation to the subject of the SA but does not repeat them. Thus, in achieving the objective stated in SA 540 (Revised), the auditor has regard to the objectives and requirements of other relevant SAs.

Use of Objectives to Determine Need for Additional Audit Procedures (Ref: Para. 21(a))

A69. The requirements of the SAs are designed to enable the auditor to achieve the objectives specified in the SAs, and thereby the overall objectives of the auditor. The proper application of the requirements of the SAs by the auditor is therefore expected to provide a sufficient basis for the auditor's achievement of the objectives. However, because the circumstances of audit engagements vary widely and all such circumstances cannot be anticipated in the SAs, the auditor is responsible for determining the audit procedures necessary to fulfill the requirements of the SAs and to achieve the objectives. In the circumstances of an engagement, there may be particular matters that require the auditor to perform audit procedures in addition to those required by the SAs to meet the objectives specified in the SAs.

Use of Objectives to Evaluate Whether Sufficient Appropriate Audit Evidence Has Been Obtained (Ref: Para. 21(b))

A70. The auditor is required to use the objectives to evaluate whether sufficient appropriate audit evidence has been obtained in the context of the overall objectives of the auditor. If as a result the auditor concludes that the audit evidence is not sufficient and appropriate, then the auditor may follow one or more of the following approaches to meeting the requirement of paragraph 21(b):

- ◆ Evaluate whether further relevant audit evidence has been, or will be, obtained as a result of complying with other SAs;
- ◆ Extend the work performed in applying one or more requirements; or
- ◆ Perform other procedures judged by the auditor to be necessary in the circumstances. Where none of the above is expected to be practical or possible in the circumstances, the auditor will not be able to obtain sufficient appropriate audit evidence and is required by the SAs to determine the effect on the auditor's report or on the auditor's ability to complete the engagement.

Complying with Relevant Requirements

Relevant Requirements (Ref: Para. 22)

A71. In some cases, an SA (and therefore all of its requirements) may not be relevant in the circumstances. For example, if an entity does not have an internal audit function, nothing in SA 610 (Revised)²³ is not relevant.

A72. Within a relevant SA, there may be conditional requirements. Such a requirement is relevant when the circumstances envisioned in the requirement apply and the condition exists. In general, the conditionality of a requirement will either be explicit or implicit, for example:

- ◆ The requirement to modify the auditor's opinion if there is a limitation of scope²⁴ represents an explicit conditional requirement.
- ◆ The requirement to communicate significant deficiencies in internal control identified during the audit to those

²³ SA 610 (Revised), "Using the Work of Internal Auditors".

²⁴ SA 705, "Modifications to the Opinion in the Independent Auditor's Report", paragraph 13.

charged with governance²⁵, which depends on the existence of such identified significant deficiencies; and the requirement to obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework²⁶, which depends on that framework requiring or permitting such disclosure, represent implicit conditional requirements.

Departure from a Requirement (Ref: Para. 23)

A73. SA 230 (Revised) establishes documentation requirements in those exceptional circumstances where the auditor departs from a relevant requirement²⁷. The SAs do not call for compliance with a requirement that is not relevant in the circumstances of the audit.

Failure to Achieve an Objective (Ref: Para. 24)

A74. Whether an objective has been achieved is a matter for the auditor's professional judgment. That judgment takes account of the results of audit procedures performed in complying with the requirements of the SAs, and the auditor's evaluation of whether sufficient appropriate audit evidence has been obtained and whether more needs to be done in the particular circumstances of the audit to achieve the objectives stated in the SAs. Accordingly, circumstances that may give rise to a failure to achieve an objective include those that:

- ◆ Prevent the auditor from complying with the relevant requirements of an SA.
- ◆ Result in its not being practicable or possible for the auditor to carry out the additional audit procedures or obtain further audit evidence as determined necessary from the use of the objectives in accordance with paragraph 21, for example due to a limitation in the available audit evidence.

A75. Audit documentation that meets the requirements of SA 230 (Revised) and the specific documentation requirements of other relevant SAs provides evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor. While it is unnecessary for the auditor to document separately (as in a checklist, for example) that individual objectives have been achieved, the documentation of a failure to achieve an objective assists the auditor's evaluation of whether such a failure has prevented the auditor from achieving the overall objectives of the auditor.

Modifications vis-à-vis ISA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing"

Deletion

Paragraph A11 of ISA 200 deals with the additional responsibilities for the execution of transactions and events in accordance with legislation or proper authority in case of public sector entities. Further, paragraph A57 of ISA 200 (A56 of Revised SA 200) deals with the auditor's additional responsibility arising out of the mandatory or obligatory laws or regulations applicable to that public sector entity. These additional responsibilities are not dealt by the SAs but dealt by the laws or regulations under which the public sector entity operates. Also, paragraph A63 of ISA 200 (A62 of Revised SA 200) deals with the inclusion of the paragraph specific to public sector entities in the application and explanatory

²⁵ SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", paragraph 9.

²⁶ SA 501 (Revised), "Audit Evidence – Specific Considerations for Selected Items".

²⁷ SA 230 (Revised), paragraph 12.

Overall Objectives of the Independent Auditor and the Conduct of an Audit material section. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of paragraphs A11, A57 and A63 in ISA, highlighting such fact, has been retained.

Limited Revisions Consequential to issuance of the Standard on Auditing (SA) 200 (Revised), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”

The amendments to the following have been shown in track change mode.

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

Standards issued by AASB Under the Authority of the Council of ICAI

3. The following Standards issued by the Auditing and Assurance Standards Board under the authority of the Council are collectively known as the Engagement Standards:

...

- (c) Standards on Assurance Engagements (SAEs), to be applied in assurance engagements ~~dealing with subject matters~~ other than [audits or reviews of](#) historical financial information.

Standards on Auditing

5. The Standards on Auditing (SAs) referred to in Paragraph 3(a) above are formulated in the context of an audit of financial statements by an independent auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. [The authority of SAs is set out in SA 200 \(Revised\)²⁸.](#)

~~6.—The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. It is undertaken to enhance the degree of confidence of intended users in the financial statements. The Standards on Auditing, taken together, provide the standards for the auditor's work in fulfilling this objective.~~

~~7.—In conducting an audit, the overall objective of the auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to report on the financial statements in accordance with the auditor's findings. However, owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs. In all cases, when this overall objective has not been or cannot be achieved, the SAs require the auditor to modify the auditor's opinion accordingly or withdraw from the engagement as may be appropriate, depending upon the facts and circumstances of each case.~~

~~8.—The auditor applies each Standard on Auditing (SA) relevant to the audit. An SA is relevant when the SA is in effect and the circumstances addressed by the SA exist.~~

~~9.—The SAs deal with the general responsibilities of the auditor, as well as the auditor's further considerations relevant to the application of those responsibilities to specific areas. An SA contains objectives and requirements together with related guidance in the form of application and other explanatory material. It may also contain introductory material that provides context to a proper understanding of the SAs, and definitions. It is, therefore, necessary to consider the entire text of an SA to understand and apply its requirements.~~

²⁸ [SA 200 \(Revised\), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”.](#)

Overall Objectives of the Independent Auditor and the Conduct of an Audit

Objectives

~~10.— Each SA contains an objective or objectives, which provide the context in which the requirements of the Standards on Auditing are set. Any limitation of the applicability of a specific Standard is made clear in the Standard itself. An individual Standard should be read in the context of the objective stated in the Standard as well as this Preface. The auditor aims to achieve these objectives, having regard to the interrelationships amongst the SAs. For this purpose, the auditor uses the objectives to judge whether, having complied with the requirements of the SAs, sufficient appropriate audit evidence has been obtained in the context of the overall objective of the auditor. Where an individual objective has not been or cannot be achieved, the auditor considers whether this prevents the auditor from achieving his overall objective.~~

Requirements²⁹

~~11.— The requirements of each SA are contained in a separate section and expressed using the word “shall”. The auditor applies the requirements in the context of the other material included in the Standard.~~

~~12.— The auditor complies with the requirements of an SA in all cases where they are relevant in the circumstances of the audit. In exceptional circumstances, however, the auditor may judge it necessary to depart from a relevant requirement by performing alternate audit procedures to achieve the aim of that requirement. The need for the auditor to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective.~~

~~13.— When a situation envisaged in paragraph 12 above arises, the auditor is required to document how alternative procedures performed achieve the aim of the requirement, and, the reasons for the departure. Further, his report also should draw attention to such departures. However, a mere disclosure in his report does not absolve an auditor from complying with the applicable Standard(s).~~

~~14.— A requirement is not relevant only in the cases where the SA is not relevant, or the circumstances envisioned do not apply because the requirement is conditional and the condition does not exist. The auditor is not required to comply with a requirement that is not relevant in the circumstances of the audit and this does not constitute a departure from the requirement. However, the auditor should document the steps undertaken by him to satisfy himself that the process adopted in the circumstances of the audit assisted him in achieving his overall objective.~~

Application and Other Explanatory Material

~~15.— The application and other explanatory material contained in an SA is an integral part of the SA as it provides further explanation of, and guidance for carrying out, the requirements of an SA, along with the background information on the matters addressed in the SA. It may include examples of procedures, some of which the auditor may judge to be appropriate in the circumstances. Such guidance is, however, not intended to impose a requirement.~~

~~16.— Appendices, which form part of the application and other explanatory material, are an integral part of an SA. The purpose and intended use of an appendix are explained in the body of the related Standard or within the title and introduction of the appendix itself.~~

Introductory Material and Definitions

~~17.— Introductory material may include, as needed, such matters as explanation of the purpose and scope of the~~

²⁹ The International Auditing and Assurance Standards Board, pursuant to its Clarity Project, has adopted a new format for presentation of the International Standards on Auditing (ISAs) issued by it. As per the new format, an ISA is divided into two sections, one, the requirements section and second, the application and other explanatory material section. Accordingly, the practice of presenting the standard portion (i.e., the principles enunciated) in bold lettering and the application/ explanatory guidance in plain lettering has been done away with. The entire text of the Standard, whether the requirements section or the application and other explanatory material section are presented in plain lettering. In so far as the Auditing and Assurance Standards (AASs) issued by the Institute are concerned, in the AASs issued prior to December 1997, the entire text of the Standard is presented in the plain lettering, whereas in case of the AASs issued subsequent to that date, the standard portion/ principles enunciated are given in bold lettering whereas the explanatory/ application guidance is given in plain lettering. The presentation of the Standards on Auditing, issued subsequent to the date this Preface comes into effect, would be in line with that adopted by the IAASB for its ISAs pursuant to the Clarity Project. In the due course, the existing Standards would also be brought in line with the abovementioned convention.

Standard, including how the SA relates to other SAs, the subject matter of the SA, specific expectations from the auditor and others, and the context in which the SA is set.

~~18. A Standard on Auditing may include, in a separate section under the heading 'Definitions', a description of the meanings attributed to certain terms for purposes of the SAs. These are provided to assist in the consistent application and interpretation of the SAs, and are not intended to override definitions that may be established for other purposes, whether in law, regulation or otherwise. Unless otherwise indicated, those terms will carry the same meanings throughout the SAs.~~

Standards on Quality Control

~~19.6.~~ SQCs are written to apply to firms³⁰ in respect of all their services falling under the Engagement Standards issued by the AASB of ICAI. The authority of SQCs is set out in the introduction to the SQCs.

SA 230 (Revised), "Audit Documentation"

Nature and Purposes of Audit Documentation

2. Audit documentation that meets the requirements of this SA and the specific documentation requirements of other relevant SAs provides:
 - (a) Evidence of the auditor's basis for a conclusion about the achievement of the overall objectives¹ of the auditor¹; and
 - (b) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements ...

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

- A11. The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes the significant matters identified during the audit and how they were addressed, or that includes cross-references to other relevant supporting audit documentation that provides such information. Such a summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist the auditor's consideration of the significant matters. It may also help the auditor to consider whether, in light of the audit procedures performed and conclusions reached, there is any individual relevant SA objective that the auditor ~~cannot achieve has not met or is unable to meet~~ that would prevent the auditor from achieving the overall objectives of the auditor's ~~overall objective~~ ...

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

A18. The ~~objectives and~~ requirements of the ~~in~~ SAs are designed to enable the auditor to achieve the objectives specified in the SAs, and thereby support the achievement of the overall objectives² of the auditor.⁷ Accordingly, other

³⁰ The term "firm" refers to a sole practitioner/proprietor, partnership, or any such entity of professional accountants, as may be permitted by law.

¹ SA 200 (Revised), "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", paragraph 11.

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

Overall Objectives of the Independent Auditor and the Conduct of an Audit than in exceptional circumstances, the SAs call for compliance with each requirement that is relevant in the circumstances of the audit.

A19. The documentation requirement applies only to requirements that are relevant in the circumstances. A requirement is not relevant⁸ only in the cases where:

- (a) The entire SA is not relevant [for example, if an entity does not have an internal audit function in a continuing engagement, nothing in ~~Proposed~~ SA 610 510 (Revised)⁹ is relevant]; or
- (b) ~~The circumstances envisioned do not apply because t~~he requirement is conditional and the condition does not exist (for example, the requirement to modify the auditor's opinion where there is an inability to obtain sufficient appropriate audit evidence, and there is no such inability).

SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements"

Responsibilities of the Auditor

5. An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. As described in SA 200 (Revised), "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing"³, owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may ~~will~~ not be detected, even though the audit is properly planned and performed in accordance with the SAs.

6. As described in SA 200 (Revised)⁴, the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

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

8. When obtaining reasonable assurance, the auditor is responsible for maintaining ~~an attitude of~~ professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in

⁸ Refer paragraph 22–~~23~~ of ISA 200 (Revised ~~and Redrafted~~).

⁹ ~~The Exposure Draft of~~ SA ~~510~~ 610 (Revised), "~~Initial Audit Engagements—Opening Balances~~ Using the Work of Internal Auditors", has been published in the ~~October, 2008~~ August, 2009 issue of the Journal.

³ Published in the March, 2010 issue of the Journal.

⁴ SA 200 (Revised), paragraph A51.

this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

Professional Skepticism

12. In accordance with SA 200 (Revised)⁵, the auditor shall maintain ~~an attitude of~~ professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. A7- A8)

A7. ~~Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence.~~ Maintaining ~~an attitude of~~ professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance where relevant. Due to the characteristics of fraud, the auditor's ~~attitude of~~ professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

A8. Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance, the auditor's ~~attitude of~~ professional skepticism is particularly important in considering the risks of material misstatement due to fraud because there may have been changes in circumstances.

SA 260 (Revised), "Communication with Those Charged with Governance"

Definitions

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

- (a) Those charged with governance – The person(s) or organisation(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector undertakings or an owner-manager. ~~In some cases, those charged with governance are responsible for approving³ the entity's financial statements (in other cases management has this responsibility).~~ For discussion of the diversity of governance structures, see paragraphs A5-A12.
- (b) Management – The person(s) with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager. ~~Management is responsible for the preparation of the financial statements, overseen by those charged with governance, and in some cases management is also responsible for approving⁴ the entity's financial statements (in other cases those charged with governance have this responsibility).~~

Those Charged with Governance (Ref: Para. 7)

⁵ SA 200 (Revised), paragraph 15.

³ ~~As described at paragraph [A43] of [proposed] SA 700, (hitherto known as AAS 28) "The Independent Auditor's Report on General Purpose Financial Statements". The Standard is being revised in the light of the corresponding International Standard.~~

⁴ ~~See footnote 3.~~

Overall Objectives of the Independent Auditor and the Conduct of an Audit

A5. Governance structures may vary reflecting different size and ownership characteristics. For example:

- ⊕◆ In most of the entities, those charged with governance hold positions that are an integral part of the entity's legal structure, for example, company directors. In others, for example, some government undertakings a body that is not part of the entity is charged with governance.
- ⊕◆ In some cases, some or all of those charged with governance are involved in managing the entity. In others, those charged with governance and management comprise different persons.
- ◆ In some cases, those charged with governance are responsible for approving⁵ the entity's financial statements (in other cases management has this responsibility).

All Final SAs

Phrases

“~~attitude of~~ professional skepticism”

- SA 250 (Revised), paragraph 8.
- SA 540 (Revised), paragraph A40.
- SA 550 (Revised), paragraph A9.

“affected by the inherent limitations of ~~inherent to~~ internal control”

- SA 315, paragraph A42.

⁵ As described at paragraph A39 of SA 700 (Revised), “Forming an Opinion and Reporting on Financial Statements,” having responsibility for approving in this context means having the authority to conclude that all the statements that comprise the financial statements, including the related notes, have been prepared.

Standard on Auditing-200A (SA-200A)- Objective and Scope of the Audit of Financial Statements

AAS 2 (SA 200A)- Objective and Scope of the Audit of Financial Statements

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The following is the text of the Auditing and Assurance Standard (AAS) 2*, "Objective and Scope of the Audit of Financial Statements", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in conjunction with the "Preface to the Statements on Standard Auditing Practices", issued by the Institute.

Introduction

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

Objective of an Audit

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

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

Responsibility for the Financial Statements

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

Scope of an Audit

5. The scope of an audit of financial statements will be determined by the auditor having regard to the terms of the engagement, the requirements of relevant legislation and the

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

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

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

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

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

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

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

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

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

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

11. The auditor is primarily concerned with items which either individually or as a group are material in relation to the affairs of an enterprise. However, it is difficult to lay down any definite standard by which materiality can be judged. Material items are those which might influence the decisions of the user of the financial statements[1]. It is a matter in which a decision is arrived at on the basis of the auditor's professional experience and judgement.

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

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

Effective Date

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

* Issued in April, 1985.

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

Standard on Auditing (SA) 230 (Revised)

Audit Documentation¹

Standard on Auditing (SA) 230 (Revised), "Audit Documentation" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review Other Assurance and Related Services²" which sets out the authority of SAs.

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements. It is to be adapted as necessary in the circumstances when applied to audits of other historical financial information. The specific documentation requirements of other SAs do not limit the application of this SA. Laws or regulations may establish additional documentation requirements.

Nature and Purposes of Audit Documentation

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

- a. Evidence of the auditor's basis for a conclusion about the achievement of the overall objective of the auditor; and
- b. Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

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

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

Effective Date

5. The objective of the auditor is to prepare documentation that provides:

- a. A sufficient and appropriate record of the basis for the auditor's report; and

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

Definitions

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

- a. **Audit documentation** - The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "workpapers" are also sometimes used).
- b. **Audit file** - One or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.
- c. **Experienced auditor** - An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of:
 - i. Audit processes;
 - ii. SAs and applicable legal and regulatory requirements;
 - iii. The business environment in which the entity operates; and
 - iv. Auditing and financial reporting issues relevant to the entity's industry

Requirements

Timely Preparation of Audit Documentation

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

Documentation of the Audit Procedures Performed and Audit Evidence Obtained

Form, Content and Extent of Audit Documentation

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

- a. The nature, timing, and extent of the audit procedures performed to comply with the SAs and applicable legal and regulatory requirements; (*Ref: Para. A6-A7*)
- b. The results of the audit procedures performed, and the audit evidence obtained; and
- c. Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. (*Ref: Para. A8-A11*)

9. In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:

- a. The identifying characteristics of the specific items or matters tested; (*Ref: Para. A12*)
- b. Who performed the audit work and the date such work was completed; and
- c. Who reviewed the audit work performed and the date and extent of such review (*Ref. Para. A13*)

10. The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place. (*Ref: Para. A14*)

11. If the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency (*Ref: Para. A15*)

Departure from a Relevant Requirement

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

Matters Arising after the Date of the Auditor's Report

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

- a. The circumstances encountered;
- b. The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and
- c. When and by whom the resulting changes to audit documentation were made and reviewed.

Assembly of the Final Audit File

14. The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. (*Ref: Para. A21-A22*)

15. After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period. (*Ref: Para. A23*)

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

- a. The specific reasons for making them; and
- b. When and by whom they were made and reviewed.

Application and Other Explanatory Material

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

A1. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalised. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

Documentation of the Audit Procedures Performed and Audit Evidence Obtained

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

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

- The size and complexity of the entity.
- The nature of the audit procedures to be performed.
- The identified risks of material misstatement.
- The significance of the audit evidence obtained.
- The nature and extent of exceptions identified.
- The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
- The audit methodology and tools used.

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

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

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

A4. The auditor need not include in audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

A5. Oral explanations by the auditor, on their own, do not represent adequate support for the work auditor performed or conclusions the auditor reached, but may be used to explain or clarify information contained in the audit documentation.

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

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

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

- The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.
- The existence of a signed engagement letter in the audit file demonstrates that the auditor has agreed the terms of the audit engagement with management, or where appropriate, those charged with governance.
- An auditor's report containing an appropriately qualified opinion demonstrates that the auditor has complied with the requirement to express a qualified opinion under the circumstances specified in the SAs.
- In relation to requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file:
 - For example, there may be no single way in which the auditor's professional skepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor's exercise of professional skepticism in accordance with SAs. Such evidence may include specific procedures performed to corroborate management's responses to the auditor's inquiries.
 - Similarly, that the engagement partner has taken responsibility for the direction, supervision and performance of the audit in compliance with the SAs may be evidenced in a number of ways within the audit documentation. This may include documentation of the engagement partner's timely involvement in aspects of the audit, such as participation in the team discussion required by SA 315⁴.

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

A8. Judging the significance of a matter requires an objective analysis of the facts and circumstances. Examples of significant matters include:

- Matters that give rise to significant risks (as defined in SA 315)⁵.
- Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's

responses to those risks.

- Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter paragraph in the auditor's report.

A9. An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results. Documentation of the professional judgments made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment. Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits, when reviewing matters of continuing significance (for example, when performing a retrospective review of accounting estimates).

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

- The rationale for the auditor's conclusion when a requirement provides that the auditor 'shall consider' certain information or factors, and that consideration is significant in the context of the particular engagement.
- The basis for the auditor's conclusion on the reasonableness of areas of subjective judgments (for example, the reasonableness of significant accounting estimates).
- The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

A11. The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes the significant matters identified during the audit and how they were addressed, or that includes cross references to other relevant supporting audit documentation that provides such information. Such a summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist the auditor's consideration of the significant matters. It may also help the auditor to consider whether, in light of the audit procedures performed and conclusions reached, there is any individual relevant SA objective that the auditor has not met or is unable to meet that would prevent the auditor from achieving the auditor's overall objective.

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

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

- For a detailed test of entity-generated purchase orders, the auditor may identify the documents selected for testing by their dates and unique purchase order numbers.
- For a procedure requiring selection or review of all items over a specific amount from a given population, the auditor may record the scope of the procedure and identify the population (for example, all journal entries over a specified amount from the journal register).

- For a procedure requiring systematic sampling from a population of documents, the auditor may identify the documents selected by recording their source, the starting point and the sampling interval (for example, a systematic sample of shipping reports selected from the shipping log for the period April 1 to September 30, starting with report number 12345 and selecting every 125th report).
- For a procedure requiring inquiries of specific entity personnel, the auditor may record the dates of the inquiries and the names and job designations of the entity personnel.
- For an observation procedure, the auditor may record the process or matter being observed, the relevant individuals, their respective responsibilities, and where and when the observation was carried out.

A13. Proposed SA 220⁶ (Revised) requires the auditor to review the audit work performed through review of the audit documentation. The requirement to document who reviewed the audit work performed does not imply a need for each specific working paper to include evidence of review. The requirement, however, means documenting what audit work was reviewed, who reviewed such work, and when it was reviewed.

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

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

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

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

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

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

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

Departure from Relevant Requirement (Ref: Para. 12)

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

A19. The documentation requirement applies only to requirements that are relevant in the circumstances. A requirement is not relevant⁸ only in the cases where:

- a. The SA is not relevant [for example, in a continuing engagement nothing in Proposed SA 510 (Revised)⁹ is relevant]; or
- b. The circumstances envisioned do not apply because the requirement is conditional and the condition does not exist (for example, the requirement to modify the auditor's opinion where there is an inability to obtain sufficient appropriate audit evidence, and there is no such inability).

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

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

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

A21. SQC 1 requires firms to establish policies and procedures for the timely completion of the assembly of audit files.¹² An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.¹³

A22. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process if they are administrative in nature. Examples of such changes include:

- Deleting or discarding superseded documentation.
- Sorting, collating and cross referencing working papers.
- Signing off on completion checklists relating to the file assembly process.
- Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

A23. SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation.¹⁴ The retention period for audit engagements ordinarily is no shorter than ten years from the date of the auditor's report, or, if later, the date of the group auditor's report.¹⁵

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

Ownership of Audit Documentation

A25. Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", issued by the Institute, provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

Material Modifications to ISA 230, "Audit Documentation"

Additions

1. Paragraph A23 of ISA 230 prescribes the minimum period of engagement documentation as five years. The SA 230 prescribes the minimum period of retention of engagement documentation as ten years since, as per the provisions of the Chartered Accountants Act, 1949, and regulations made there under, prescribe the minimum period of retention of working papers as ten years.

2. An additional paragraph A25 has been added from SQC 1, giving provisions regarding Ownership of Audit Documentation.

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

² Published in July, 2007 issue of the Journal.

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

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

⁵ SA 315, paragraph 4(c).

⁶ Hitherto known as AAS 17, refer paragraph 15.

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

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

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

¹⁰ SA 560 (Revised), "Subsequent Events", paragraph 13.

¹¹ Refer footnote 3.

¹² Refer para 74 of SQC 1.

¹³ Refer para 75 of SQC 1.

¹⁴ Refer para 82 of SQC 1.

¹⁵ Refer para 83 of SQC 1.

STANDARD ON AUDITING (SA) 240 (REVISED)¹

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

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

Introduction

Scope of this SA

This Standard on Auditing (SA) deals with the auditor's responsibilities relating to fraud in an audit of financial statements. Specifically, it expands on how SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment"³, and SA 330, "The Auditor's Responses to Assessed Risks"⁴ are to be applied in relation to risks of material misstatement due to fraud.

Characteristics of Fraud

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

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

Responsibility for the Prevention and Detection of Fraud

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

Responsibilities of the Auditor

5. An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. As described in SA 200, "Objective and General Principles Governing an Audit of Financial Statements"⁵, owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.

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

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

8. When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

Effective Date

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

10. The objectives of the auditor are:

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

- b. To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses, and
- c. To respond appropriately to identified or suspected fraud.

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

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

Requirements

Professional Skepticism

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

13. Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. (Ref: Para. A9)

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

Discussion Among the Engagement Team⁶

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

Risk Assessment Procedures and Related Activities

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

Management and Others within the Entity

17. The auditor shall make inquiries of management regarding:

- a. Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments; (Ref: Para. A12-A13)
- b. Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist; (Ref: Para. A14)
- c. Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and
- d. Management's communication, if any, to employees regarding its views on business practices and ethical behaviour.

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

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

Those Charged with Governance

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

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

Unusual or Unexpected Relationships Identified

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

Other Information

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

Evaluation of Fraud Risk Factors

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

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

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

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

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

Responses to the Assessed Risks of Material Misstatement Due to Fraud

Overall Responses

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

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

- a. Assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud for the engagement; (Ref: Para. A34-A35)
- b. Evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings; and

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

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

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

Audit Procedures Responsive to Risks Related to Management Override of Controls

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

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

- a. Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:
 - i. Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;
 - ii. Select journal entries and other adjustments made at the end of a reporting period; and
 - iii. Consider the need to test journal entries and other adjustments throughout the period. (Ref: Para. A41-A44)
- b. Review accounting estimates⁷ for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the auditor shall:
 - i. Evaluate whether the judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor shall reevaluate the accounting estimates taken as a whole; and
 - ii. Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of

the prior year⁸. (Ref: Para. A45-A46)

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

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

Evaluation of Audit Evidence (Ref.. Para. A 48)

34. The auditor shall evaluate whether analytical procedures⁹ that are performed when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity and its environment indicate a previously unrecognized risk of material misstatement due to fraud. (Ref: Para. A49)

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

36. If the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor shall reevaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained. (Ref: Para. A51)

37. When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud the auditor shall evaluate the implications for the audit. (Ref: Para. A52)

Auditor Unable to Continue the Engagement

38. If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

- a. Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
- b. Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and
- c. If the auditor withdraws:
 - i. Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and
 - ii. Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, 41 the auditor's withdrawal from the engagement and the reasons for the withdrawal. (Ref: Para. A53-A56)

Management Representations

39. The auditor shall obtain written representations from management that:

- a. It acknowledges its responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;
- b. It has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud;
- c. It has disclosed to the auditor its knowledge of fraud or suspected fraud affecting the entity involving:
 - i. Management;
 - ii. Employees who have significant roles in internal control; or
 - iii. Others where the fraud could have a material effect on the financial statements; and
- d. It has disclosed to the auditor its knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (Ref: Para. A57-A58)

Communications to Management and with Those Charged with Governance

40. If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. (Ref: Para. A59)

41. Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving:

- a. Management;
- b. Employees who have significant roles in internal control; or

- c. Others where the fraud results in a material misstatement in the financial statements.

The auditor shall communicate these matters to those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit. (Ref: Para. A60-A62)

42. In accordance with SA 260 (Revised), "Communication with Those Charged with Governance"¹⁰, the auditor shall communicate with those charged with governance any other matters related to fraud that are, in the auditor's judgment, relevant to their responsibilities. (Ref: Para. A63)

Communications to Regulatory and Enforcement Authorities

43. If the auditor has identified or suspects a fraud, the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances. (Ref: Para. A64-A66)

Documentation

44. The auditor's documentation of the understanding of the entity and its environment and the assessment of the risks of material misstatement required by SA 315 shall include:

- a. The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and
- b. The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.

45. The auditor's documentation of the responses to the assessed risks of material misstatement required by SA 330 shall include:

- a. The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and
- b. The results of the audit procedures, including those designed to address the risk of management override of controls.

46. The auditor shall document communications about fraud made to management, those charged with governance, regulators and others.

47. When the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is not applicable in the circumstances of the engagement, the auditor shall document the reasons for that conclusion.

Application and Other Explanatory Material

Characteristics of Fraud (Ref. Para. 3)

A1. Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. For example:

- Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome particularly since the consequences to management for failing to meet financial goals can be significant. Similarly, individuals may have an incentive to misappropriate assets, for example, because the individuals are living beyond their means.
- A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in internal control.
- Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

A2. Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. It can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability. Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting. Such a situation could occur when, due to pressures to meet market expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.

A3. Fraudulent financial reporting may be accomplished by the following:

- Manipulation, falsification' (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.

- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

A4. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:

- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- Inappropriately adjusting assumptions and changing judgments used to estimate account balances.
- Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
- Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.
- Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
- Altering records and terms related to significant and unusual transactions.

A5. Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:

- Embezzling receipts (for example, misappropriating collections on accounts of receivable or diverting receipts in respect of written off accounts to personal bank accounts).
- Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).
- Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).
- Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

A6. The auditor may, at times, be required to by a legislation or a regulation to make a specific assertion in respect of frauds on/ by the entity in his report. For example, Clause (xxi) of Paragraph 4 of the Companies (Auditor's Report) Order, 2003 requires the auditor to specifically report "whether any fraud on or by the entity has been noticed or reported during the year; if yes, the nature and amount involved is to be indicated". Similarly, in case of audit of banks, the auditors, in terms of the circular no. D13SYGM

(F).No. BC/23.08.001/2001 02, is required to report to the Reserve Bank of India anything susceptible to fraud or fraudulent activity or act of excess power or any foul play in any transaction. Consequently, in such cases, the auditor's responsibilities may not be limited to consideration of risks of material misstatement of the financial statements but may also include a broader responsibility to consider risks of fraud.

Professional Skepticism (Ref Para. 12-14)

A7. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. Maintaining an attitude of professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance where relevant. Due to the characteristics of fraud, the auditor's attitude of professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

A8. Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance, the auditor's attitude of professional skepticism is particularly important in considering the risks of material misstatement due to fraud because there may have been changes in circumstances.

A9. As explained in SA 200, an audit performed in accordance with SAs rarely involves the authentication of documents, nor is the auditor trained as or expected to be an expert in such authentication. However, when the auditor identifies conditions that cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, possible procedures to investigate further may include:

- Confirming directly with the third party.
- Using the work of an expert to assess the document's authenticity.

Discussion Among the Engagement Team (Ref: Para. 15)

A10. Discussing the susceptibility of the entity's financial statements to material misstatement due to fraud with the engagement team:

- Provides an opportunity for more experienced engagement team members to share their insights about how and where the financial statements may be susceptible to material misstatement due to fraud.
- Enables the auditor to consider an appropriate response to such susceptibility and to determine which members of the engagement team will conduct certain audit procedures.
- Permits the auditor to determine how the results of audit procedures will be shared among the engagement team and how to deal with any allegations of fraud that may come to the auditor's attention.

A 11. The discussion may include such matters as:

- An exchange of ideas among engagement team members about how and where they believe the entity's financial statements may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.
- A consideration of circumstances that might be indicative of earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting.
- A consideration Of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud.
- A consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation.
- A consideration of any unusual or unexplained changes in behavior or lifestyle of management or employees which have come to the attention of the engagement team.
- An emphasis on the importance of maintaining a proper state of mind throughout the audit regarding the potential for material misstatement due to fraud.
- A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud.
- A consideration of how an element of unpredictability will be incorporated into the nature, timing and extent of the audit procedures to be performed.
- A consideration of the audit procedures that might be selected to respond to the susceptibility of the entity's financial statement to material misstatement due to fraud and whether certain types of audit procedures are more effective than others.
- A consideration of any allegations of fraud that have come to the auditor's attention.
- A consideration of the risk of management override of controls.

Risk Assessment Procedures and Related Activities

Inquiries of Management

Management's Assessment of the Risk of Material Misstatement Due to Fraud (Ref: Para. 17(a))

A12. Management is responsible for the entity's internal control and for the preparation of the financial statements. Accordingly, it is appropriate for the auditor to make inquiries of management regarding management's own assessment of the risk of fraud and the controls in place to prevent and detect it. The nature, extent and frequency of management's assessment of such risk and controls may vary from entity to entity. In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In other entities, management's assessment may be less structured and less frequent. The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may in some circumstances be indicative of the lack of importance that management places on internal control.

Considerations specific to smaller entities

A13. In some entities, particularly smaller entities, the focus of management's assessment may be on the risks of employee fraud or misappropriation of assets.

Management's Process for Identifying and Responding to the Risks of Fraud (Ref: Para. 17(b))

A14.1n the case of entities with multiple locations management's processes may include different levels of monitoring of operating locations, or business segments. Management may also have identified particular operating locations or business segments for which a risk of fraud may be more likely to exist.

Inquiry of Management and Others within the Entity (Ref: Para. 18)

A15.The auditor's inquiries of management may provide useful information concerning the risks of material misstatements in the financial statements resulting from employee fraud. However, such inquiries are unlikely to provide useful information regarding the risks of material misstatement in the financial statements resulting from management fraud. Making inquiries of others within the entity may provide individuals with an opportunity to convey information to the auditor that may not otherwise be communicated.

A16. Examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud include:

- Operating personnel not directly involved in the financial reporting process.
- Employees with different levels of authority.
- Employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees.
- In house legal counsel.
- Chief ethics officer or equivalent person.
- The person or persons charged with dealing with allegations of fraud.

A17. Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information.

Inquiry of Internal Audit (Ref: Para. 19)

A18. SA 610, "Considering the Work of Internal Audit¹¹", establishes requirements and provides guidance in audits of those entities that have an internal audit function. In carrying out the requirement of SA 610 in the context of fraud, the auditor may inquire about specific internal audit activities including, for example:

- The procedures performed, if any, by the internal auditors during the year to detect fraud.

- Whether management has satisfactorily responded to any findings resulting from those procedures.

Obtaining an Understanding of Oversight Exercised by Those Charged With Governance (Ref: Para. 20)

A19. Those charged with governance of an entity have oversight responsibility for systems for monitoring risk financial control and compliance with the law. In many entities, corporate governance practices are well developed and those charged with governance play an active role in oversight of the entity's assessment of the risks of fraud and of the relevant internal control. Since the responsibilities of those charged with governance and management may vary by entity, it is important that the auditor understands their respective responsibilities to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals.¹²

A20. An understanding of the oversight exercised by those charged with governance may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of internal control over risks of fraud, and the competency and integrity of management. The auditor may obtain this understanding in a number of ways, such as by attending meetings where such discussions take place, reading the minutes from such meetings or making inquiries of those charged with governance.

Considerations Specific to Smaller Entities

A21. In some cases, all of those charged with governance are involved in managing the entity. This may be the case in a small entity where a single owner manages the entity and no one else has a governance role. In these cases, there is ordinarily no action on the part of the auditor because there is no oversight separate from management.

Consideration of Other Information (Ref: Para. 23)

A22. In addition to information obtained from applying analytical procedures, other information obtained about the entity and its environment may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members may provide information that is helpful in identifying such risks. In addition, information obtained from the auditor's client acceptance and retention processes, and experience gained on other engagements performed for the entity, for example engagements to review interim financial information, may be relevant in the identification of the risks of material misstatement due to fraud.

Evaluation of Fraud Risk Factors (Ref: Para. 24)

A23. The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, the auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud (fraud risk factors). For example:

- The need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud;
 - o The granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; and
 - o A control environment that is not effective may create an opportunity to commit fraud.

A24. Fraud risk factors cannot easily be ranked in order of importance. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present risks of material misstatement. Accordingly, the determination of whether a fraud risk factor is present and whether it is to be considered in assessing the risks of material misstatement of the financial statements due to fraud requires the exercise of professional judgment.

A25. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in Appendix 1. These illustrative risk factors are classified based on the three conditions that are generally present when fraud exists:

- An incentive or pressure to commit fraud;
- A perceived opportunity to commit fraud; and
- An ability to rationalize the fraudulent action.

Risk factors reflective of an attitude that permits rationalisation of the fraudulent action may not be susceptible to observation by the auditor. Nevertheless, the auditor may become aware of the existence of such information. Although the fraud risk factors described in Appendix 1 cover a broad range of situations that may be faced by auditors, they are only examples and other risk factors may exist.

A26. The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example, in the case of a large entity, there may be factors that generally constrain improper conduct by management, such as:

- Effective oversight by those charged with governance.
- An effective internal audit function.
- The existence and enforcement of a written code of conduct.

Furthermore, fraud risk factors considered at a business segment operating level may provide different insights when compared with those obtained when considered at an entity-wide level).

Considerations Specific to Smaller Entities

A27. In the case of a small entity, some or all of these considerations may be inapplicable or less relevant. For example, a smaller entity may not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Domination of management by a

single individual in 3 small entity does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In some entities, the need for management authorization can compensate for otherwise weak controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential weakness since there is an opportunity for management override of controls.

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

Risks of Fraud in Revenue Recognition (Ref: Para. 26)

A28. Material misstatement due to fraudulent financial reporting relating to revenue recognition often results from an overstatement of revenues through, for example, premature revenue recognition or recording fictitious revenues. It may result also from an understatement of revenues through, for example, improperly shifting revenues to a later period.

A29. The risks of fraud in revenue recognition may be greater in some entities than others. For example, there may be pressures or incentives on management to commit fraudulent financial reporting through inappropriate revenue recognition in the case of listed entities when, for example, performance is measured in terms of year over year revenue growth or profit. Similarly, for example, there may be greater risks of fraud in revenue recognition in the case of entities that generate a substantial portion of revenues through cash sales.

A30. The presumption that there are risks of fraud in revenue recognition may be rebutted. For example, the auditor may conclude that there is no risk of material misstatement due to fraud relating to revenue recognition in the case where there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property.

Identifying and Assessing the Risks of Material Misstatement Due to Fraud and Understanding the Entity's Related Controls (Ref: Para. 27)

A31. As explained in SA 315 management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume. In determining which controls to implement to prevent and detect fraud, management considers the risks that the financial statements may be materially misstated as a result of fraud. As part of this consideration, management may conclude that it is not cost effective to implement and maintain a particular control in relation to the reduction in the risks of material misstatement due to fraud to be achieved.

A32. It is therefore important for the auditor to obtain an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud. In doing so, the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. Information from obtaining this understanding may also be useful in identifying fraud risks factors that may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

Responses to the Assessed Risks of Material Misstatement Due to Fraud

Overall Responses (Ref: Para. 28)

A33. Determining overall responses to address the assessed risks of material misstatement due to fraud generally includes the consideration of how the overall conduct of the audit can reflect increased professional skepticism, for example, through:

- Increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions.
- Increased recognition of the need to corroborate management explanations or representations concerning material matters.

It also involves more general considerations apart from the specific procedures otherwise planned; these considerations include the matters listed in paragraph 29, which are discussed below.

Assignment and Supervision of Personnel (Ref: Para. 29(a))

A34. The auditor may respond to identified risks of material misstatement due to fraud by, for example, assigning additional individuals with specialised skill and knowledge, such as forensic and IT experts, or by assigning more experienced individuals to the engagement.

A35. The extent of supervision reflects the auditor's assessment of risks of material misstatement due to fraud and the competencies of the engagement team members performing the work.

Unpredictability in the Selection of Audit Procedures (Ref: Para. 29(c))

A36. incorporating an element of unpredictability in the selection of the nature, timing and extent of audit procedures to be performed is important as individuals within the entity who are familiar with the audit procedures normally performed on engagements may be more able to conceal fraudulent financial reporting. This can be achieved by, for example:

- Performing substantive procedures on selected account balances and assertions not otherwise tested due to their materiality or risk.
- Adjusting the timing of audit procedures from that otherwise expected.
- Using different sampling methods.
- Performing audit procedures at different locations or at locations on an unannounced basis.

Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level (Ref: Para. 30)

A37. The auditor's responses to address the assessed risks of material misstatement due to fraud at the assertion level may include changing the nature, timing, and extent of audit procedures in the following ways:

- The nature of audit procedures to be performed may need to be changed to obtain audit evidence that is more reliable and relevant or to obtain additional corroborative information. This may affect both the type of audit procedures to be performed and their combination. For example:
 - o Physical observation or inspection of certain assets may become more important or the auditor may choose to use computer assisted audit techniques to gather more evidence about data contained in significant accounts or electronic transaction files.
 - o The auditor may design procedures to obtain additional corroborative information. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a related risk that management is inflating sales by entering into sales agreements that include terms that preclude revenue recognition or by invoicing sales before delivery. In these circumstances, the auditor may, for example, design external confirmations not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor might find it effective to supplement such external confirmations with inquiries of non financial personnel in the entity regarding any changes in sales agreements and delivery terms.
 - o The timing of substantive procedures may need to be modified. The auditor may conclude that performing substantive testing at or near the period end better addresses an assessed risk of material misstatement due to fraud. The auditor may conclude that, given the assessed risks of intentional misstatement or manipulation, audit procedures to extend audit conclusions from an interim date to the period end would not be effective. In contrast, because an intentional misstatement for example, a misstatement involving improper revenue recognition may have been initiated in an interim period, the auditor may elect to apply substantive procedures to transactions occurring earlier in or throughout the reporting period.
 - o The extent of the procedures applied reflects the assessment of the risks of material misstatement due to fraud. For example, increasing sample sizes or performing analytical procedures at a more detailed level may be appropriate. Also, computer assisted audit techniques may enable more extensive testing of electronic transactions and account files. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

A38. If the auditor identifies a risk of material misstatement due to fraud that affects inventory quantities, examining the entity's inventory records may help to identify locations or items that require specific attention during or after the physical inventory count. Such a review may lead to a decision to observe inventory counts at certain locations on an unannounced basis or to conduct inventory counts at all that locations on the same date.

A39. The auditor may identify a risk of material misstatement due to fraud affecting a number of accounts and assertions. These may include asset valuation, estimates relating to specific

transactions (such as acquisitions, restructurings, or disposals of a segment of the business), and other significant accrued liabilities (such as pension and other post employment benefit obligations, or environmental remediation liabilities). The risk may also relate to significant changes in assumptions relating to recurring estimates. Information gathered through obtaining an understanding of the entity and its environment may assist the auditor in evaluating the reasonableness of such management estimates and underlying judgments and assumptions. A retrospective review of similar management judgments and assumptions applied in prior periods may also provide insight about the reasonableness of judgments and assumptions supporting management estimates.

A40. Examples of possible audit procedures to address the assessed risks of material misstatement due to fraud, including those that illustrate the incorporation of an element of unpredictability, are presented in Appendix 2. The appendix includes examples of responses to the auditor's assessment of the risks of material misstatement resulting from both fraudulent financial reporting, including fraudulent financial reporting resulting from revenue recognition, and misappropriation of assets.

Audit Procedures Responsive to Risks Related to Management Override of Controls

Journal Entries and Other Adjustments (Ref.. Para. 32(a))

A41. Material misstatement of financial statements due to fraud often involve the manipulation of the financial reporting process by recording inappropriate or unauthorized journal entries. This may occur throughout the year or at period end, or by management making adjustments to amounts reported in the financial statements that are not reflected in journal entries, such as through consolidating adjustments and reclassifications.

A42. Further, the auditor's consideration of the risks of material misstatement associated with inappropriate override of controls over journal entries is important since automated processes and controls may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or to the financial reporting system. Furthermore, when IT is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information systems.

A43. When identifying and selecting journal entries and other adjustments for testing and determining the appropriate method of examining the underlying support for the items selected, the following matters are of relevance:

- The assessment of the risks of material misstatement due to fraud the presence of fraud risk factors and other information obtained during the auditor's assessment of the risks of material misstatement due to fraud may assist the auditor to identify specific classes of journal entries and other adjustments for testing.
- Controls that have been implemented over journal entries and other adjustments effective controls over the preparation and posting of journal entries and other adjustments may

reduce the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of the controls.

- The entity's financial reporting process and the nature of evidence that can be obtained for many entities routine processing of transactions involves a combination of manual and automated steps and procedures. Similarly, the processing of journal entries and other adjustments may involve both manual and automated procedures and controls. When information technology is used in the financial reporting process, journal entries and other adjustments may exist only in electronic form.
- The characteristics of fraudulent journal entries or other adjustments inappropriate journal entries or other adjustments often have unique identifying characteristics. Such characteristics may include entries (a) made to unrelated, unusual, or seldom used accounts, (b) made by individuals who typically do not make journal entries, (c) recorded at the end of the period or as post closing entries that have little or no explanation or description, (d) made either before or during the preparation of the financial statements that do not have account numbers, or (e) containing round numbers or consistent ending numbers.
- The nature and complexity of the accounts inappropriate journal entries or adjustments may be applied to accounts that (a) contain transactions that are complex or unusual in nature, (b) contain significant estimates and period end adjustments, (c) have been prone to misstatements in the past, (d) have not been reconciled on a timely basis or contain unreconciled differences, (e) contain inter company transactions, or (f) are otherwise associated with an identified risk of material misstatement due to fraud. In audits of entities that have several locations or components, consideration is given to the need to select journal entries from multiple locations.
- Journal entries or other adjustments processed outside the normal course of business non standard journal entries may not be subject to the same level of internal control as those journal entries used on a recurring basis to record transactions such as monthly sales, purchases and cash disbursements.

A44. The auditor uses professional judgment in determining the nature, timing and extent of testing of journal entries and other adjustments. However, because fraudulent journal entries and other adjustments are often made at the end of a reporting period, paragraph 32(a)(ii) requires the auditor to select the journal entries and other adjustments made at that time. Further, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how the fraud is accomplished, paragraph 32(a)(iii) requires the auditor to consider whether there is also a need to test journal entries and other adjustments throughout the period.

Accounting Estimates (Ref: Para. 32(b))

A45.1n preparing financial statements, management is responsible for making a number of judgments or assumptions that affect significant accounting estimates and for monitoring the reasonableness of such estimates on an ongoing basis. Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates. This may be achieved by, for example, understating or overstating all provisions or reserves in the same fashion so as to be designed either to smooth earnings over two or more accounting periods, or to achieve a

designated earnings level in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.

A46. The purpose of performing a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year is to determine whether there is an indication of a possible bias on the part of management. It is not intended to call into question the auditor's professional judgments made in the prior year that were based on information available at the time.

Business Rationale for Significant Transactions (Ref: Para. 32(c))

A47. Indicators that may suggest that significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual, may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets include:

- The form of such transactions appears overly complex (for example, the transaction involves multiple entities within a consolidated group or multiple unrelated third parties).
- Management has not discussed the nature of and accounting for such transactions with those charged with governance of the entity, and there is inadequate documentation.
- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- Transactions that involve non consolidated related parties, including special purpose entities, have not been properly reviewed or approved by those charged with governance of the entity.
- The transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.

Evaluation of Audit Evidence (Ref.. Para. 34-37)

A48. SA 330 requires the auditor, based on the audit procedures performed and the audit evidence obtained, to evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate. This evaluation is primarily a qualitative matter based on the auditor's judgment. Such an evaluation may provide further insight about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures. Appendix 3 contains examples of circumstances that may indicate the possibility of fraud.

Analytical Procedures Performed in the Overall Review of the Financial Statements (Ref: Para. 34)

A49. Determining which particular trends and relationships may indicate a risk of material misstatement due to fraud requires professional judgment. Unusual relationships involving year end revenue and income are particularly relevant. These might include, for example: uncharacteristically large amounts of income being reported in the last few weeks of the

reporting period or unusual transactions; or income that is inconsistent with trends in cash flow from operations.

Consideration of Identified Misstatements (Ref: Para. 35-37)

A50. Since fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so or some rationalization of the act, an instance of fraud is unlikely to be an isolated occurrence. Accordingly, misstatements, such as numerous misstatements at a specific location even though the cumulative effect is not material, may be indicative of a risk of material misstatement due to fraud.

A51. The implications of identified fraud depend on the circumstances. For example, an otherwise insignificant fraud may be significant if it involves senior management. In such circumstances, the reliability of evidence previously obtained may be called into question, since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. There may also be a possibility of collusion involving employees, management or third parties.

A52. SA 450, "Evaluation of Misstatements Identified during the Audit"¹³, and SA 700, "The Independent Auditor's Report on General Purpose Financial Statements"¹⁴, establish requirements and provide guidance on the evaluation and disposition of misstatements and the effect on the auditor's opinion in the auditor's report.

Auditor Unable to Continue the Engagement (Ref. Para. 38)

A53. Examples of exceptional circumstances that may arise and that may bring into question the auditor's ability to continue performing the audit include:

- a. The entity does not take the appropriate action regarding fraud that the auditor considers necessary in the circumstances, even when the fraud is not material to the financial statements;
- b. The auditor's consideration of the risks of material misstatement due to fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or
- c. The auditor has significant concern about the competence or integrity of management or those charged with governance.

A54. Because of the variety of the circumstances that may arise, it is not possible to describe definitively when withdrawal from an engagement is appropriate. Factors that affect the auditor's conclusion include the implications of the involvement of a member of management or of those charged with governance (which may affect the reliability of management representations) and the effects on the auditor of a continuing association with the entity.

A55. The auditor has professional and legal responsibilities in such circumstances and these responsibilities may vary under different legislations and regulations and, accordingly, the clients. Under some legislations/ regulations, for example, the auditor may be entitled to, or required to, make a statement or report to the person or persons who made the audit appointment

or, in some cases, to regulatory authorities. Given the exceptional nature of the circumstances and the need to consider the legal requirements, the auditor may consider it appropriate to seek legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action, including the possibility of reporting to shareholders, regulators or others .¹⁵

A56. In some cases, the option of withdrawing from the engagement may not be available to the auditor due to the nature of the terms of appointment or public interest considerations.

Management Representations (Ref.. Para. 39)

A57. SA 580, "Management Representation"¹⁶ establishes requirements and provides guidance on obtaining appropriate representations from management in the audit. In addition to acknowledging its responsibility for the financial statements, it is important that, irrespective of the size of the entity, management acknowledge its responsibility for internal control designed, implemented and maintained to prevent and detect fraud.

A58. Because of the nature of fraud and the difficulties encountered by auditors in detecting material misstatements in the financial statements resulting from fraud, it is important that the auditor obtain a written representation from management confirming that it has disclosed to the auditor:

- a. The results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud; and
- b. Its knowledge of actual, suspected or alleged fraud affecting the entity.

Communications to Management and with Those Charged with Governance

Communication to Management (Ref: Para. 40)

A59. When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of the appropriate level of management as soon as practicable. This is so even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity's organization). The determination of which level of management is the appropriate one is a matter of professional judgment and is affected by such factors as the likelihood of collusion and the nature and magnitude of the suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the suspected fraud.

Communication with Those Charged with Governance (Ref: Para. 41)

A60. The auditor's communication with those charged with governance may be made orally or in writing. SA260 (Revised) identifies factors the auditor considers in determining whether to communicate orally or in writing. Due to the nature and sensitivity of fraud involving senior management, or fraud that results in a material misstatement in the financial statements,

the auditor reports such matters on a timely basis and may consider it necessary to also report such matters in writing.

A61. In some cases, the auditor may consider it appropriate to communicate with those charged with governance when the auditor becomes aware of fraud involving employees other than management that does not result in a material misstatement. Similarly, those charged with governance may wish to be informed of such circumstances. The communication process is assisted if the auditor and those charged with governance agree at an early stage in the audit about the nature and extent of the auditor's communications in this regard.

A62. In the exceptional circumstances where the auditor has doubts about the integrity or honesty of management or those charged with governance, the auditor may consider it appropriate to obtain legal advice to assist in determining the appropriate course of action.

Other Matters Related to Fraud (Ref: Para. 42)

A63. Other matters related to fraud to be discussed with those charged with governance of the entity may include, for example:

- Concerns about the nature, extent and frequency of management's assessments of the controls in place to prevent and detect fraud and of the risk that the financial statements may be misstated.
- A failure by management to appropriately address identified material weaknesses in internal control, or to appropriately respond to an identified fraud.
- The auditor's evaluation of the entity's control environment, including questions regarding the competence and integrity of management.
- Actions by management that may be indicative of fraudulent financial reporting, such as management's selection and application of accounting policies that may be indicative of management's effort to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.
- Concerns about the adequacy and completeness of the authorization of transactions that appear to be outside the normal course of business.

Communications to Regulatory and Enforcement Authorities (Ref. Para. 43)

A64. The auditor's professional duty to maintain the confidentiality of client information may preclude reporting fraud to a party outside the client entity. However, the auditor's legal responsibilities vary by law & statute and, in certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law. In some entities, for example, in case of audit of banks, the auditor has a statutory duty to report the occurrence of fraud to the supervisory authorities, i.e., the Reserve Bank of India, in terms of the latter's circular no. D13S.FGV(F).No. BC/23,08.001/2001 02. Also, in some entities the auditor may have a duty to report misstatements to authorities in those cases where Management and those charged with governance fail to take corrective action.

A65. The auditor may consider it appropriate to obtain legal advice to determine the appropriate course of action in the circumstances, the purpose of which is to ascertain the steps necessary in considering the public interest aspects of identified fraud.

A66. In some clients, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related legislation or regulation.

Material Modifications to ISA 240, The Auditor's Responsibility relating to Fraud in an Audit of Financial Statements

Additions

1. In paragraph A64, the guidance has been made entity specific, in the context of Indian legal requirement, by way of an example.

Deletions

1. Paragraph A6 of the Application Section of ISA 240 dealt with the application of the requirements of ISA 240 to the audits of public sector entities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific reporting requirement may also exist in case of non public sector entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A6, highlighting the fact that in some cases, the auditors may be required by the legislature or the regulator to specifically report on the instances of actual/suspected fraud in the client entity, has been retained and examples of such situations have also been added.

2. Paragraph A56 of the Application Section of ISA 240 dealt with the considerations specific to public sector entities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that option of withdrawal may not be available in case of non public sector entities pursuant to a requirement under the statute or terms of appointment of the auditor. Accordingly, the spirit of erstwhile A56, highlighting that in some cases, the auditors may not be having an option to withdraw from the engagement has been retained.

3. Paragraph A66 of the Application Section of ISA 240 dealt with the application of the requirements of ISA 240 to the audits of public sector entities. Since as mentioned in the

"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services" the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific reporting requirement may also exist in case of non public sector entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of A66 as given ISA 240, highlighting the fact that in some cases, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related legislation or regulation, has been retained.

Appendix 1
(Ref: Para. A25)

Examples of Fraud Risk Factors

The fraud risk factors identified in this Appendix are examples of such factors that may be faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor's consideration, i.e., fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (a) incentives/pressures, (b) opportunities, and (c) attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of, the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.

Incentives1Pressures

Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

- High degree of competition or market saturation, accompanied by declining margins.
- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
- Significant declines in customer demand and increasing business failures in either the industry or overall economy.

- Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent.
- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.
- Rapid growth or unusual profitability especially compared to that of other companies in the same industry.
- New accounting, statutory, or regulatory requirements.

Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

- Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages.
- Need to obtain additional debt or equity financing to stay competitive -- including financing of major research and development or capital expenditures.
- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements.
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.

Information available indicates that the personal financial situation of management or those charged with governance is threatened by the entity's financial performance arising from the following:

- Significant financial interests in the entity.
- Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow¹⁷.
- Personal guarantees of debts of the entity.
- There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.

Opportunities

the nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

- Significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's length transactions.

- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.
- Use of business intermediaries for which appears to be no clear business justification.
- Significant bank accounts or subsidiary or branch operations in tax haven jurisdictions for which there appears to be no clear business justification.

The monitoring of management is not effective as a result of the following:

- Domination of management by a single person or small group (in a non owner-managed business) without compensating controls.
- Oversight by those charged with governance over the financial reporting process and internal control is not effective.

There is a complex or unstable organisational structure, as evidenced by the following:

- Difficulty in determining the organization or individuals that have controlling interest in the entity.
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority.
- High turnover of senior management, legal counsel, or those charged with governance.

Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required).
- High turnover rates or employment of accounting, internal audit, or information technology staff that are not effective.
- Accounting and information systems that are not effective, including situations involving material weaknesses in internal control.

Attitudes/Rationalisations

- Communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective.
- Non financial management's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates.
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations.
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.

- The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.
- Management failing to correct known material weaknesses in internal control on a timely basis.
- An interest by management in employing inappropriate means to minimise reported earnings for tax motivated reasons.
- Low morale among senior management.
- The owner manager makes no distinction between personal and business transactions.
- Dispute between shareholders in a closely held entity.
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
 - o Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
 - o Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report.
 - o Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.
 - o Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

Risk Factors Arising from Misstatements Arising from Misappropriation of Assets

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/ pressures, opportunities, and attitudes/ rationalisation. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, monitoring of management and weaknesses in internal control that is not effective may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

Incentives/Pressures

Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

- Known or anticipated future employee layoffs.
- Recent or anticipated changes to employee compensation or benefit plans.
- Promotions, compensation, or other rewards inconsistent with expectations.

Opportunities

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

- Large amounts of cash on hand or processed.
- Inventory items that are small in size, of high value, or in high demand.
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips.
- Fixed assets which are small in size, marketable, or lacking observable identification of ownership.

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

- Inadequate segregation of duties or independent checks.
- Inadequate oversight of senior management expenditures, such as travel and other reimbursements.
- Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations.
- Inadequate job applicant screening of employees with access to assets.
- Inadequate record keeping with respect to assets.
- Inadequate system of authorization and approval of transactions (for example, in purchasing).
- Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
- Lack of complete and timely reconciliations of assets.
- Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
- Lack of mandatory vacations for employees performing key control functions.
- Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
- Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Attitudes/Rationalisations

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies.
- Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee.

- Changes in behavior or lifestyle that may indicate assets have been misappropriated.
 - Tolerance of petty theft.
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Appendix 2

(Ref: Para. A40)

Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatement Due to Fraud

The following are examples of possible audit procedures to address the assessed risks of material misstatement due to fraud resulting from both fraudulent financial reporting and misappropriation of assets. Although these procedures cover a broad range of situations, they are only examples and, accordingly they may not be the most appropriate nor necessary in each circumstance. Also the order of the procedures provided is not intended to reflect their relative importance.

Consideration at the Assertion Level

Specific responses to the auditor's assessment of the risks of material misstatement due to fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified, and the classes of transactions, account balances, disclosures and assertions they may affect.

The following are specific examples of responses:

- Visiting locations or performing certain tests on a surprise or unannounced basis. For example, observing inventory at locations where auditor attendance has not been previously announced or counting cash at a particular date on a surprise basis.
- Requesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period.
- Altering the audit approach in the current year. For example, contacting major customers and suppliers orally in addition to sending written confirmation, sending confirmation requests to a specific party within an organization or seeking more or different information.
- Performing a detailed review of the entity's quarter end or year end adjusting entries and investigating any that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year end, investigating the possibility of related parties and the sources of financial resources supporting the transactions.
- Performing substantive analytical procedures using disaggregated data. For example, comparing sales and cost of sales by location, line of business or month to expectations developed by the auditor.

- Conducting interviews of personnel involved in areas where a risk of material misstatement due to fraud has been identified, to obtain their insights about the risk and whether, or how, controls address the risk.
- When other independent auditors are auditing the financial statements of one or more subsidiaries, divisions or branches, discussing with them the extent of work necessary to be performed to address the assessed risk of material misstatement due to fraud resulting from transactions and activities among these components.
- If the work of an expert becomes particularly significant with respect to a financial statement item for which the assessed risk of misstatement due to fraud is high, performing additional procedures relating to some or all of the expert's assumptions, methods or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose.
- Performing audit procedures to analyze selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgments, for example, an allowance for sales returns, were resolved with the benefit of hindsight.
- Performing procedures on account or other reconciliations prepared by the entity, including considering reconciliations performed at interim periods.
- Performing computer assisted techniques, such as data mining to test for anomalies in a population.
- Testing the integrity of computer produced records and transactions.
- Seeking additional audit evidence from sources outside of the entity being audited.

Specific Responses Misstatement Resulting from Fraudulent Financial Reporting

Examples of responses to the auditor's assessment of the risks of material misstatement due to fraudulent financial reporting are as follows:

Revenue Recognition

- Performing substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods. Computer assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.
- Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or agreements and basis for rebates or the period to which they relate are often poorly documented. For example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances.
- Inquiring of the entity's sales and marketing personnel or in house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions.

- Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cut off procedures.
- For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded.

Inventory Quantities

- Examining the entity's inventory records to identify locations or items that require specific attention during or after the physical inventory count.
- Observing inventory counts at certain locations on an unannounced basis or conducting inventory counts at all locations on the same date.
- Conducting inventory counts at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period.
- Performing additional procedures during the observation of the count, for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labeled, and the quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals. Using the work of an expert may be helpful in this regard.
- Comparing the quantities for the current period with prior periods by class or category of inventory, location or other criteria, or comparison of quantities counted with perpetual records.
- Using computer assisted audit techniques to further test the compilation of the physical inventory counts for example, sorting by tag number to test tag controls or by item serial number to test the possibility of item omission or duplication.

Management Estimates

- Using an expert to develop an independent estimate for comparison to management's estimate.
- Extending inquiries to individuals outside of management and the accounting department to corroborate management's ability and intent to carry out plans that are relevant to developing the estimate.

Specific Responses -- Misstatements Due to Misappropriation of Assets

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to an assessed risk of material misstatement due to fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions. Although some of the audit responses noted in the two categories above may apply in such circumstances, the scope of the work is to be linked to the specific information about the misappropriation risk that has been identified.

Examples of responses to the auditor's assessment of the risk of material misstatements due to misappropriation of assets are as follows:

- Counting cash or securities at or near year end.
- Confirming directly with customers the account activity (including credit memo and sales return activity as well as dates payments were made) for the period under audit.
- Analyzing recoveries of written off accounts.
- Analyzing inventory shortages by location or product type.
- Comparing key inventory ratios to industry norm.
- Reviewing supporting documentation for reductions to the perpetual inventory records.
- Performing a computerized match of the vendor list with a list of employees to identify matches of addresses or phone numbers.
- Performing a computerized search of payroll records to identify duplicate addresses, employee identification or taxing authority numbers or bank accounts.
- Reviewing personnel files for those that contain little or no evidence of activity, for example, lack of performance evaluations.
- Analyzing sales discounts and returns Conflicting or missing evidence, including: for unusual patterns or trends,
- Confirming specific terms of contracts with third parties.
- Obtaining evidence that contracts are being carried out in accordance with their terms.
- Reviewing the propriety of large and unusual expenses.
- Reviewing the authorization and carrying value of senior management and related party loans.
- Reviewing the level and propriety of expense reports submitted by senior management.

Appendix 3
(Ref: Para. A48)

Examples of Circumstances that Indicate the Possibility of Fraud

The following are examples of circumstances that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud.

Discrepancies in the accounting records, including:

- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.
- Unsupported or unauthorized balances or transactions.
- Last minute adjustments that significantly affect financial results.
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties.
- Tips or complaints to the auditor about alleged fraud.

Conflicting or missing evidence, including:

- Missing documents.
- Documents that appear to have been altered.
- Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist.
- Significant unexplained items on reconciliations.
- Unusual balance sheet changes, or changes in trends or important financial statement ratios or relationships, for example, receivables growing faster than revenues.
- Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures.
- Unusual discrepancies between the entity's records and confirmation replies.
- Large numbers of credit entries and other adjustments made to accounts receivable records.
- Unexplained or inadequately explained differences between the accounts receivable sub ledger and the control account, or between the customer statements and the accounts receivable sub ledger.
- Missing or non existent cancelled checks in circumstances where cancelled checks are ordinarily returned to the entity with the bank statement.
- Missing inventory or physical assets of significant magnitude.
- Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies.
- Fewer responses to confirmations than anticipated or a greater number of responses than anticipated.
- Inability to produce evidence of key Other systems development and program change testing and implementation activities for current year system changes and deployments.

Problematic or unusual relationships between the auditor and management, including:

- Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.
- Undue time pressures imposed by management to resolve complex or contentious issues.
- Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management.
- Unusual delays by the entity in providing requested information.
- Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer assisted audit techniques.
- Denial of access to key IT operations Staff and facilities, including security, operations, and systems development personnel.
- An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable.
- An unwillingness to address identified weaknesses in internal control on a timely basis.
- Unwillingness by management to permit the auditor to meet privately with those charged with governance.
- Accounting policies that appear to be at variance with industry norms.

- Frequent changes in accounting estimates that do not appear to result from changed circumstances.
- Tolerance of violations of the entity's Code of Conduct.

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

² Published in the July 2007 issue of the Journal.

³ The Auditing and Assurance Standards Board has issued the Revised Exposure Draft of the proposed Standard on Auditing (SA) 315, published in the September, 2007 issue of the Journal. The original Exposure Draft of the corresponding AAS was published in the April, 2005 issue of the Journal.

⁴ The Auditing and Assurance Standards Board has issued the Revised Exposure Draft of the proposed Standard on Auditing (SA) 330, published in the September, 2007 issue of the Journal. The original Exposure Draft of the corresponding AAS was published in the April, 2005 issue of the Journal. Once the final SAs 315 and 330 are issued, the existing AAS 6, "Risk Assessment and Internal Control", AAS 20, "Knowledge of the Business", and AAS 29, "Auditing in a Computer Information Systems Environment" shall stand withdrawn.

⁵ Presently, AAS 1 (Renumbered as SA 200), "Basic Principles Governing an Audit" and AAS 2 (Renumbered as SA 200A), "Objective and Scope of an Audit of Financial Statements" correspond to International Standard on Auditing (ISA) 200. Both the AASs are currently being revised in the light of ISA 200. Post this revision, the principles covered by AAS 1 and AAS 2 will be merged into one Standard i.e., SA 200.

⁶ The proposed Standard on Auditing (SA) 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" establishes requirements and provides guidance on the engagement team's discussion of the susceptibility of the entity to material misstatements of the financial statements.

⁷ Reference may be made to the AAS 18 (Re-numbered as SA 540, "Auditing of Accounting Estimates"). The Standard is being revised in the light of the corresponding International Standard.

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

⁹ Reference may be made to the AAS 14 (Re-numbered as SA 520, "Analytical Procedures"). The Standard is being revised in the light of the corresponding International Standard.

¹⁰ Hitherto known as the Auditing and Assurance Standard (AAS) 27, "Communication of Audit Matters with Those Charged with Governance". The Standard is being revised in the light of the corresponding International Standard.

¹¹ Hitherto known as Auditing and Assurance Standard (AAS) 7, "Relying Upon the Work of an Internal Auditor". The Standard is being revised in the light of the corresponding International Standard on Auditing.

¹² SA 260 (Revised), "Communication with Those Charged with Governance", discusses with whom the auditor communicates when the entity's governance structure is not well defined.

¹³ The Auditing and Assurance Standards Board will issue an Exposure Draft of the proposed new Standard based on the corresponding International Standard on Auditing in the near future.

¹⁴ Hitherto known as the Auditing and Assurance Standard (AAS) 28, "The Auditor's Report on Financial Statements" The Standard is being revised in the light of the corresponding International Standard.

¹⁵ The Code of Ethics issued by the Institute of Chartered Accountants of India contains guidance on communication between the outgoing and incoming auditor.

¹⁶ Hitherto known as the Auditing and Assurance Standard (AAS) 11, "Management Representations" The Standard is being revised in the light of the corresponding International Standard.

¹⁷ Management incentive plans may be contingent upon achieving targets relating only to certain accounts or selected activities of the entity, even though the related accounts or activities may not be material to the entity as a whole.

Standard on Auditing (SA) 500 (Revised)^{*}

Audit Evidence

Proposed Standard on Auditing (SA) 500 (Revised), “Audit Evidence” should be read in the context of the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”¹, which sets out the authority of SAs.

Introduction

Scope of this SA

1. This Standard on Auditing (SA) explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor’s responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor’s opinion.
2. This SA is applicable to all the audit evidence obtained during the course of the audit. Other SAs deal with specific aspects of the audit (for example, SA 315²), the audit evidence to be obtained in relation to a particular topic (for example, SA 570 (Revised)³), specific procedures to obtain audit evidence (for example, Proposed SA 520 (Revised)⁴), and the evaluation of whether sufficient appropriate audit evidence has been obtained (Proposed SA 200 (Revised)⁵ and SA 330⁶).

Effective Date

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

Objective

4. The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor’s opinion.

Definitions

5. For purposes of the SAs, the following terms have the meanings attributed below:
 - a. Accounting records – The records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

- b. Appropriateness (of audit evidence) – The measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.
- c. Audit evidence – Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.
- d. Management's expert – An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.
- e. Sufficiency (of audit evidence) – The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.

Requirements

Sufficient Appropriate Audit Evidence

6. The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. (Ref: Para. A1-A25)

Information to Be Used as Audit Evidence

7. When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence. (Ref: Para. A26-A33)

8. When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes, (Ref: Para. A34-A36)

- a. Evaluate the competence, capabilities and objectivity of that expert; (Ref: Para. A37-A43)
- b. Obtain an understanding of the work of that expert; and (Ref: Para. A44-A47)
- c. Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion. (Ref: Para. A48)

9. When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, including as necessary in the circumstances:

- a. Obtaining audit evidence about the accuracy and completeness of the information; and (Ref: Para. A49-A50)
- b. Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes. (Ref: Para. A51)

Selecting Items for Testing to Obtain Audit Evidence

10. When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure. (Ref: Para. A52-A56)

Inconsistency in, or Doubts over Reliability of, Audit Evidence

11. If:

- a. audit evidence obtained from one source is inconsistent with that obtained from another;
or
- b. the auditor has doubts over the reliability of information to be used as audit evidence,

the auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter, and shall consider the effect of the matter, if any, on other aspects of the audit. (Ref: Para. A57)

Application and Other Explanatory Material

Sufficient Appropriate Audit Evidence (Ref: Para. 6)

A1. Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit)² or a firm's quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared using the work of a management's expert. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

A2. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, reperformance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

A3. As explained in Proposed SA 200 (Revised),⁸ reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level.

A4. The sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

A5. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

A6. SA 330 requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained.⁹ Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. SA 200 (Revised) contains discussion of such matters as the nature of audit procedures, the timeliness of financial reporting, and the balance between benefit and cost, which are relevant factors when the auditor exercises professional judgment regarding whether sufficient appropriate audit evidence has been obtained.

Sources of Audit Evidence

A7. Some audit evidence is obtained by performing audit procedures to test the accounting records, for example, through analysis and review, reperforming procedures followed in the financial reporting process, and reconciling related types and applications of the same information. Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements.

A8. More assurance is ordinarily obtained from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. For example, corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from audit evidence that is generated internally, such

as evidence existing within the accounting records, minutes of meetings, or a management representation.

A9. Information from sources independent of the entity that the auditor may use as audit evidence may include confirmations from third parties, analysts' reports, and comparable data about competitors (benchmarking data).

Audit Procedures for Obtaining Audit Evidence

A10. As required by, and explained further in, SA 315 and SA 330, audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

(a) Risk assessment procedures; and

(b) Further audit procedures, which comprise:

- i. Tests of controls, when required by the SAs or when the auditor has chosen to do so; and
- ii. Substantive procedures, including tests of details and substantive analytical procedures.

A11. The audit procedures described in paragraphs A14-A25 below may be used as risk assessment procedures, tests of controls or substantive procedures, depending on the context in which they are applied by the auditor. As explained in SA 330, audit evidence obtained from previous audits may, in certain circumstances, provide appropriate audit evidence where the auditor performs audit procedures to establish its continuing relevance.^{[10](#)}

A12. The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time. For example, source documents, such as purchase orders and invoices, may exist only in electronic form when an entity uses electronic commerce, or may be discarded after scanning when an entity uses image processing systems to facilitate storage and reference.

A13. Certain electronic information may not be retrievable after a specified period of time, for example, if files are changed and if backup files do not exist. Accordingly, the auditor may find it necessary as a result of an entity's data retention policies to request retention of some information for the auditor's review or to perform audit procedures at a time when the information is available.

Inspection

A14. Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorisation.

A15. Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.

A16. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

Observation

A17. Observation consists of looking at a process or procedure being performed by others, for example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed. See Proposed SA 501 (Revised) for further guidance on observation of the counting of inventory.^{[11](#)}

External Confirmation

A18. An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a "side agreement" that may influence revenue recognition. See Proposed SA 505 (Revised) for further guidance.^{[12](#)}

Recalculation

A19. Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

Reperformance

A20. Repperformance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

Analytical Procedures

A21. Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts. See Proposed SA 520 (Revised) for further guidance.

Inquiry

A22. Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

A23. Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

A24. Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

A25. In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries. See SA 580 (Revised) for further guidance.¹³

Information to Be Used as Audit Evidence

Relevance and Reliability (Ref: Para. 7)

A26. As noted in paragraph A1, while audit evidence is primarily obtained from audit procedures performed during the course of the audit, it may also include information obtained from other sources such as, for example, previous audits, in certain circumstances, and a firm's quality control procedures for client acceptance and continuance. The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based.

Relevance

A27. Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. The relevance of

information to be used as audit evidence may be affected by the direction of testing. For example, if the purpose of an audit procedure is to test for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure. On the other hand, when testing for understatement in the existence or valuation of accounts payable, testing the recorded accounts payable would not be relevant, but testing such information as subsequent disbursements, unpaid invoices, suppliers' statements, and unmatched receiving reports may be relevant.

A28. A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others. For example, inspection of documents related to the collection of receivables after the period end may provide audit evidence regarding existence and valuation, but not necessarily cut-off. Similarly, obtaining audit evidence regarding a particular assertion, for example, the existence of inventory, is not a substitute for obtaining audit evidence regarding another assertion, for example, the valuation of that inventory. On the other hand, audit evidence from different sources or of a different nature may often be relevant to the same assertion.

A29. Tests of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. Designing tests of controls to obtain relevant audit evidence includes identifying conditions (characteristics or attributes) that indicate performance of a control, and deviation conditions which indicate departures from adequate performance. The presence or absence of those conditions can then be tested by the auditor.

A30. Substantive procedures are designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures. Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.

Reliability

A31. The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity. While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

- The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.

- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitised or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

A32. Proposed SA 520 (Redrafted) provides further guidance regarding the reliability of data used for purposes of designing analytical procedures as substantive procedures.¹⁴

A33. SA 240 (Revised) deals with circumstances where the auditor has reason to believe that a document may not be authentic, or may have been modified without that modification having been disclosed to the auditor.¹⁵

Reliability of Information Produced by a Management's Expert (Ref: Para. 8)

A34. The preparation of an entity's financial statements may require expertise in a field other than accounting or auditing, such as actuarial calculations, valuations, or engineering data. The entity may employ or engage experts in these fields to obtain the needed expertise to prepare the financial statements. Failure to do so when such expertise is necessary increases the risks of material misstatement.

A35. When information to be used as audit evidence has been prepared using the work of a management's expert, the requirement in paragraph 8 of this SA applies. For example, an individual or organisation may possess expertise in the application of models to estimate the fair value of securities for which there is no observable market. If the individual or organisation applies that expertise in making an estimate which the entity uses in preparing its financial statements, the individual or organisation is a management's expert and paragraph 8 applies. If, on the other hand, that individual or organization merely provides price data regarding private transactions not otherwise available to the entity which the entity uses in its own estimation methods, such information, if used as audit evidence, is subject to paragraph 7 of this SA, but is not the use of a management's expert by the entity.

A36. The nature, timing and extent of audit procedures in relation to the requirement in paragraph 8 of this SA, may be affected by such matters as:

- The nature and complexity of the matter to which the management's expert relates.
- The risks of material misstatement in the matter.
- The availability of alternative sources of audit evidence.
- The nature, scope and objectives of the management's expert's work.

- Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services.
- The extent to which management can exercise control or influence over the work of the management's expert.
- Whether the management's expert is subject to technical performance standards or other professional or industry requirements.
- The nature and extent of any controls within the entity over the management's expert's work.
- The auditor's knowledge and experience of the management's expert's field of expertise.
- The auditor's previous experience of the work of that expert.

The Competence, Capabilities and Objectivity of a Management's Expert (Ref: Para. 8(a))

A37. Competence relates to the nature and level of expertise of the management's expert. Capability relates the ability of the management's expert to exercise that competence in the circumstances. Factors that influence capability may include, for example, geographic location, and the availability of time and resources. Objectivity relates to the possible effects that bias, conflict of interest or the influence of others may have on the professional or business judgment of the management's expert. The competence, capabilities and objectivity of a management's expert, and any controls within the entity over that expert's work, are important factors in relation to the reliability of any information produced by a management's expert.

A38. Information regarding the competence, capabilities and objectivity of a management's expert may come from a variety of sources, such as:

- Personal experience with previous work of that expert.
- Discussions with that expert.
- Discussions with others who are familiar with that expert's work.
- Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
- Published papers or books written by that expert.
- An auditor's expert, if any, who assists the auditor in obtaining sufficient appropriate audit evidence with respect to information produced by the management's expert.

A39. Matters relevant to evaluating the competence, capabilities and objectivity of a management's expert include whether that expert's work is subject to technical performance standards or other professional or industry requirements, for example, ethical standards and other membership requirements of a professional body or industry association, accreditation standards of a licensing body, or requirements imposed by law or regulation.

A40. Other matters that may be relevant include:

- The relevance of the management's expert's competence to the matter for which that expert's work will be used, including any areas of specialty within that expert's field. For example, a particular actuary may specialise in property and casualty insurance, but have limited expertise regarding pension calculations.

- The management's expert's competence with respect to relevant accounting requirements, for example, knowledge of assumptions and methods, including models where applicable, that are consistent with the applicable financial reporting framework.
- Whether unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures indicate that it may be necessary to reconsider the initial evaluation of the competence, capabilities and objectivity of the management's expert as the audit progresses.

A41. A broad range of circumstances may threaten objectivity, for example, self-interest threats, advocacy threats, familiarity threats, self-review threats and intimidation threats. Safeguards may reduce such threats, and may be created either by external structures (for example, the management's expert's profession, legislation or regulation), or by the management's expert's work environment (for example, quality control policies and procedures).

A42. Although safeguards cannot eliminate all threats to a management's expert's objectivity, threats such as intimidation threats may be of less significance to an expert engaged by the entity than to an expert employed by the entity, and the effectiveness of safeguards such as quality control policies and procedures may be greater. Because the threat to objectivity created by being an employee of the entity will always be present, an expert employed by the entity cannot ordinarily be regarded as being more likely to be objective than other employees of the entity.

A43. When evaluating the objectivity of an expert engaged by the entity, it may be relevant to discuss with management and that expert any interests and relationships that may create threats to the expert's objectivity, and any applicable safeguards, including any professional requirements that apply to the expert; and to evaluate whether the safeguards are adequate. Interests and relationships creating threats may include:

- Financial interests.
- Business and personal relationships.
- Provision of other services.

Obtaining an Understanding of the Work of the Management's Expert (Ref: Para. 8(b))

A44. An understanding of the work of the management's expert includes an understanding of the relevant field of expertise. An understanding of the relevant field of expertise may be obtained in conjunction with the auditor's determination of whether the auditor has the expertise to evaluate the work of the management's expert, or whether the auditor needs an auditor's expert for this purpose.¹⁶

A45. Aspects of the management's expert's field relevant to the auditor's understanding may include:

- Whether that expert's field has areas of specialty within it that are relevant to the audit.
- Whether any professional or other standards, and regulatory or legal requirements apply.

- What assumptions and methods are used by the management's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.
- The nature of internal and external data or information the auditor's expert uses.

A46. In the case of a management's expert engaged by the entity, there will ordinarily be an engagement letter or other written form of agreement between the entity and that expert. Evaluating that agreement when obtaining an understanding of the work of the management's expert may assist the auditor in determining the appropriateness of the following for the auditor's purposes:

- The nature, scope and objectives of that expert's work;
- The respective roles and responsibilities of management and that expert; and
- The nature, timing and extent of communication between management and that expert, including the form of any report to be provided by that expert.

A47. In the case of a management's expert employed by the entity, it is less likely there will be a written agreement of this kind. Inquiry of the expert and other members of management may be the most appropriate way for the auditor to obtain the necessary understanding.

Evaluating the Appropriateness of the Management's Expert's Work (Ref: Para. 8(c))

A48. Considerations when evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion may include:

- The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;
- If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and
- If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

Information Produced by the Entity and Used for the Auditor's Purposes (Ref: Para. 9(a)-(b))

A49. In order for the auditor to obtain reliable audit evidence, information produced by the entity that is used for performing audit procedures needs to be sufficiently complete and accurate. For example, the effectiveness of auditing revenue by applying standard prices to records of sales volume is affected by the accuracy of the price information and the completeness and accuracy of the sales volume data. Similarly, if the auditor intends to test a population (for example, payments) for a certain characteristic (for example, authorisation), the results of the test will be less reliable if the population from which items are selected for testing is not complete.

A50. Obtaining audit evidence about the accuracy and completeness of such information may be performed concurrently with the actual audit procedure applied to the information when obtaining such audit evidence is an integral part of the audit procedure itself. In other situations,

the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the preparation and maintenance of the information. In some situations, however, the auditor may determine that additional audit procedures are needed.

A51. In some cases, the auditor may intend to use information produced by the entity for other audit purposes. For example, the auditor may intend to make use of the entity's performance measures for the purpose of analytical procedures, or to make use of the entity's information produced for monitoring activities, such as internal auditor's reports. In such cases, the appropriateness of the audit evidence obtained is affected by whether the information is sufficiently precise or detailed for the auditor's purposes. For example, performance measures used by management may not be precise enough to detect material misstatements.

Selecting Items for Testing to Obtain Audit Evidence (Ref: Para. 10)

A52. An effective test provides appropriate audit evidence to an extent that, taken with other audit evidence obtained or to be obtained, will be sufficient for the auditor's purposes. In selecting items for testing, the auditor is required by paragraph 7 to determine the relevance and reliability of information to be used as audit evidence; the other aspect of effectiveness (sufficiency) is an important consideration in selecting items to test. The means available to the auditor for selecting items for testing are:

- a. Selecting all items (100% examination);
- b. Selecting specific items; and
- c. Audit sampling.

The application of any one or combination of these means may be appropriate depending on the particular circumstances, for example, the risks of material misstatement related to the assertion being tested, and the practicality and efficiency of the different means.

Selecting All Items

A53. The auditor may decide that it will be most appropriate to examine the entire population of items that make up a class of transactions or account balance (or a stratum within that population). 100% examination is unlikely in the case of tests of controls; however, it is more common for tests of details. 100% examination may be appropriate when, for example:

- The population constitutes a small number of large value items;
- There is a significant risk and other means do not provide sufficient appropriate audit evidence; or
- The repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective.

Selecting Specific Items

A54. The auditor may decide to select specific items from a population. In making this decision, factors that may be relevant include the auditor's understanding of the entity, the assessed risks

of material misstatement, and the characteristics of the population being tested. The judgmental selection of specific items is subject to non-sampling risk. Specific items selected may include:

- High value or key items. The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic, for example, items that are suspicious, unusual, particularly riskprone or that have a history of error.
- All items over a certain amount. The auditor may decide to examine items whose recorded values exceed a certain amount so as to verify a large proportion of the total amount of a class of transactions or account balance.
- Items to obtain information. The auditor may examine items to obtain information about matters such as the nature of the entity or the nature of transactions.

A55. While selective examination of specific items from a class of transactions or account balance will often be an efficient means of obtaining audit evidence, it does not constitute audit sampling. The results of audit procedures applied to items selected in this way cannot be projected to the entire population; accordingly, selective examination of specific items does not provide audit evidence concerning the remainder of the population.

Audit Sampling

A56. Audit sampling is designed to enable conclusions to be drawn about an entire population on the basis of testing a sample drawn from it. Audit sampling is discussed in SA 530 (Revised).¹⁷

Inconsistency in, or Doubts over Reliability of, Audit Evidence (Ref: Para. 11)

A57. Obtaining audit evidence from different sources or of a different nature may indicate that an individual item of audit evidence is not reliable, such as when audit evidence obtained from one source is inconsistent with that obtained from another. This may be the case when, for example, responses to inquiries of management, internal audit, and others are inconsistent, or when responses to inquiries of those charged with governance made to corroborate the responses to inquiries of management are inconsistent with the response by management. SA 230 (Revised) includes a specific documentation requirement if the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter.¹⁸

Material Modifications to Redrafted ISA 500, "Audit Evidence"

The Standard on Auditing (SA) 500 (Revised), "Audit Evidence" does not contain any material modifications vis-a-vis Redrafted ISA 500.

* Hitherto known as SA 500 (AAS 5) "Audit Evidence".

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

2 SA 315 "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

3 SA 570 (Revised), “Going Concern”, published in December, 2008 issue of the Journal.

4 Currently, SA 520 (AAS 14), “Analytical Procedures” is in force. The standard is being revised in the light of the corresponding International Standard.

5 Presently, SA 200 (AAS 1), “Basic Principles Governing an Audit” and SA 200A (AAS 2), “Objective and Scope of an Audit of Financial Statements” correspond to International Standard on Auditing (ISA) 200 (Revised and Redrafted). Both the SAs are currently being revised in the light of the Proposed ISA 200 (Revised and Redrafted).

6 SA 330, “The Auditor’s Responses to Assessed Risks”.

7 SA 315, paragraph 9.

8 See footnote no. 5.

9 SA 330, paragraph 27.

10 SA 330, paragraph A35.

11 Currently, SA 501 (AAS 34), “Audit Evidence—Additional Considerations for Specific Items” is in force. The standard is being revised in the light of the corresponding International Standard.

12 Currently, SA 505 (AAS 30), “External Confirmations” is in force. The standard is being revised in the light of the corresponding International Standard.

13 SA 580 (Revised), “Written Representations”.

14 See footnote no. 4.

15 SA 240 (Revised), “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”, paragraph 13.

16 Currently, SA 620 (AAS 9), “Using the Work of an Expert” is in force. The standard is being revised in the light of the corresponding International Standard.

17 SA 530 (Revised), “Audit Sampling”, published in February, 2009 issue of the Journal.

18 SA 230 (Revised), “Audit Documentation”, paragraph 11, published in January, 2009 issue of the Journal.

AAS 6

RISK ASSESSMENTS AND INTERNAL CONTROL

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The following is the text of the Auditing and Assurance Standard (AAS) 6, "Risk Assessments and Internal Control", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in conjunction with the "Preface to the Statements on Standard Auditing Practices", issued by the Institute.*

Introduction

1. The purpose of this Auditing and Assurance Standard (AAS) is to establish standards on the procedures to be followed to obtain an understanding of the accounting and internal control systems and on audit risk and its components: inherent risk, control risk and detection risk. The principles laid down in the other AASs, issued by the Institute of Chartered Accountants of India, would be applicable, to the extent practicable, to this AAS also. In this Standard, the term 'financial information' encompasses 'financial statements'. In some circumstances, specific legislations and regulations may require the auditor to undertake procedures additional to those set out in this AAS.
2. **The auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. The auditor should use professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level.**
3. "Audit risk" means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk has three components: inherent risk, control risk and detection risk.

4. "Inherent risk" is the susceptibility of an account balance or class of transactions to misstatement that could be material, either individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.
5. "Control risk" is the risk that a misstatement, that could occur in an account balance or class of transactions and that could be material, either individually or when aggregated with misstatements in other balances or classes, will not be prevented or detected and corrected on a timely basis by the accounting and internal control systems.
6. "Detection risk" is the risk that an auditor's substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material, either individually or when aggregated with misstatements in other balances or classes.
7. "Accounting System" means the series of tasks and records of an entity by which transactions are processed as a means of maintaining financial records. Such systems identify, assemble, analyse, calculate, classify, record, summarise and report transactions and other events.
8. "Internal Control System" means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. The internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly operated.
9. The system of internal control must be under continuing supervision by management to determine that it is functioning as prescribed and is modified, as appropriate, for changes in conditions. The internal control system extends beyond those matters which relate directly to the functions of the accounting system and comprises:
 - (a) "the control environment" which means the overall attitude, awareness and actions of directors and management regarding the internal control system and its importance in the entity. The control environment has an effect on the effectiveness of the specific control procedures and provides the background against which other controls are operated. A strong control environment, for example, one with tight budgetary controls and an effective internal audit function, can significantly complement specific control procedures. However, a strong control environment does not, by itself, ensure the effectiveness of the internal control system. Factors reflected in the control environment include:
 - ◆ The entity's organisational structure and methods of assigning authority and responsibility (including segregation of duties and supervisory functions).
 - ◆ The function of the board of directors and its committees in the case of a company or the corresponding governing body in case of any other entity.
 - ◆ Management's philosophy and operating style.
 - ◆ Management's control system including the internal audit function, personnel policies and procedures.

(b) "control procedures" which means those policies and procedures in addition to the control environment which management has established to achieve the entity's specific objectives. Specific control procedures include:

- ◆ Reporting and reviewing reconciliations.
- ◆ Checking the arithmetical accuracy of the records.
- ◆ Controlling applications and environment of computer information systems, for example, by establishing controls over:
 - changes to computer programs
 - access to data files.
- ◆ Maintaining and reviewing control accounts and related subsidiary ledgers.
- ◆ Approving and controlling of documents.
- ◆ Comparing internal data with external sources of information.
- ◆ Comparing the results of physical verification of cash, fixed assets, investments and inventory with corresponding accounting records.
- ◆ Restricting direct access to assets, records and information.
- ◆ Comparing and analysing the financial results with corresponding budgeted figures.

10. In the audit of financial statements, the auditor is concerned only with those policies and procedures within the accounting and internal control systems that are relevant to the assertions made in the financial statements. The understanding of relevant aspects of the accounting and internal control systems, together with the inherent and control risk assessments and other considerations, will enable the auditor to:

- (a) assess the adequacy of the accounting system as a basis for preparing the financial statements;
- (b) identify the types of potential material misstatements that could occur in the financial statements;
- (c) consider factors that affect the risk of material misstatements; and
- (d) develop an appropriate audit plan and determine the nature, timing and extent of his audit procedures.

11. When developing the audit approach, the auditor considers the preliminary assessment of control risk (in conjunction with the assessment of inherent risk) to determine the appropriate detection risk that may be accepted by the auditor for the assertions made in the financial statements and to determine the nature, timing and extent of substantive procedures for such assertions.

Inherent Risk

12. In developing the overall audit plan, the auditor should assess inherent risk at the level of financial statements. In developing the audit programme, the auditor should relate such assessment to material account balances and classes of transactions at the level of assertions made in the financial statements, or assume that inherent risk is high for the assertion, taking into account factors relevant both to the financial statements as a whole and to the specific

assertions. When the auditor makes an assessment that the inherent risk is not high, he should document the reasons for such assessment.

13. To assess inherent risk, the auditor would use professional judgement to evaluate numerous factors, having regard to his experience of the entity from previous audit engagements of the entity, any controls established by management to compensate for a high level of inherent risk, and his knowledge of any significant changes which might have taken place since his last assessment. Examples of such factors are:

At the Level of Financial Statements

- ◆ The integrity of the management.
- ◆ Management's experience and knowledge and changes in management during the period, for example, the inexperience of management may affect the preparation of the financial statements of the entity.
- ◆ Unusual pressures on management, for example, circumstances that might predispose management to misstate the financial statements, such as the industry experiencing a large number of business failures or an entity that lacks sufficient capital to continue operations.
- ◆ The nature of the entity's business, for example, the potential for technological obsolescence of its products and services, the complexity of its capital structure, the significance of related parties and the number of locations and geographical spread of its production facilities.
- ◆ Factors affecting the industry in which the entity operates, for example, economic and competitive conditions as indicated by financial trends and ratios, and changes in technology, consumer demand and accounting practices common to the industry.

At the Level of Account Balance and Class of Transactions

- ◆ Quality of the accounting system.
- ◆ Financial statements are likely to be susceptible to misstatement, for example, accounts which required adjustment in the prior period or which involve a high degree of estimation.
- ◆ The complexity of underlying transactions and other events which might require using the work of an expert.
- ◆ The degree of judgement involved in determining account balances.
- ◆ Susceptibility of assets to loss or misappropriation, for example, assets which are highly desirable and movable such as cash.
- ◆ The completion of unusual and complex transactions, particularly, at or near period end.
- ◆ Transactions not subjected to ordinary processing.

Accounting and Internal Control Systems

14. Internal controls relating to the accounting system are concerned with achieving the following objectives:

- ◆ Transactions are executed in accordance with management's general or specific authorisation.

- ◆ All transactions and other events are promptly recorded in the correct amount, in the appropriate accounts and in the proper accounting period so as to permit preparation of financial statements in accordance with the applicable accounting standards, other recognised accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets. .
- ◆ Assets and records are safeguarded from unauthorised access, use or disposition.
- ◆ Recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

Inherent Limitations of Internal Controls

15. Accounting and internal control systems can provide only reasonable, but not absolute, assurance that the objectives stated above are achieved. This is because the internal control systems are subject to some inherent limitations, such as:

- ◆ Management's consideration that the cost of an internal control does not exceed the expected benefits to be derived.
- ◆ The fact that most internal controls do not tend to be directed at transactions of unusual nature.
- ◆ The potential for human error, such as, due to carelessness, distraction, mistakes of judgement and the misunderstanding of instructions.
- ◆ The possibility of circumvention of internal controls through the collusion with employees or with parties outside the entity.
- ◆ The possibility that a person responsible for exercising an internal control could abuse that responsibility, for example, a member of management overriding an internal control.
- ◆ The possibility that procedures may become inadequate due to changes in conditions and compliance with procedures may deteriorate.
- ◆ Manipulations by management with respect to transactions or estimates and judgements required in the preparation of financial statements.

Understanding the Accounting and Internal Control Systems

16. When obtaining an understanding of the accounting and internal control systems to plan the audit, the auditor obtains a knowledge of the design of the accounting and internal control systems, and their operation. For example, an auditor may perform a "walk-through" test, that is, tracing a few transactions through the accounting system. When the transactions selected are typical of those transactions that pass through the system, this procedure may be treated as part of the tests of control. The nature and extent of walk-through tests performed by the auditor are such that they alone would not provide sufficient appropriate audit evidence to support a control risk assessment which is less than high.

17. The nature, timing and extent of the procedures performed by the auditor to obtain an understanding of the accounting and internal control systems will vary with, among other things:

- ◆ The size and complexity of the entity and of its information system.
- ◆ Materiality considerations.
- ◆ The type of internal controls involved.
- ◆ The nature of the entity's documentation of specific internal controls.

- ◆ The auditor's assessment of inherent risk.

18. Ordinarily, the auditor's understanding of the accounting and internal control systems significant to the audit is obtained through previous experience with the entity and is supplemented by:

- (a) inquiries of appropriate management, supervisory and other personnel at various organisational levels within the entity, together with reference to documentation, such as procedures manuals, job descriptions, systems descriptions and flow charts;
- (b) inspection of documents and records produced by the accounting and internal control systems; and
- (c) observation of the entity's activities and operations, including observation of the organisation of computer operations, personnel performing control procedures and the nature of transaction processing.

Accounting System

19. The auditor should obtain an understanding of the accounting system sufficient to identify and understand:

- (a) major classes of transactions in the entity's operations;**
- (b) how such transactions are initiated;**
- (c) significant accounting records, supporting documents and specific accounts in the financial statements; and**
- (d) the accounting and financial reporting process, from the initiation of significant transactions and other events to their inclusion in the financial statements.**

Control Environment

20. **The auditor should obtain an understanding of the control environment sufficient to assess management's attitudes, awareness and actions regarding internal controls and their importance in the entity.** Such an understanding would also help the auditor to make a preliminary assessment of the adequacy of the accounting and internal control systems as a basis for the preparation of the financial statements, and of the likely nature, timing and extent of audit procedures.

21. **The auditor should obtain an understanding of the control procedures sufficient to develop the audit plan.** In obtaining this understanding, the auditor would consider knowledge about the presence or absence of control procedures obtained from the understanding of the control environment and accounting system in determining whether any additional understanding of control procedures is necessary. Because control procedures are integrated with the control environment and the accounting system, as the auditor obtains an understanding of the control environment and the accounting system, some knowledge about control procedures is also likely to be obtained, for example, in obtaining an understanding of the accounting system pertaining to cash, the auditor ordinarily becomes aware of whether bank accounts are reconciled regularly. Ordinarily, development of the overall audit plan does not require an understanding of control procedures for every financial statement assertion in each account balance and transaction class.

Control Risk

22. After obtaining an understanding of the accounting system and internal control system, the auditor should make a preliminary assessment of control risk, at the assertion level, for each material account balance or class of transactions.

Preliminary Assessment of Control Risk

23. The preliminary assessment of control risk is the process of evaluating the likely effectiveness of an entity's accounting and internal control systems in preventing or detecting and correcting material misstatements. The preliminary assessment of control risk is based on the assumption that the controls operate generally as described and that they operate effectively throughout the period of intended reliance. There will always be some control risk because of the inherent limitations of any accounting and internal control system.

24. The auditor ordinarily assesses control risk at a high level for some or all assertions when:

- (a) the entity's accounting and internal control systems are not effective; or
- (b) evaluating the effectiveness of the entity's accounting and internal control systems would not be efficient.

In the above circumstances, the auditor would obtain sufficient appropriate audit evidence from substantive procedures and from any audit work carried out in the preparation of financial statements.

25. The preliminary assessment of control risk for a financial statement assertion should be high unless the auditor:

- (a) is able to identify internal controls relevant to the assertion which are likely to prevent or detect and correct a material misstatement; and
- (b) plans to perform tests of control to support the assessment.

Documentation of Understanding and Assessment of Control Risk

26. The auditor should document in the audit working papers:

- (a) the understanding obtained of the entity's accounting and internal control systems; and
- (b) the assessment of control risk.

When control risk is assessed at less than high, the auditor would also document the basis for the conclusions.

27. Different techniques may be used to document information relating to accounting and internal control systems. Selection of a particular technique is a matter for the auditor's judgement. Common techniques, used alone or in combination, are narrative descriptions, questionnaires, check lists and flow charts. The form and extent of this documentation is influenced by the size and complexity of the entity and the nature of the entity's accounting and internal control systems. Generally, the more complex the entity's accounting and internal control systems and the more extensive the auditor's procedures, the more extensive the auditor's documentation will need to be.

Tests of Control

28. Tests of control are performed to obtain audit evidence about the effectiveness of the:

- (a) design of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements; and
- (b) operation of the internal controls throughout the period.

Tests of control include tests of elements of the control environment where strengths in the control environment are used by auditors to reduce control risk.

29. Some of the procedures performed to obtain the understanding of the accounting and internal control systems may not have been specifically planned as tests of control but may provide audit evidence about the effectiveness of the design and operation of internal controls relevant to certain assertions and, consequently, serve as tests of control. For example, in obtaining the understanding of the accounting and internal control systems pertaining to cash, the auditor may have obtained audit evidence about the effectiveness of the bank reconciliation process through inquiry and observation.

30. When the auditor concludes that procedures performed to obtain the understanding of the accounting and internal control systems also provide audit evidence about the suitability of design and operating effectiveness of policies and procedures relevant to a particular financial statement assertion, the auditor may use that audit evidence, provided it is sufficient to support a control risk assessment at less than a high level.

31. Tests of control may include:

- ◆ Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised.
- ◆ Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.
- ◆ Re-performance of internal controls, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.
- ◆ Testing of internal control operating on specific computerised applications or over the overall information technology function, for example, access or program change controls.

32. The auditor should obtain audit evidence through tests of control to support any assessment of control risk which is less than high. The lower the assessment of control risk, the more evidence the auditor should obtain that accounting and internal control systems are suitably designed and operating effectively.

33. When obtaining audit evidence about the effective operation of internal controls, the auditor considers how they were applied, the consistency with which they were applied during the period and by whom they were applied. The concept of effective operation recognises that some deviations may have occurred. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. When deviations are detected the auditor makes specific inquiries regarding these matters, particularly, the timing of staff changes in key internal control functions. The auditor then ensures that the tests of control appropriately cover such a period of change or fluctuation.

34. In a computer information systems environment, the objectives of tests of control do not change from those in a manual environment; however, some audit procedures may change. The auditor may find it necessary, or may prefer, to use computer-assisted audit techniques. The use of such techniques, for

example, file interrogation tools or audit test data, may be appropriate when the accounting and internal control systems provide no visible evidence documenting the performance of internal controls which are programmed into a computerised accounting system.

35. Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. The evaluation of deviations may result in the auditor concluding that the assessed level of control risk needs to be revised. In such cases, the auditor would modify the nature, timing and extent of planned substantive procedures.

Quality and Timeliness of Audit Evidence

36. Certain types of audit evidence obtained by the auditor are more reliable than others. Ordinarily, the auditor's observation provides more reliable audit evidence than merely making inquiries, for example, the auditor might obtain audit evidence about the proper segregation of duties by observing the individual who applies a control procedure or by making inquiries of appropriate personnel. However, audit evidence obtained by some tests of control, such as observation, pertains only to the point in time at which the procedure was applied. The auditor may decide, therefore, to supplement these procedures with other tests of control capable of providing audit evidence about other periods of time.

37. In determining the appropriate audit evidence to support a conclusion about control risk, the auditor may consider the audit evidence obtained in prior audits. In a continuing engagement, the auditor will be aware of the accounting and internal control systems through work carried out previously but will need to update the knowledge gained and consider the need to obtain further audit evidence of any changes in control. **Before relying on procedures performed in prior audits, the auditor should obtain audit evidence which supports this reliance.** The auditor would obtain audit evidence as to the nature, timing and extent of any changes in the entity's accounting and internal control systems since such procedures were performed and assess their impact on the auditor's intended reliance. The longer the time elapsed since the performance of such procedures the less assurance that may result.

38. **The auditor should consider whether the internal controls were in use throughout the period.** If substantially different controls were used at different times during the period, the auditor would consider each separately. A breakdown in internal controls for a specific portion of the period requires separate consideration of the nature, timing and extent of the audit procedures to be applied to the transactions and other events of that period.

39. The auditor may decide to perform some tests of control during an interim visit in advance of the period end. However, the auditor cannot rely on the results of such tests without considering the need to obtain further audit evidence relating to the remainder of the period. Factors to be considered include:

- ◆ The results of the interim tests.
- ◆ The length of the remaining period.
- ◆ Whether any changes have occurred in the accounting and internal control systems during the remaining period.
- ◆ The nature and amount of the transactions and other events and the balances involved.
- ◆ The control environment, especially supervisory controls.
- ◆ The nature, timing and extent of substantive procedures which the auditor plans to carry out.

Final Assessment of Control Risk

40. Before the conclusion of the audit, based on the results of substantive procedures and other audit evidence obtained by the auditor, the auditor should consider whether the assessment of control risk is confirmed. In case of deviations from the prescribed accounting and internal control systems, the auditor would make specific inquiries to consider their implications. Where, on the basis of such inquiries, the auditor concludes that the deviations are such that the preliminary assessment of control risk is not supported, he would amend the same unless the audit evidence obtained from other tests of control supports that assessment. Where the auditor concludes that the assessed level of control risk needs to be revised, he would modify the nature, timing and extent of his planned substantive procedures.

Relationship Between the Assessments of Inherent and Control Risks

41. Management often reacts to inherent risk situations by designing accounting and internal control systems to prevent or detect and correct misstatements and therefore, in many cases, inherent risk and control risk are highly interrelated. In such situations, if the auditor attempts to assess inherent and control risks separately, there is a possibility of inappropriate risk assessment. As a result, audit risk may be more appropriately determined in such situations by making a combined assessment.

Detection Risk

42. The level of detection risk relates directly to the auditor's substantive procedures. The auditor's control risk assessment, together with the inherent risk assessment, influences the nature, timing and extent of substantive procedures to be performed to reduce detection risk, and therefore audit risk, to an acceptably low level. Some detection risk would always be present even if an auditor were to examine 100 percent of the account balances or class of transactions because, for example, most audit evidence is persuasive rather than conclusive.

43. **The auditor should consider the assessed levels of inherent and control risks in determining the nature, timing and extent of substantive procedures required to reduce audit risk to an acceptably low level.** In this regard the auditor would consider:

- (a) the nature of substantive procedures, for example, using tests directed toward independent parties outside the entity rather than tests directed toward parties or documentation within the entity, or using tests of details for a particular audit objective in addition to analytical procedures;
- (b) the timing of substantive procedures, for example, performing them at period end rather than at an earlier date; and
- (c) the extent of substantive procedures, for example, using a larger sample size.

44. There is an inverse relationship between detection risk and the combined level of inherent and control risks. For example, when inherent and control risks are high, acceptable detection risk needs to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risk to an acceptably low level. Refer to the Appendix to this SAP for an illustration of the interrelationship of the components of audit risk.

45. While tests of control and substantive procedures are distinguishable as to their purpose, the results of either type of procedure may contribute to the purpose of the other. Misstatements discovered

in conducting substantive procedures may cause the auditor to modify the previous assessment of control risk. Refer to the Appendix to this SAP for an illustration of the interrelationship of the components of audit risk.

46. The assessed levels of inherent and control risks cannot be sufficiently low to eliminate the need for the auditor to perform any substantive procedures. **Regardless of the assessed levels of inherent and control risks, the auditor should perform some substantive procedures for material account balances and classes of transactions.**

47. The auditor's assessment of the components of audit risk may change during the course of an audit, for example, information may come to the auditor's attention when performing substantive procedures that differs significantly from the information on which the auditor originally assessed inherent and control risks. In such cases, the auditor would modify the planned substantive procedures based on a revision of the assessed levels of inherent and control risks.

48. **The higher the assessment of inherent and control risks, the more audit evidence the auditor should obtain from the performance of substantive procedures.** When both inherent and control risks are assessed as high, the auditor needs to consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptably low level. **When the auditor determines that detection risk regarding a financial statement assertion for a material account balance or class of transactions cannot be reduced to an acceptable level, the auditor should express a qualified opinion or a disclaimer of opinion as may be appropriate.**

Audit Risk in the Small Business

49. The auditor needs to obtain the same level of assurance in order to express an unqualified opinion on the financial statements of both small and large entities. However, many internal controls which would be relevant to large entities are not practical in the small business. For example, in small businesses, accounting procedures may be performed by a few persons who may have both operating and custodial responsibilities, and therefore segregation of duties may be missing or severely limited. Inadequate segregation of duties may, in some cases, be offset by a strong management control system in which owner/manager supervisory controls exist because of direct personal knowledge of the entity and involvement in transactions. In circumstances where segregation of duties is limited and audit evidence of supervisory controls is lacking, the audit evidence necessary to support the auditor's opinion on the financial statements may have to be obtained entirely through the performance of substantive procedures.

Communication of Weaknesses

50. As a result of obtaining an understanding of the accounting and internal control systems and tests of control, the auditor may become aware of weaknesses in the systems. **The auditor should make management aware, as soon as practical and at an appropriate level of responsibility, of material weaknesses in the design or operation of the accounting and internal control systems, which have come to the auditor's attention.** The communication to management of material weaknesses would ordinarily be in writing. However, if the auditor judges that oral communication is appropriate, such communication would be documented in the audit working papers. It is important to indicate in the communication that only weaknesses which have come to the auditor's attention as a result of the audit

have been reported and that the examination has not been designed to determine the adequacy of internal control for management purposes.

Effective Date

51. This Auditing and Assurance Standard becomes operative for all audits related to accounting periods beginning on or after 1st April, 2002.

Appendix

Illustration of the Interrelationship of the Components of Audit Risk

The following table shows how the acceptable level of detection risk may vary based on assessments of inherent and control risks.

		Auditor's assessment of control risk		
		High	Medium	Low
Auditor's assessment of inherent risk	High	Lowest	Lower	Medium
	Medium	Lower	Medium	Higher
	Low	Medium	Higher	Highest

The shaded areas in this table relate to detection risk.

There is an inverse relationship between detection risk and the combined level of inherent and control risks. For example, when inherent and control risks are high, acceptable levels of detection risk need to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risk to an acceptably low level.

* Issued in June, 2002. The Standard was originally issued in May, 1988 and was titled "Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit".

SA 610 (Revised)

Using the Work of Internal Auditors

(Effective for all audits relating to accounting periods beginning on or after April 1, 2010)

Standard on Auditing (SA) 610 (Revised), “Using the Work of Internal Auditors” should be read in the context of the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”¹, which sets out the authority of SAs and proposed SA 200 (Revised), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”².

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the external auditor’s responsibilities regarding the work of internal auditors when the external auditor has determined, in accordance with SA 315,³ that the internal audit function is likely to be relevant to the audit. (Ref: Para. A1-A2)
2. This SA does not deal with instances when individual internal auditors provide direct assistance to the external auditor in carrying out audit procedures or where, in terms of the applicable legal and regulatory framework, it is not permissible for the internal auditor to provide access to his working papers to the third parties.

Relationship between the Internal Audit Function and the External Auditor

3. The role and objectives of the internal audit function are determined by management and, where applicable, those charged with governance. While the objectives of the internal audit function and the external auditor are different, some of the ways in which the internal audit function and the external auditor achieve their respective objectives may be similar. (Ref: Para. A3)
4. Irrespective of the degree of autonomy and objectivity of the internal audit function, such function is not independent of the entity as is required of the external auditor when expressing an opinion on financial statements. The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor’s use of the work of the internal auditors.

Effective Date

5. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objectives

6. The objectives of the external auditor, where the entity has an internal audit function that the external auditor has determined is likely to be relevant to the audit, are to determine:

- a. Whether, and to what extent, to use specific work of the internal auditors; and
- b. If so, whether such work is adequate for the purposes of the audit.

Definitions

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

- a. Internal audit function – An appraisal activity established or provided as a service to the entity. Its functions include, amongst other things, examining, evaluating and monitoring the adequacy and effectiveness of internal control. The Preface to the Standards on Internal Audit, issued by the Institute of Chartered Accountants of India, issued in November 2004 describes internal audit as “an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity’s strategic risk management and internal control system. Internal audit, therefore, provides assurance that there is transparency in reporting, as a part of good governance.”
- b. Internal auditors – Those individuals who perform the activities of the internal audit function. Internal auditors may belong to an internal audit department or equivalent function.

Requirements

Determining Whether and to What Extent to Use the Work of the Internal Auditors

8. The external auditor shall determine:

- a. Whether the work of the internal auditors is likely to be adequate for purposes of the audit; and
- b. If so, the planned effect of the work of the internal auditors on the nature, timing or extent of the external auditor’s procedures.

9. In determining whether the work of the internal auditors is likely to be adequate for purposes of the audit, the external auditor shall evaluate:

- a. The objectivity of the internal audit function;

- b. The technical competence of the internal auditors;
- c. Whether the work of the internal auditors is likely to be carried out with due professional care; and
- d. Whether there is likely to be effective communication between the internal auditors and the external auditor. (Ref: Para. A4)

10. In determining the planned effect of the work of the internal auditors on the nature, timing or extent of the external auditor's procedures, the external auditor shall consider:

- a. The nature and scope of specific work performed, or to be performed, by the internal auditors;
- b. The assessed risks of material misstatement at the assertion level for particular classes of transactions, account balances, and disclosures; and
- c. The degree of subjectivity involved in the evaluation of the audit evidence gathered by the internal auditors in support of the relevant assertions. (Ref: Para. A5)

Using Specific Work of the Internal Auditors

11. In order for the external auditor to use specific work of the internal auditors, the external auditor shall evaluate and perform audit procedures on that work to determine its adequacy for the external auditor's purposes. (Ref: Para. A6)

12. To determine the adequacy of specific work performed by the internal auditors for the external auditor's purposes, the external auditor shall evaluate whether:

- a. The work was performed by internal auditors having adequate technical training and proficiency;
- b. The work was properly supervised, reviewed and documented;
- c. Adequate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions;
- d. Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed; and
- e. Any exceptions or unusual matters disclosed by the internal auditors are properly resolved.

Documentation

13. When the external auditor uses specific work of the internal auditors, the external auditor shall document conclusions regarding the evaluation of the adequacy of the work of the internal auditors, and the audit procedures performed by the external auditor on that work, in accordance with paragraph 11.

Application and Other Explanatory Material

Scope of this SA (Ref: Para. 1)

A1. As described in SA 315⁴, the entity's internal audit function is likely to be relevant to the audit if the nature of the internal audit function's responsibilities and activities are related to the entity's financial reporting, and the auditor expects to use the work of the internal auditors to modify the nature or timing, or reduce the extent, of audit procedures to be performed.

A2. Carrying out procedures in accordance with this SA may cause the external auditor to re-evaluate the external auditor's assessment of the risks of material misstatement. Consequently, this may affect the external auditor's determination of the relevance of the internal audit function to the audit. Similarly, the external auditor may decide not to otherwise use the work of the internal auditors to affect the nature, timing or extent of the external auditor's procedures. In such circumstances, the external auditor's further application of this SA may not be necessary.

Scope and Objectives of the Internal Audit Function (Ref: Para. 3)

A3. The objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. The activities of the internal audit function may include one or more of the following:

- Monitoring of internal control. The internal audit function may be assigned specific responsibility for reviewing controls, monitoring their operation and recommending improvements thereto.
- Examination of financial and operating information. The internal audit function may be assigned to review the means used to identify, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.
- Review of operating activities. The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non- financial activities of an entity.

- Review of compliance with laws and regulations. The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.
- Risk management. The internal audit function may assist the organization by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and control systems.
- Governance. The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.

Determining Whether and to What Extent to Use the Work of the Internal Auditors

Whether the Work of the Internal Auditors Is Likely to Be Adequate for Purposes of the Audit (Ref: Para. 9)

A4. Factors that may affect the external auditor's determination of whether the work of the internal auditors is likely to be adequate for the purposes of the audit include:

Objectivity

- The status of the internal audit function within the entity and the effect such status has on the ability of the internal auditors to be objective.
- Whether the internal audit function reports to those charged with governance or an officer with appropriate authority, and whether the internal auditors have direct access to those charged with governance.
- Whether the internal auditors are free of any conflicting responsibilities.
- Whether those charged with governance oversee employment decisions related to the internal audit function.
- Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance.
- Whether, and to what extent, management acts on the recommendations of the internal audit function, and how such action is evidenced.

Technical competence

- Whether the internal auditors are members of relevant professional bodies.
- Whether the internal auditors have adequate technical training and proficiency as internal auditors.
- Compliance with the mandatory/ recommendatory Standards on Internal Audit (SIAs) issued by Internal Audit Standards Board of the Institute of Chartered Accountants of India (ICAI).
- Whether there are established policies for hiring and training internal auditors.

Due professional care

- Whether activities of the internal audit function are properly planned, supervised, reviewed and documented.
- The existence and adequacy of audit manuals or other similar documents, work programs and internal audit documentation.

Communication

Communication between the external auditor and the internal auditors may be most effective when the internal auditors are free to communicate openly with the external auditors, and:

- Meetings are held at appropriate intervals throughout the period;
- The external auditor is advised of and has access to relevant internal audit reports and is informed of any significant matters that come to the attention of the internal auditors when such matters may affect the work of the external auditor; and
- The external auditor informs the internal auditors of any significant matters that may affect the internal audit function.

Planned Effect of the Work of the Internal Auditors on the Nature, Timing or Extent of the External Auditor's Procedures (Ref: Para. 10)

A5. Where the work of the internal auditors is to be a factor in determining the nature, timing or extent of the external auditor's procedures, it may be useful to agree in advance the following matters with the internal auditors:

- The timing of such work;

- The extent of audit coverage;
- Materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures), and performance materiality;
- Proposed methods of item selection;
- Documentation of the work performed; and
- Review and reporting procedures.

Using Specific Work of the Internal Auditors (Ref: Para. 11)

A6. The nature, timing and extent of the audit procedures performed on specific work of the internal auditors will depend on the external auditor's assessment of the risk of material misstatement, the evaluation of the internal audit function, and the evaluation of the specific work of the internal auditors. Such audit procedures may include:

- Examination of items already examined by the internal auditors;
- Examination of other similar items; and
- Observation of procedures performed by the internal auditors.

Material Modifications to ISA 610, "Using the Work of Internal Auditors"

Addition

Paragraph 2 of ISA 610 deals with the situations where this ISA would not be applicable. In India, clause 1 of Part I of the Second Schedule to the Code of Ethics provides that a Chartered Accountant in Practice shall be deemed to be guilty of professional misconduct if he discloses information acquired in the course of his professional engagement to any person other than his client, an auditor cannot provide access to his working paper to the another auditor. Therefore, keeping in view the requirements of Code of Ethics, the situation, "where, in terms of the applicable legal and regulatory framework, it is not permissible for the internal auditor to provide access to his working papers to the third parties" has been added.

Limited Revision Consequential to issuance of the Standard on Auditing (SA) 610 (Revised), "Using the Work of Internal Auditors"

The amendments to Standard on Auditing (SA) 315 have been shown in track change mode.

SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment"

22. The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates corrective actions to its controls. (Ref: Para. A94-A96)

22a. If the entity has an internal audit function,^{*} the auditor shall obtain an understanding of the following in order to determine whether the internal audit function is likely to be relevant to the audit:

- a. The nature of the internal audit function's responsibilities and how the internal audit function fits in the entity's organisational structure; and
- b. The activities performed, or to be performed, by the internal audit function. (Ref: Para. A96a - A96c)

23. The auditor shall obtain an understanding of the sources of the information used in the entity's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for that purpose. (Ref: Para. A97)

[When the conforming amendments are included in SA 315, paragraph 22a will become paragraph 23 and the SA will be re-numbered accordingly.]

Components of Internal Control-Monitoring of Controls (Ref: Para. 22)

A94. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary corrective actions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

A95. In many entities, internal auditor or personnel performing similar functions contribute to the monitoring of an entity's activities. [Proposed] SA 610 (Revised) establishes requirements and provides guidance on the auditor's consideration of the work of internal auditing. Management's monitoring activities may also include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

Considerations Specific to Smaller Entities

A96. Management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to corrective action to the control.

Internal Audit Functions (Ref: Para 22a)

A96a. The entity's internal audit function is likely to be relevant to the audit if the nature of the internal audit function's responsibilities and activities are related to the entity's financial reporting, and the auditor expects to use the work of the internal auditors to modify the nature or timing, or reduce the extent, of audit procedures to be performed. When the auditor determines that the internal audit function is likely to be relevant to the audit, SA 610 (Revised) applies.

A96b. The objectives of an internal audit function, and therefore the nature of its responsibilities and its status within the organisation, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. The responsibilities of an internal audit function may include, for example, monitoring of internal control, risk management, and review of compliance with laws and regulations. On the other hand, the responsibilities of the internal audit function may be limited to the review of the economy, efficiency and effectiveness of operations, for example, and accordingly, may not relate to the entity's financial reporting.

A96c. If the nature of the internal audit function's responsibilities are related to the entity's financial reporting, the external auditor's consideration of the activities performed, or to be performed by, the internal audit function may include review of the internal audit function's audit plan for the period, if any, and discussion of that plan with the internal auditors.

[When the conforming amendments are included in SA 315, paragraphs A96a-A96c will become paragraphs A97-A99 and the SA will be re-numbered accordingly.]

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

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

3 SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment," paragraph 22a.

4 SA 315, paragraph A96a.

* The term "internal audit function" is defined in SA 610 (Revised), "Using the Work of Internal Auditors", paragraph 7(a).

STANDARD ON AUDITING (SA) 300¹

PLANNING AN AUDIT OF FINANCIAL STATEMENTS

Standard on Auditing (SA) 300, "Planning an Audit of Financial Statements" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services²," which sets out the authority of Standards on Auditing (SAs).

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to plan an audit of financial statements. This SA is framed in the context of recurring audits. Additional considerations in initial audit engagements are separately identified. (Ref: Para.A1-A4)

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after 1st April, 2008.

Objective

3. The objective of the auditor is to plan the audit so that it will be performed in an effective manner.

Requirements

Involvement of Key Engagement Team Members

4. The engagement partner and other key members of the engagement team shall be involved in planning the audit, including planning and participating in the discussion among engagement team members. (Ref: Para. A5)

Preliminary Engagement Activities

5. The auditor shall undertake the following activities at the beginning of the current audit engagement:

- a. Performing procedures required by SA 220³, "Quality Control for Audit Work" regarding the continuance of the client relationship and the specific audit engagement;
- b. Evaluating compliance with ethical requirements, including independence, as required by SA 220; and
- c. Establishing an understanding of the terms of the engagement, as required by SA 210⁴, "Terms of Audit Engagements". (Ref: Para. A6-A8)

Planning Activities

6. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

7. In establishing the overall audit strategy, the auditor shall:

- a. Identify the characteristics of the engagement that define its scope;
- b. Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
- c. Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;
- d. Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
- e. Ascertain the nature, timing and extent (Ref: Para. A9-A12)

8. The auditor shall develop an audit plan that shall include a description of:

- a. The nature, timing and extent of planned risk assessment procedures, as determined under SA 315⁵, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".
- b. The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330⁶, "The Auditor's Responses to Assessed Risks".
- c. Other planned audit procedures that are required to be carried out so that the engagement complies with SAs. (Ref: Para. A13)

9. The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. (Ref: Para. A14)

10. The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. (Ref: Para. A15-A16)

Documentation

11. The auditor shall document:

- a. The overall audit strategy;
- b. The audit plan; and
- c. Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. (Ref: Para. A17-A20)

Additional consideration in Initial Audit Engagements

12. The auditor shall undertake the following activities prior to starting an initial audit:

- a. Performing procedures required by SA 220 regarding the acceptance of the client relationship and the specific audit engagement; and

- b. Communicating with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements. (Ref: Para.A21)

Application and Other Explanatory Material

The Role and Timings of Planning (Ref: Para.1)

A1. Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways, including the following:

- Helping the auditor to devote appropriate attention to important areas of the audit.
- Helping the auditor identify and resolve potential problems on a timely basis.
- Helping the auditor properly organise and manage the audit engagement so that it is performed in an effective and efficient manner.
- Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
- Facilitating the direction and supervision of engagement team members and the review of their work.
- Assisting, where applicable, in coordination of work done by auditors of components⁷ and experts⁸.

A2. The nature and extent of planning activities will vary according to the size and complexity of the entity, the key engagement team members' previous experience with the entity, and changes in circumstances that occur during the audit engagement.

A3. Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as:

- The analytical procedures to be applied as risk assessment procedures.
- Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
- The determination of materiality.
- The involvement of experts.
- The performance of other risk assessment procedures.

A4. The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement (for example, to coordinate some of the planned audit procedures with the work of the entity's personnel). Although these discussions often occur, the overall audit strategy and the audit plan remain the auditor's

responsibility. When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit. For example, discussing the nature and timing of detailed audit procedures with management may compromise the effectiveness of the audit by making the audit procedures too predictable.

Involvement of Key Engagement Team Members (Ref: Para. 4)

A5. The involvement of the engagement partner and other key members of the engagement team in planning the audit draws on their experience and insight, thereby enhancing the effectiveness and efficiency of the planning process⁹.

Preliminary Engagement Activities (Ref: Para. 5)

A6. Performing the preliminary engagement activities specified in paragraph 5 at the beginning of the current audit engagement assists the auditor in identifying and evaluating events or circumstances that may adversely affect the auditor's ability to plan and perform the audit engagement.

A7. Performing these preliminary engagement activities enables the auditor to plan an audit engagement for which, for example:

- The auditor maintains the necessary independence and ability to perform the engagement.
- There are no issues with management integrity that may affect the auditor's willingness to continue the engagement.
- There is no misunderstanding with the client as to the terms of the engagement.

A8. The auditor's consideration of client continuance and ethical requirements, including independence, occurs throughout the audit engagement as changes in conditions and circumstances occur. Performing initial procedures on both client continuance and evaluation of ethical requirements (including independence) at the beginning of the current audit engagement means that they are completed prior to the performance of other significant activities for the current audit engagement. For continuing audit engagements, such initial procedures often occur shortly after (or in connection with) the completion of the previous audit.

Planning Activities

The Overall Audit Strategy (Ref: Para.6-7)

A9. The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as:

- The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters;
- The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of

review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas;

- When these resources are to be deployed, such as whether at an interim audit stage or at key cut off dates; and
- How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

A10. The Appendix lists examples of considerations in establishing the overall audit strategy.

A11. Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely interrelated since changes in one may result in consequential changes to the other.

Considerations Specific to Smaller Entities

A12. In audits of small entities, the entire audit may be conducted by a very small audit team. Many audits of small entities involve the engagement partner (who may be a sole practitioner) working with one engagement team member (or without any engagement team members). With a smaller team, coordination of, and communication between, team members are easier. Establishing the overall audit strategy for the audit of a small entity need not be a complex or time-consuming exercise; it varies according to the size of the entity, the complexity of the audit, and the size of the engagement team. For example, a brief memorandum prepared at the completion of the previous audit, based on a review of the working papers and highlighting issues identified in the audit just completed, updated in the current period based on discussions with the owner manager, can serve as the documented audit strategy for the current audit engagement if it covers the matters noted in paragraph 7.

The Audit Plan (Ref: Para.8)

A13. The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops. For example, planning of the auditor's assessment procedures occurs early in the audit process. However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of risk assessment procedures. In addition, the auditor may begin the execution of further audit procedures for some classes of transactions, account balances and disclosures before planning all remaining further audit procedures.

Changes to Planning Decisions During the Course of the Audit (Ref: Para. 9)

A14. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures. For example, audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls.

Direction, Supervision and Review (Ref: Para. 10)

A15. The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including:

- The size and complexity of the entity.
- The area of the audit.
- The assessed risks of material misstatement (for example, an increase in the assessed risk of material misstatement for a given area of the i audit ordinarily requires a corresponding increase in the extent and timeliness of direction and supervision of engagement team members, and a more detailed review of their work).
- The capabilities and competence of the individual team members performing the audit work.

SA 220 contains further guidance on the direction, supervision and review of audit work.

Considerations Specific to Smaller Entities

A16. When an audit is carried out entirely by the engagement partner, questions of direction and supervision of engagement team members and review of their work do not arise. In such cases, the engagement partner, having personally conducted all aspects of the work, will be aware of all material issues. Forming an objective view on the appropriateness of the judgments made in the course of the audit can present practical problems when the same individual also performs the entire audit. When particularly complex or unusual issues are involved, and the audit is performed by a sole practitioner, it may be desirable to consult with other suitably experienced auditors or the auditor's professional body¹⁰.

Documentation (Ref: Para. 11)

A17. The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team. For example, the auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing and conduct of the audit.

A18. The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the

assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

A19. A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

Considerations Specific to Smaller Entities

A20. As discussed in paragraph A1 2, a suitable, brief memorandum may serve as the documented strategy for the audit of a smaller entity. For the audit plan, standard audit programs and/or checklists (see paragraph A1 8) drawn up on the assumption of few relevant control activities, as is likely to be the case in a smaller entity, may be used provided that they are tailored to the circumstances of the engagement, including the auditor's risk assessments.

Additional Considerations in Initial Audit Engagements (Ref: Para. 12)

A21. The purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not ordinarily have the previous experience with the entity that is considered when planning recurring engagements. For initial audits, additional matters the auditor may consider in establishing the overall audit strategy and audit plan include the following:

- Unless prohibited by law or regulation, arrangements to be made with the predecessor auditor, for example, to review the predecessor auditor's working papers. Any major issues (including the application of accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan.
- The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances (see SA 510¹¹, Initial Engagements -- Opening Balances").
- Other procedures required by the firm's system of quality control for initial audit engagements (for example, the firm's system of quality control may require the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance).

Considerations in Establishing the Overall Audit Strategy

This appendix provides examples of matters the auditor may consider in establishing the overall audit strategy. Many of these matters will also influence the auditor's detailed audit plan. The examples provided cover a broad range of matters applicable to many engagements. While some of the matters referred to below may be required by other SAs, not all matters are relevant to every audit engagement and the list is not necessarily complete.

Characteristics of the Engagement

- The financial reporting framework on which the financial information to be audited has been prepared including any need for reconciliations to another financial reporting framework.
- Industry specific reporting requirements such as reports mandated by industry regulators.
- The expected audit coverage, including Reporting Objectives, Timing of the Audit, the number and locations of components to be included.
- The nature of the control relationships between a parent and its components that determine how the group is to be consolidated.
- The extent to which components are audited by other auditors.
- The nature of the business segments to be audited, including the need for specialised knowledge.
- The reporting currency to be used, including any need for currency translation for the financial information audited.
- The need for a statutory audit of standalone financial statements in addition to an audit for consolidation purposes.
- The availability of the work of internal auditors and the extent of the auditor's potential reliance on such work.
- The entity's use of service organisations and how the auditor may obtain evidence concerning the design or operation of controls performed by them.
- The expected use of audit evidence obtained in previous audits, for example, audit evidence related to risk assessment procedures and tests of controls.
- The effect of information technology on the audit procedures, including the availability of data and the expected use of computer assisted audit techniques.
- The coordination of the expected coverage and timing of the audit work with any reviews of interim financial information and the effect on the audit of the information obtained during such reviews.
- The availability of client personnel and data.

Reporting Objectives, Timing of the Audit, and Nature of Communications

- The entity's timetable for reporting, such as at interim and final stages.
- The organisation of meetings with management and those charged with governance to discuss the nature, timing and extent of the audit work.

- The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications, both written and oral, including the auditor's report, management letters and communications to those charged with governance.
- The discussion with management regarding the expected communications on the status of audit work throughout the engagement.
- Communication with auditors of components regarding the expected types and timing of reports to be issued and other communications in connection with the audit of components.
- The expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.
- Whether there are any other expected communications with third parties, including any statutory or contractual reporting responsibilities arising from the audit.

Significant Factors, Preliminary Engagement Activities, and Knowledge Gained on Other Engagements

- The determination of appropriate materiality levels, including:
 - Setting materiality for planning purposes.
 - Setting and communicating materiality for auditors of components.
 - Reconsidering materiality as audit procedures are performed during the course of the audit.
 - Preliminary identification of material components and account balances.
- Preliminary identification of areas where there may be a higher risk of material misstatement.
- The impact of the assessed risk of material misstatement at the overall financial statement level on direction, supervision and review.
- The manner in which the auditor emphasizes to engagement team members the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence.
- Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified weakness and action taken to address them.
- The discussion of matters that may affect the audit with firm personnel responsible for performing other services to the entity.
- Evidence of management's commitment to the design, implementation and maintenance of sound internal control, including evidence of appropriate documentation of such internal control.
- Volume of transactions, which may determine whether it is more efficient for the auditor to rely on internal control.
- Importance attached to internal control throughout the entity to the successful operation of the business.
- Significant business developments affecting the entity, including changes in information technology and business processes, changes in key management, and acquisitions, mergers and divestments.

- Significant industry developments such as changes in industry regulations and new reporting requirements.
- Significant changes in the financial reporting framework, such as changes in accounting standards.
- Other significant relevant developments, such as changes in the legal environment affecting the entity.

Nature, Timing and Extent of Resources

- The selection of the engagement team (including, where necessary, the engagement quality control reviewer) and the assignment of appropriately experienced team members to areas where there may be higher risks of material misstatements.

¹ Earlier known as the Auditing and Assurance Standard (AAS) 8, "Audit Planning".

² Published in July 2007 issue of the Journal.

³ Hitherto known as the Auditing and Assurance Standard, (AAS) 17, "Quality Control for Audit Work". The Standard is being revised in the light of the corresponding International Standard.

⁴ Hitherto known as the Auditing and Assurance Standard (AAS) 26, "Terms of Audit Engagements" The Standard is being revised in the light of the corresponding International Standard.

⁵ The Auditing and Assurance Standards Board has issued the Revised Exposure Draft of the proposed Standard on Auditing (SA) 315, published in the September, 2007 issue of the Journal. The original Exposure Draft of the corresponding AAS was published in the April, 2005 issue of the Journal.

⁶ The Auditing and Assurance Standards Board has issued the Revised Exposure Draft of the proposed Standard on Auditing (SA) 330, published in the September, 2007 issue of the Journal. The original Exposure Draft of the corresponding AAS was published in the April, 2005 issue of the Journal. Once the final SAs 315 and 330 are issued, the existing AAS 6, "Risk Assessment and Internal Control, AAS 20, "Knowledge of the Business" and AAS 29, "Auditing in a Computer Information Systems Environment" shall stand withdrawn.

⁷ The auditor may refer the requirements of AAS 10 (Re-numbered as SA 600), "Using the Work of an Another Auditor".

⁸ The auditor may refer the requirements of AAS 9 (Re-numbered as SA 620) , "Using the Work of an Expert".

⁹ The proposed Standard on Auditing (SA) 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" establishes requirements and provides guidance on the engagement team's discussion of the susceptibility of the entity to material misstatements of the financial statements. Proposed SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" shall provide guidance on the emphasis given during this discussion to the susceptibility of the entity's financial statements to material misstatement due to fraud.

¹⁰ In India, the Institute of Chartered Accountants of India governs the accountancy profession to provide services of high quality in the public interest which are accepted worldwide.

¹¹ Hitherto known as AAS 22, "Initial Engagements-Opening Balances".

AAS 9

USING THE WORK OF AN EXPERT

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The following is the text of the Auditing and Assurance Standard (AAS) 9¹, "Using the Work of an Expert", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in conjunction with the 'Preface to the Statements on Standard Auditing Practices', issued by the Institute.

Introduction

1. Auditing and Assurance Standard (AAS) 1, *Basic Principles Governing an Audit*, states (paragraphs 9-10):

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

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

This Standard discusses the auditor's responsibility in relation to, and the procedures the auditor should consider in, using the work of an expert as audit evidence. In this Standard, the term 'financial information' encompasses financial statements.

2. The auditor's education and experience enable him to be knowledgeable about business matters in general, but he is not expected to have the expertise of a person trained for, or qualified to engage in, the practice of another profession or occupation, such as an actuary or engineer.

3. An expert (or a specialist), for the purpose of this Statement, is a person, firm or other association of persons possessing special skill, knowledge and experience in a particular field other than accounting and auditing. An 'expert' may be:

- ◆ engaged by the client,
- ◆ engaged by the auditor,
- ◆ employed by the client, or
- ◆ employed by the auditor.

4. When the auditor uses the work of an expert employed by him, he is using that work in the employee's capacity as an expert rather than delegating the work to an assistant on the audit. Accordingly, in such circumstances, he should apply relevant procedures described in this Statement in satisfying himself as to his employee's work and findings.

Determining the Need to Use the Work of an Expert

5. During the audit, the auditor may seek to obtain, in conjunction with the client or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert. Examples are:

- ◆ Valuations of certain types of assets, for example, land and buildings, plant and machinery, works of art, and precious stones.
- ◆ Determination of quantities or physical condition of assets, for example, minerals stored in stockpiles, mineral and petroleum reserves, and the remaining useful life of plant and machinery.
- ◆ Determination of amounts using specialised techniques or methods, for example, an actuarial valuation.
- ◆ The measurement of work completed and to be completed on contracts in progress for the purpose of revenue recognition.
- ◆ Legal opinions concerning interpretations of agreements, statutes, regulations, notifications, circulars, etc.

6. When determining whether to use the work of an expert or not, the auditor should consider:

- ◆ the materiality of the item being examined in relation to the financial information as a whole,
- ◆ the nature and complexity of the item including the risk of error therein, and
- ◆ the other audit evidence available with respect to the item.

Skills and Competence of the Expert

7. When the auditor plans to use the expert's work as audit evidence, he should satisfy himself as to the expert's skills and competence by considering the expert's:

- ◆ professional qualifications, licence or membership in an appropriate professional body, and
- ◆ experience and reputation in the field in which the evidence is sought.

However, when the auditor uses the work of an expert employed by him, he will not need to inquire into his skills and competence.

Objectivity of the Expert

8. The auditor should also consider the objectivity of the expert. The risk that an expert's objectivity will be impaired increases when the expert is:

- ◆ employed by the client, or
- ◆ related in some other manner to the client.

Accordingly, in these circumstances, the auditor should (after taking into account the factors in paragraphs 6 and 7) consider performing more extensive procedures than would otherwise have been planned, or he might consider engaging another expert.

Evaluating the Work of an Expert

9. When the auditor intends to use the work of an expert, he should examine evidence to gain knowledge regarding the terms of the expert's engagement and such other matters as :

- ◆ the objectives and scope of the expert's work,
- ◆ a general outline as to the specific items in the expert's report,
- ◆ confidentiality of the expert's work, including the possibility of its communication to third parties,
- ◆ the expert's relationship with the client, if any,
- ◆ confidentiality of the client's information used by the expert.

10. The auditor should seek reasonable assurance that the expert's work constitutes appropriate audit evidence in support of the financial information, by considering:-

- ◆ the source data used,
- ◆ the assumptions and methods used and, if appropriate, their consistency with the prior period, and
- ◆ the results of the expert's work in the light of the auditor's overall knowledge of the business and of the results of his audit procedures.

The auditor should also satisfy himself that the substance of the expert's findings is properly reflected in the financial information.

11. The auditor should consider whether the expert has used source data which are appropriate in the circumstances. The procedures to be applied by the auditor should include:

- ◆ making inquiries of the expert to determine how he has satisfied himself that the source data are sufficient, relevant and reliable, and
- ◆ conducting audit procedures on the data provided by the client to the expert to obtain reasonable assurance that the data are appropriate.

12. The appropriateness and reasonableness of assumptions and methods used and their application are the responsibility of the expert. The auditor does not have the same expertise and, therefore, cannot always challenge the expert's assumptions and methods. However, the auditor should obtain an understanding of those assumptions and methods to determine that they are reasonable based on the auditor's knowledge of the client's business and on the results of his audit procedures.

13. Normally, completion of the above procedures will provide the auditor with reasonable assurance that he has obtained appropriate audit evidence in support of the financial information. In exceptional cases where the work of an expert does not support the related representations in the financial information, the auditor should attempt to resolve the inconsistency by discussions with the client and the expert. Applying additional procedures, including possibly engaging another expert, may also assist the auditor in resolving the inconsistency.

14. If, after performing these procedures, the auditor concludes that:

- ◆ the work of the expert is inconsistent with the information in the financial statements, or that
- ◆ the work of the expert does not constitute sufficient appropriate audit evidence (e.g., where the work of the expert involves highly technical matters or where, on grounds of confidentiality, the expert refuses to make available to the auditor the source data used by him),

he should express a qualified opinion, a disclaimer of opinion or an adverse opinion, as may be appropriate.

Reference to an Expert in the Auditor's Report

15. When expressing an unqualified opinion, the auditor should not refer to the work of an expert in his report. If, as a result of the work of an expert, the auditor decides to express other than an unqualified opinion, it may in some circumstances benefit the reader of his report if the auditor, in explaining the nature of his reservation, refers to or describes the work of the expert. Where, in doing so, the auditor considers it appropriate to disclose the identity of the expert, he should obtain prior consent of the expert for such disclosure if such consent has not already been obtained.

Effective Date

16. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods beginning on or after April 1, 1991.

* Issued in December, 1991.

AAS 10

USING THE WORK OF ANOTHER AUDITOR

Contents

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The following is the text of the Auditing and Assurance Standard (AAS) 10, "Using the Work of Another Auditor ", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in conjunction with the "Preface to the Statements on Standard Auditing Practices", issued by the Institute.*

Introduction

1. The Auditing and Assurance Standard (AAS) 1, *Basic Principles Governing an Audit*, states (paragraph 9):

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

2. The purpose of this Auditing and Assurance Standard (AAS) is to establish standards to be applied in situations where an auditor (referred to herein as the 'principal auditor'), reporting on the financial information of an entity, uses the work of another auditor (referred to herein as the 'other auditor') with respect to the financial information of one or more components included in the financial information of the entity. This Statement also discusses the principal auditor's responsibility in relation to his use of the work of the other auditor. In this Statement, the term 'financial information' encompasses 'financial statements'.

3. This Standard does not deal with those instances where two or more auditors are appointed as joint auditors¹⁴ nor does it deal with the auditor's relationship with a predecessor auditor.
4. When the principal auditor concludes that the financial information of a component is immaterial, the procedures outlined in this Statement do not apply. When several components, immaterial in themselves, are together material in relation to the financial information of the entity as a whole, the procedures outlined in this Statement should be considered.
5. **When the principal auditor uses the work of another auditor, the principal auditor should determine how the work of the other auditor will affect the audit.**
6. "Principal auditor" means the auditor with responsibility for reporting on the financial information of an entity when that financial information includes the financial information of one or more components audited by another auditor.
7. "Other auditor" means an auditor, other than the principal auditor, with responsibility for reporting on the financial information of a component which is included in the financial information audited by the principal auditor.
8. "Component" means a division, branch, subsidiary, joint venture, associated enterprises or other entity whose financial information is included in the financial information audited by the principal auditor.

Acceptance as Principal Auditor

9. **The auditor should consider whether the auditor's own participation is sufficient to be able to act as the principal auditor.** For this purpose the auditor would consider:
 - (a) the materiality of the portion of the financial information which the principal auditor audits;
 - (b) the principal auditor's degree of knowledge regarding the business of the components;
 - (c) the risk of material misstatements in the financial information of the components audited by the other auditor; and
 - (d) the performance of additional procedures as set out in this AAS regarding the components audited by other auditor resulting in the principal auditor having significant participation in such audit.

The Principal Auditor's Procedures

10. In certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of account and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component.
11. **When planning to use the work of another auditor, the principal auditor should consider the professional competence of the other auditor in the context of specific assignment if the other auditor is not a member of the Institute of Chartered Accountants of India.**
12. **The principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in**

the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:

- (a) advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as areas requiring special consideration, procedures for the identification of inter-component transactions that may require disclosure and the time-table for completion of audit; and
- (b) advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

13. The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor. This knowledge may have been enhanced from the review of the previous audit work of the other auditor.

14. The principal auditor may conclude that it is not necessary to apply procedures such as those described in paragraph 13 because sufficient appropriate audit evidence previously obtained that acceptable quality control policies and procedures are complied with in the conduct of other auditor's practice.

15. The principal auditor should consider the significant findings of the other auditor.

16. The principal auditor may consider it appropriate to discuss with the other auditor and the management of the component, the audit findings or other matters affecting the financial information of the components. He may also decide that supplemental tests of the records or the financial statements of the component are necessary. Such tests may, depending upon the circumstances, be performed by the principal auditor or the other auditor.

17. In certain circumstances, the other auditor may happen to be a person other than a professionally qualified auditor. This may happen, for instance, where a component is situated in a foreign country and the applicable laws permit a person other than a professionally qualified auditor to audit the financial statements of such component. In such circumstances, the procedures outlined in paragraphs 10 to 16 assume added importance.

18. The principal auditor should document in his working papers the components whose financial information was audited by other auditors; their significance to the financial information of the entity as a whole; the names of the other auditors; and any conclusions reached that individual components are not material. The principal auditor should also document the procedures performed and the conclusions reached. For example, the auditor would document the results of discussions with the other auditor and review of the written summary of the other auditor's procedures. However, the principal auditor need not document the reasons for limiting the procedures in the circumstances described at 14 above, provided those reasons are summarised elsewhere in the documentation maintained by the principal auditor. Where the other auditor's report is other than unmodified^[2], the principal auditor should also document how he has dealt with the qualifications or adverse remarks contained in the other auditor's report in framing his own report.

Co-ordination Between Auditors

19. **There should be sufficient liaison between the principal auditor and the other auditor.** For this purpose, the principal auditor may find it necessary to issue written communication(s) to the other auditor.

20. **The other auditor, knowing the context in which his work is to be used by the principal auditor, should co-ordinate with the principal auditor.** For example, by bringing to the principal auditor's immediate attention any significant findings requiring to be dealt with at entity level, adhering to the timetable for audit of the component, etc. He should ensure compliance with the relevant statutory requirements. Similarly, the principal auditor should advise the other auditor of any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.

21. When considered necessary by him, the principal auditor may require the other auditor to answer a detailed questionnaire regarding matters on which the principal auditor requires information for discharging his duties. The other auditor should respond to such questionnaire on a timely basis.

Reporting Considerations

22. **When the principal auditor concludes, based on his procedures, that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation on the scope of audit.**

23. In all circumstances, if the other auditor issues, or intends to issue, a modified auditor's report, the principal auditor should consider whether the subject of the modification is of such nature and significance, in relation to the financial information of the entity on which the principal auditor is reporting, that it requires a modification of the principal auditor's report.

Division of Responsibility

24. The principal auditor would not be responsible in respect of the work entrusted to the other auditors, except in circumstances which should have aroused his suspicion about the reliability of the work performed by the other auditors.

25. **When the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/branches/subsidiaries or other components audited by other auditors.**

Effective Date

26. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods beginning on or after April 1, 2002.

Compatibility with International Standard on Auditing (ISA) 600

The auditing standards established in this Auditing and Assurance Standard (AAS) are generally consistent, in all material respects, with those set out in ISA 600 "Using the Work of Another Auditor".

* Issued in April, 1995. Revised in September, 2002.

[1] Auditing and Assurance Standard (AAS) 12, "*Responsibility of Joint Auditors*", deals with the audit procedures to be employed where two or more auditors are appointed as joint auditors.

[2] Auditing and Assurance Standard (AAS) 28, "Auditor's Report on Financial Statements", deals with the concept of "modified audit report". An auditor's report is considered to be modified when it includes:

Matters that do not affect the auditor 's opinion

(a) emphasis of matter

Matters that do affect the auditor 's opinion

(a) qualified opinion,

(b) disclaimer of opinion, or

(c) adverse opinion.

AAS 12

RESPONSIBILITY OF JOINT AUDITORS

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The following is the text of the Auditing and Assurance Standard (AAS) 12¹, “Responsibility of Joint Auditors”, issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in conjunction with the “Preface to the Statements on Standard Auditing Practices”, issued by the Institute.

The Statement on the Responsibility of Joint Auditors issued by the Institute earlier shall stand completely withdrawn in respect of all audits relating to accounting periods beginning on or after April 1, 1996.^[1]

Introduction

1. The practice of appointing more than one auditor to conduct the audit of large entities is in vogue these days. Such auditors, known as joint auditors, conduct the audit jointly and report on the financial statements of the entity. This Standard deals with the professional responsibilities which the auditors undertake in accepting such appointments as joint auditors. The Standard does not deal with the relationship between a principal auditor who is appointed to report on the financial statements of an entity and another auditor who is appointed to report on the financial statements of one or more divisions or branches included in the financial statements of the entity, e.g., the relationship between a company auditor appointed under section 224 of the Companies Act, 1956 and a branch auditor appointed under section 228 of the said Act.^[2]

Division of Work

2. Where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. Certain areas

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

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

Coordination

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

Relationship Among Joint Auditors

5. In respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible –

- (a) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;
- (b) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors. It may, however, be clarified that all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing or extent of the audit procedures agreed upon among them; proper execution of these audit procedures is the separate and specific responsibility of the joint auditor concerned;
- (c) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;
- (d) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and
- (e) for ensuring that the audit report complies with the requirements of the relevant statute.

6. If any matters of the nature referred to in paragraph 4 above are brought to the attention of the entity or other joint auditors by an auditor after the audit report has been submitted, the other joint auditors would not be responsible for those matters.

7. Subject to paragraph 5(b) above, it is the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the area of work allocated to him. The issues such as appropriateness of using test checks or sampling should be decided by each joint auditor in relation to his own area of work. This responsibility is not shared by the other joint auditors. Thus, it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him. Similarly, the nature, timing and extent of the enquiries to be made in the course of audit as well as the other audit procedures to be applied are solely the responsibility of each joint auditor.

8. In the case of audit of a large entity with several branches, including those required to be audited by branch auditors, the branch audit reports/returns may be required to be scrutinised by different joint auditors in accordance with the allocation of work. In such cases, it is the specific and separate responsibility of each joint auditor to review the audit reports/returns of the divisions/branches allocated to him and to ensure that they are properly incorporated into the accounts of the entity. In respect of the branches which do not fall within any divisions or zones which are separately assigned to the various joint auditors, they may agree among themselves as regards the division of work relating to the review of such branch returns. It is also the separate and specific responsibility of each joint auditor to exercise his judgement with regard to the necessity of visiting such divisions/branches in respect of which the work is allocated to him.

9. A significant part of the audit work involves obtaining and evaluating information and explanations from the management. This responsibility is shared by all the joint auditors unless they agree upon a specific pattern of distribution of this responsibility. In cases where specific divisions, zones or units are allocated to different joint auditors, it is the separate and specific responsibility of each joint auditor to obtain appropriate information and explanations from the management in respect of such divisions/zones/units and to evaluate the information and explanations so obtained by him.

10. Each joint auditor is entitled to assume that the other joint auditors have carried out their part of the audit work in accordance with the generally accepted audit procedures.^[3] It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in such a manner. Each joint auditor is entitled to rely upon the other joint auditors for bringing to his notice any departure from generally accepted accounting principles or any material error noticed in the course of the audit.

11. Where separate financial statements of a division/branch are audited by one of the joint auditors, the other joint auditors are entitled to proceed on the basis that such financial statements comply with all the legal and professional requirements regarding the disclosures to be made and present a true and fair view of the state of affairs and of the working results of the division/branch concerned, subject to such observations as may be communicated by the joint auditor concerned.

Reporting Responsibilities

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

Effective Date

13. This Auditing and Assurance Standard becomes operative in respect of all audits relating to accounting periods beginning on or after April 1, 1996.

* Issued in November, 1996.

^[3] Paragraphs 17-29 of the *Statement on the Responsibility of Joint Auditors* already stand withdrawn in respect of all audits relating to accounting periods beginning on or after April 1, 1995, pursuant to the issuance of AAS 10, *Using the Work of Another Auditor* in 1995.

^[2] These aspects have been dealt with in Auditing and Assurance Standard (AAS) 10 (revised 2002), *Using the Work of Another Auditor*. It may also be mentioned that presently, there is no legal requirement under the Companies Act, 1956 to prepare consolidated accounts or group accounts. Section 212 of the Companies Act, 1956 requires that the accounts of a holding company shall have attached thereto the Balance Sheet, Profit and Loss Account, Directors' Report and Auditors' Report of each subsidiary company. Certain additional information is also required. In view of the fact that a subsidiary is a separate legal entity, the Council of the Institute is of the opinion that no responsibility is cast upon the auditors of a holding company in respect of the work performed by the auditors of the subsidiary. However, Auditing and Assurance Standard (AAS) 10 (revised 2002), '*Using the Work of Another Auditor*' lays down the responsibility of the auditors of the holding company when they are required to issue an audit opinion on consolidated financial statements.

^[3] Reference may be made in this regard to the Auditing and Assurance Standards and other mandatory Statements relating to auditing matters issued by the Council of the Institute from time to time.

SA 320 (Revised)

Materiality in Planning and Performing an Audit

(Effective for all audits relating to accounting periods beginning on or after April 1, 2010)

Standard on Auditing (SA) 320 (Revised), “Materiality in Planning and Performing an Audit” should be read in the context of the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services¹,” which sets out the authority of SAs and proposed SA 200 (Revised), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”².

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor’s responsibility to apply the concept of materiality in planning and performing an audit of financial statements. SA 450³, explains how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

Materiality in the Context of an Audit

2. Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
- Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group.⁴ The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

3. Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to in paragraph 2 provide the auditor with such a frame of reference.

4. The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:

- a. Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
- b. Understand that financial statements are prepared, presented and audited to levels of materiality;
- c. Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
- d. Make reasonable economic decisions on the basis of the information in the financial statements.

5. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report. (Ref: Para. A1)

6. In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:

- a. Determining the nature, timing and extent of risk assessment procedures;
- b. Identifying and assessing the risks of material misstatement; and
- c. Determining the nature, timing and extent of further audit procedures.

The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. Although, it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements.⁵

Effective Date

7. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

8. The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.

Definition

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

Requirements

Determining Materiality and Performance Materiality when Planning the Audit

10. When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. (Ref: Para. A2-A11)

11. The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (Ref: Para. A12)

Revision as the Audit Progresses

12. The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. (Ref: Para. A13)

13. If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

Documentation

14. The audit documentation shall include the following amounts and the factors considered in their determination:

- a. Materiality for the financial statements as a whole (see paragraph 10);
- b. If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures (see paragraph 10);
- c. Performance materiality (see paragraph 11); and
- d. Any revision of (a)-(c) as the audit progressed (see paragraphs 12-13).

* * *

Application and Other Explanatory Material

Materiality and Audit Risk (Ref: Para. 5)

A1. In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.⁶ The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level⁷. Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk⁸. Materiality and audit risk are considered throughout the audit, in particular, when:

- a. Identifying and assessing the risks of material misstatement⁹;
- b. Determining the nature, timing and extent of further audit procedures¹⁰; and
- c. Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report¹¹.

Determining Materiality and Performance Materiality when Planning the Audit (Ref: Para. 10)

Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole

A2. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the

financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
- The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
- The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- The relative volatility of the benchmark.

A3. Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

A4. In relation to the chosen benchmark, relevant financial data ordinarily includes prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates. For example, when, as a starting point, the materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that the materiality for the financial statements as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.

A5. Materiality relates to the financial statements on which the auditor is reporting. Where the financial statements are prepared for a financial reporting period of more or less than twelve months, such as may be the case for a new entity or a change in the financial reporting period, materiality relates to the financial statements prepared for that financial reporting period.

A6. Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will

normally be higher than a percentage applied to total revenue. For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in different circumstances.

Considerations Specific to Small Entities

A7. When an entity's profit before tax from continuing operations is consistently nominal, as might be the case for an owner-managed business where the owner takes much of the profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be more relevant.

A8. In the case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), legislators and regulators are often the primary users of its financial statements. Furthermore, the financial statements may be used to make decisions other than economic decisions. The determination of materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) in an audit of the financial statements of those entities may therefore be influenced by legislative and regulatory requirements, and by the financial information needs of legislators and the public in relation to public utility programs/projects, such as, Accelerated Irrigation Benefit Programme (AIBP), Pradhan Mantri Gram Sadak Yojana (PMGSY) undertaken by the Central/State governments or related government entities.

A9. In an audit of the entities doing public utility programs/projects, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for that particular program/project activity. Where an entity has custody of the assets, assets may be an appropriate benchmark.

Materiality Level or Levels for Particular Classes of Transactions, Account Balances or Disclosures (Ref: Para. 10)

A10. Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements include the following:

- Whether law, regulations or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions, and the remuneration of management and those charged with governance).

- The key disclosures in relation to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company).
- Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, a newly acquired business).

A11. In considering whether, in the specific circumstances of the entity, such classes of transactions, account balances or disclosures exist, the auditor may find it useful to obtain an understanding of the views and expectations of those charged with governance and management.

Performance Materiality (Ref: Para. 11)

A12. Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

Revision as the Audit Progresses (Ref: Para. 12)

A13. Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. For example, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

Material Modifications to ISA 320, "Materiality in Planning and Performing an Audit"

Deletions

1. Paragraph A2 of ISA 320 dealt with the determination of materiality for the financial statements as a whole or for particular assertion in an audit of financial statements of a public sector entity, which is influenced by legislative and regulatory requirements, and by the financial information needs of legislators and the public in relation to public sector programs. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.
Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities, or programs/projects launched by them, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A2, highlighting such fact, has been retained and the paragraph has been re-numbered as A8.
2. Paragraph A9 of ISA 320 states that in an audit of the public sector entities, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for program/project activities. Where a public sector entity has custody of assets, assets may be an appropriate benchmark. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.
Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities, or programs/projects launched by them, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A9, highlighting such fact, has been retained

Limited Revision Consequential to issuance of the Standard on Auditing (SA) 320 (Revised), “Materiality in Planning and Performing an Audit”

The amendments to the following Standards on Auditing (SAs) have been shown in track change mode.

SA 230 (Revised), “Audit Documentation”

A17.Examples of matters that may be documented together in the audit of a smaller entity include the understanding of the entity and its internal control, the overall audit strategy and audit plan, materiality determined in accordance with SA 320(Revised)¹², assessed risks, significant matters noted during the audit, and conclusions reached.

SA 260 (Revised), “Communication with Those Charged with Governance”

A15. Communication regarding the planned scope and timing of the audit may:

- a. Assist those charged with governance to understand better the consequences of the auditor's work, to discuss issues of risk and the concept of materiality with the auditor, and to identify any areas in which they may request the auditor to undertake additional procedures ...

A17. Matters communicated may include:

- The application of the concept of materiality in the context of an audit.

SA 300 (Revised), "Planning an Audit of Financial Statements"

Appendix

Considerations in Establishing the Overall Audit Strategy

Significant Factors, Preliminary Engagement Activities, and Knowledge Gained on Other Engagements

- The determination of appropriate materiality levels in accordance with SA 320 (Revised), ¹³ and, where applicable: including:
 - o Setting materiality for planning purposes.
- Setting Determination of materiality for components and communication materiality for thereof to component auditors of components.
 - o Reconsidering materiality as audit procedures are performed during the course of the audit.
- Preliminary identification of material significant components and material classes of transactions, account balances and disclosures.

SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment"

A1. The understanding establishes a frame of reference within which the auditor plans to audit and exercise professional judgment throughout the audit, for example, when: ...

- Establishing Determining materiality in accordance with SA 320(Revised) and evaluating whether the judgment about materiality remains appropriate as the audit

progresses; ¹⁴ ...

SA 540 (Revised), “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”

A94. Ordinarily, a range that has been narrowed to be equal to or less than the amount lower than the materiality level for the financial statements as a whole determined for purposes of assessing risks of material misstatement, and designing further audit procedures performance materiality is adequate for the purposes of evaluating the reasonableness of management’s point estimate.

A122. The auditor’s evaluation of the adequacy of disclosure of estimation uncertainty increases in importance the greater the range of possible outcomes of the accounting estimate is in relation to materiality (see related discussion in paragraph A95 & A94).

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

2 Presently, SA 200, “Basic Principles Governing an Audit” and SA 200A, “Objective and Scope of an Audit of Financial Statements” correspond to International Standard on Auditing (ISA) 200 (Revised and Redrafted). Both the SAs are currently being revised in the light of the ISA 200 (Revised and Redrafted). Post revision, the principles covered by SA 200 (AAS 1) and SA 200A (AAS 2) will be merged into one Standard, i.e., SA 200.

3 SA 450, “Evaluation of Misstatements Identified during the Audit”.

4 For example, paragraph 10 of the “Framework for the Preparation and Presentation of Financial Statements,” issued by the Institute of Chartered Accountants of India (ICAI) in July 2000, indicates for a profit-oriented entity that “as providers of risk capital to the enterprise, investor need more comprehensive information than other users. The provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy”.

5 SA 450, paragraph A16.

6 Presently, SA 200, “Basic Principles Governing an Audit” and SA 200A, “Objective and Scope of an Audit of Financial Statements” correspond to International Standard on Auditing (ISA) 200 (Revised and Redrafted). Both the SAs are currently being revised in the light of the ISA 200 (Revised and Redrafted). Post revision, the principles covered by SA 200 (AAS 1) and SA 200A (AAS 2) will be merged into one Standard, i.e., SA 200. ISA 200 (Revised and Redrafted), paragraph 11 states as follows:

“In conducting an audit of financial statements, the overall objectives of the auditor are:

- (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
- (b) To report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor’s findings.”

7 ISA 200 (Revised and Redrafted), paragraph 17 states as follows:

“To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor’s opinion.”

8 ISA 200 (Revised and Redrafted), paragraph 13(c) defines the Audit Risk as follows:

“The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk”.

9 SA 315, “Identifying and Assessing the Risks of Material Misstatements Through Understanding the Entity and Its Environment”.

10 SA 330, “The Auditor’s Responses to Assessed Risks”.

11 Currently, SA 700 (AAS 28), “The Auditor’s Report on Financial Statements”, issued by ICAI in January 2003 is in force. The Auditing and Assurance Standards Board has issued an Exposure Draft of the Revised SA 700 corresponding to International Standard on Auditing (ISA) 700, “Forming an

Opinion and Reporting on Financial Statements". The said Exposure Draft has been published in the June, 2009 issue of the Journal and has also been hosted on ICAI's website.

12 SA 320 (Revised), "Materiality in Planning and Performing an Audit".

13 SA 320 (Revised), "Materiality in Planning and Performing an Audit".

14 SA 320 (Revised), "Materiality in Planning and Performing an Audit".

AAS 14

ANALYTICAL PROCEDURES

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The following is the text of Auditing and Assurance Standard (AAS) 14, "Analytical Procedures", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in conjunction with the "Preface to the Statements on Standard Auditing Practices", issued by the Institute.*

Introduction

1. The purpose of this Auditing and Assurance Standard (AAS) is to establish standards on the application of analytical procedures during an audit.
2. **The auditor should apply analytical procedures at the planning and overall review stages of the audit.** Analytical procedures may also be applied at other stages.
3. "Analytical procedures" means the analysis of significant ratios and trends, including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts.

Nature and Purpose of Analytical Procedures

4. Analytical procedures include the consideration of comparisons of the entity's financial information with, for example:
 - ◆ Comparable information for prior periods.
 - ◆ Anticipated results of the entity, such as budgets or forecasts.
 - ◆ Predictive estimates prepared by the auditor, such as an estimation of depreciation charge for the year.

- ◆ Similar industry information, such as a comparison of the entity's ratio of sales to trade debtors with industry averages, or with other entities of comparable size in the same industry.
5. Analytical procedures also include consideration of relationships:
- ◆ Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
 - ◆ Between financial information and relevant non-financial information, such as payroll costs to number of employees.
6. Various methods may be used in performing the above procedures. These range from simple comparisons to complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, financial statements of components (such as subsidiaries, divisions or segments) and individual elements of financial information. The auditor's choice of procedures, methods and level of application is a matter of professional judgement.
7. Analytical procedures are used for the following purposes:
- (a) to assist the auditor in planning the nature, timing and extent of other audit procedures;
 - (b) as substantive procedures when their use can be more effective or efficient than tests of details in reducing detection risk for specific financial statement assertions; and
 - (c) as an overall review of the financial statements in the final review stage of the audit.

Analytical Procedures in Planning the Audit

8. **The auditor should apply analytical procedures at the planning stage to assist in understanding the business and in identifying areas of potential risk.** Application of analytical procedures may indicate aspects of the business of which the auditor was unaware and will assist in determining the nature, timing and extent of other audit procedures.
9. Analytical procedures in planning the audit use both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

Analytical Procedures as Substantive Procedures

10. The auditor's reliance on substantive procedures to reduce detection risk relating to specific financial statement assertions may be derived from tests of details, from analytical procedures, or from a combination of both. The decision about which procedures to use to achieve a particular audit objective is based on the auditor's judgement about the expected effectiveness and efficiency of the available procedures in reducing detection risk for specific financial statement assertions.
11. The auditor will ordinarily inquire of management as to the availability and reliability of information needed to apply analytical procedures and the results of any such procedures performed by the entity. It may be efficient to use analytical data prepared by the entity, provided the auditor is satisfied that such data is properly prepared.
12. When intending to perform analytical procedures as substantive procedures, the auditor will need to consider a number of factors such as the:
- ◆ Objectives of the analytical procedures and the extent to which their results can be relied upon (paragraphs 14-16).

- ◆ Nature of the entity and the degree to which information can be disaggregated, for example, analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.
- ◆ Availability of information, both financial, such as budgets or forecasts, and non-financial, such as the number of units produced or sold.
- ◆ Reliability of the information available, for example, whether budgets are prepared with sufficient care.
- ◆ Relevance of the information available, for example, whether budgets have been established as results to be expected rather than as goals to be achieved.
- ◆ Source of the information available, for example, sources independent of the entity are ordinarily more reliable than internal sources.
- ◆ Comparability of the information available, for example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products.
- ◆ Knowledge gained during previous audits, together with the auditor's understanding of the effectiveness of the accounting and internal control systems and the types of problems that in prior periods have given rise to accounting adjustments.

Analytical Procedures in the Overall Review at the End of the Audit

13. **The auditor should apply analytical procedures at or near the end of the audit when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's knowledge of the business.** The conclusions drawn from the results of such procedures are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements and assist in arriving at the overall conclusion as to the reasonableness of the financial statements. However, in some cases, as a result of application of analytical procedures, the auditor may identify areas where further procedures need to be applied before the auditor can form an overall conclusion about the financial statements.

Extent of Reliance on Analytical Procedures

14. The application of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the completeness, accuracy and validity of the data produced by the accounting system. However, reliance on the results of analytical procedures will depend on the auditor's assessment of the risk that the analytical procedures may identify relationships as expected when, in fact, a material misstatement exists.

15. The extent of reliance that the auditor places on the results of analytical procedures depends on the following factors:

- (a) materiality of the items involved, for example, when inventory balances are material, the auditor does not rely only on analytical procedures in forming conclusions. However, the auditor may rely solely on analytical procedures for certain income and expense items when they are not individually material;

- (b) other audit procedures directed toward the same audit objectives, for example, other procedures performed by the auditor in reviewing the collectibility of accounts receivable, such as the review of subsequent cash receipts, might confirm or dispel questions raised from the application of analytical procedures to an ageing schedule of customers' accounts;
- (c) accuracy with which the expected results of analytical procedures can be predicted. For example, the auditor will ordinarily expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising; and
- (d) assessments of inherent and control risks, for example, if internal control over sales order processing is weak and, therefore, control risk is high, more reliance on tests of details of transactions and balances than on analytical procedures in drawing conclusions on receivables may be required.

16. The auditor will need to consider testing the controls, if any, over the preparation of information used in applying analytical procedures. When such controls are effective, the auditor will have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The controls over non-financial information can often be tested in conjunction with tests of accounting-related controls. For example, an entity in establishing controls over the processing of sales invoices may include controls over the recording of unit sales. In these circumstances, the auditor could test the controls over the recording of unit sales in conjunction with tests of the controls over the processing of sales invoices.

Investigating Unusual Items

17. **When analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or that deviate from predicted amounts, the auditor should investigate and obtain adequate explanations and appropriate corroborative evidence.**

18. The investigation of unusual fluctuations and relationships ordinarily begins with inquiries of management, followed by:

- (a) corroboration of management's responses, for example, by comparing them with the auditor's knowledge of the business and other evidence obtained during the course of the audit; and
- (b) consideration of the need to apply other audit procedures based on the results of such inquiries, if management is unable to provide an explanation or if the explanation is not considered adequate.

Effective Date

19. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods beginning on or after April 1, 1997.

* Issued in December, 1997.

Revised Standard on Auditing (SA) 530^{*}

Audit Sampling

Standard on Auditing (SA) 530 (Revised), "Audit Sampling" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"¹, which sets out the authority of SAs.

Introduction

Scope of this SA

1. This Standard on Auditing (SA) applies when the auditor has decided to use audit sampling in performing audit procedures. It deals with the auditor's use of statistical and non statistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details, and evaluating the results from the sample.
2. This SA complements SA 500 (Revised)², which deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion. SA 500 (Revised) provides guidance on the means available to the auditor for selecting items for testing, of which audit sampling is one means.

Effective Date

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

Objective

4. The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

Definitions

5. For purposes of the SAs, the following terms have the meanings attributed below:
 - a. Audit sampling (sampling) - The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.
 - b. Population - The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

- c. Sampling risk - The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure, Sampling risk can lead to two types of erroneous conclusions:
 - (i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
 - (ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.
- d. Non sampling risk - The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. (Ref: Para. A1)
- e. Anomaly - A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.
- f. Sampling unit - The individual items constituting a population. (Ref: Para. A2)
- g. Statistical sampling - An approach to sampling that has the following characteristics:
 - (i) Random selection of the sample items; and
 - (ii) The use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have characteristics (i) and (d) is considered non statistical sampling.
- h. Stratification - The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).
- i. Tolerable misstatement A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population. (Ref: Para. A3)
- j. Tolerable rate of deviation - A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

Requirements

Sample Design, Size and Selection of Items for Testing

6. When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn. (Ref: Para. A4-A9)
7. The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level. (Ref: Para. A10-A11)
8. The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection. (Ref: Para. A12-A13)

Performing Audit Procedures

9. The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.
10. If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item. (Ref: Para. A14)
11. If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation from the prescribed control, in the case of tests of controls, or a misstatement, in the case of tests of details. (Ref: Para. A15-A16)

Nature and Cause of Deviations and Misstatements

12. The auditor shall investigate the nature and cause of my deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit. (Ref: Para. A17)
13. In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population. The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

Projecting Misstatements

14. For tests of details, the auditor shall project misstatements found in the sample to the population. (Ref: Para. A18-A20)

Evaluating Results of Audit Sampling

15. The auditor shall evaluate:

- a. The results of the sample; and (Ref: Para. A21-A22)
- b. Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. (Ref: Para. A23)

Application and Other Explanatory Material

Definitions

Non-Sampling Risk (Ref: Para. 5(d))

A1. Examples of non sampling risk include use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognise a misstatement or deviation.

Sampling Unit (Ref: Para. 5(f))

A2. The sampling units might be physical items (for example, cheques listed on deposit slips, credit entries on bank statements, sales invoices or debtors' balances) or monetary units.

Tolerable Misstatement (Ref: Para.5(i))

A3. When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements. Tolerable misstatement is the application of performance materiality as defined in SA 320 (Revised),³ to a particular sampling procedure. Tolerable misstatement may be the same amount or an amount lower than performance materiality.

Sample Design, Size and Selection of Items for Testing

Sample Design (Ref: Para. 6)

A4. Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non statistical or statistical sampling approaches.

A5. When designing an audit sample, the auditor's consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose. Consideration of the nature of the audit evidence sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling. In fulfilling the requirement of paragraph 8 of SA 500 (Revised), when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

A6. The auditor's consideration of the purpose of the audit procedure, as required by paragraph 6, includes a clear understanding of what constitutes a deviation or misstatement so that all, and only, those conditions that are relevant to the purpose of the audit procedure are included in the evaluation of deviations or projection of misstatements. For example, in a test of details relating to the existence of accounts receivable, such as confirmation, payments made by the customer before the confirmation date but received shortly after that date by the client, are not considered a misstatement. Also, a misposting between customer accounts does not affect the total accounts receivable balance. Therefore, it may not be appropriate to consider this a misstatement in evaluating the sample results of this particular audit procedure, even though it may have an important effect on other areas of the audit, such as the assessment of the risk of fraud or the adequacy of the allowance for doubtful accounts.

A7. In considering the characteristics of a population, for tests of controls, the auditor makes an assessment of the expected rate of deviation based on the auditor's understanding of the relevant controls or on the examination of a small number of items from the population. This assessment is made in order to design an audit sample and to determine sample size. For example, if the expected rate of deviation is unacceptably high, the auditor will normally decide not to perform tests of controls. Similarly, for tests of details, the auditor makes an assessment of the expected misstatement in the population. If the expected misstatement is high, 100% examination or use of a large sample size may be appropriate when performing tests of details.

A8. In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value weighted selection is appropriate. Appendix I provides further discussion on stratification and value weighted selection.

A9. The decision whether to use a statistical or non statistical sampling approach is a matter for the auditor's judgment, however, sample size is not a valid criterion to distinguish between statistical and non statistical approaches.

Sample Size (Ref: Para. 7)

A10. The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

A11. The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. Appendices 2 and 3 indicate the influences that various factors typically have on the determination of sample size. When circumstances are similar, the effect on sample size of factors such as those identified in Appendices 2 and 3 will be similar regardless of whether a statistical or non statistical approach is chosen.

***Selection of Items for Testing* (Ref: Para. 8)**

A12. With statistical sampling, sample items are selected in a way that each sampling unit has a known probability of being selected. With non statistical sampling, judgment is used to select sample items. Because the purpose of sampling is to provide a reasonable basis for the auditor to

draw conclusions about the population from which the sample is selected, it is important that the auditor selects a representative sample, so that bias is avoided, by choosing sample items which have characteristics typical of the population.

A13. The principal methods of selecting samples are the use of random selection, systematic selection and haphazard selection. Each of these methods is discussed in Appendix 4.

Performing Audit Procedures (Ref: Para. 10-11)

A14. An example of when it is necessary to perform the procedure on a replacement item is when a cancelled cheque is selected while testing for evidence of payment authorisation. If the auditor is satisfied that the cheque has been properly cancelled such that it does not constitute a deviation, an appropriately chosen replacement is examined.

A15. An example of when the auditor is unable to apply the designed audit procedures to a selected item is when documentation relating to that item has been lost.

A16. An example of a suitable alternative procedure might be the examination of subsequent cash receipts together with evidence of their source and the items they are intended to settle when no reply has been received in response to a positive confirmation request.

Nature and Cause of Deviations and Misstatements (Ref. Para. 12)

A17. In analysing the deviations and misstatements identified, the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time. In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures to those items. In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud.

Projecting Misstatements (Ref: Para. 14)

A18. The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded.

A19. When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population. However, the effect of my such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.

A20. For tests of controls, no explicit projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole. SA 330⁴ provides guidance when deviations from controls upon which the auditor intends to rely are detected.

Evaluating Results of Audit Sampling (Ref: Para. 15)

A21. For tests of controls, an unexpectedly high sample deviation rate may lead to an increase in the assessed risk of material misstatement, unless further audit evidence substantiating the initial assessment is obtained. For tests of details, an unexpectedly high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no material misstatement exists.

A22. In the case of tests of details, the projected misstatement plus anomalous misstatement, if any, is the auditor's best estimate of misstatement in the population. When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested. The closer the projected misstatement plus anomalous misstatement is to tolerable misstatement, the more likely that actual misstatement in the population may exceed tolerable misstatement. Also if the projected misstatement is greater than the auditor's expectations of misstatement used to determine the sample size, the auditor may conclude that there is an unacceptable sampling risk that the actual misstatement in the population exceeds the tolerable misstatement. Considering the results of other audit procedures helps the auditor to assess the risk that actual misstatement in the population exceeds tolerable misstatement, and the risk may be reduced if additional audit evidence is obtained.

A23. If the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may:

- Request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or
- Tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

Material Modifications to ISA 530, "Audit Sampling"

ISA 530 (Revised), 'Audit Sampling' does not contain any modifications *vis-a-vis* ISA 530.

Appendix 1

(Ref: Para. A8)

Stratification and Value Weighted Selection

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value weighted selection is appropriate. This Appendix provides guidance to the auditor on the use of stratification and value weighted sampling techniques.

Stratification

1. Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic. The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.
2. When performing tests of details, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement. Similarly a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.
3. The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population. For example, 20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).
4. If a class of transactions or account balance has been divided into strata, the misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.

Value Weighted Selection

5. When performing tests of details it may be efficient to identify the sampling unit as the individual monetary units that make up the population. Having selected specific monetary units from within the population, for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units. One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes. This approach may be used in conjunction with the systematic method of sample selection (described in Appendix 4) and is most efficient when selecting items using random selection.

Appendix 2

(Ref: Para. A11)

Examples of Factors Influencing Sample Size for Tests of Controls

The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

Factor	Effect On Sample Size	
1. An increase in the extent to which the auditor's risk assessment takes into account relevant controls	Increase	The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls. Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of controls (and therefore, the sample size is increased).
2. An increase in the tolerable rate of deviation	Decrease	The lower the tolerable rate of deviation, the larger the sample size needs to be.
3. An increase in the expected rate of deviation of the population to be tested	Increase	The higher the expected rate of deviation, the larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected rate of deviation include the auditor's understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.
4. An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the	Increase	The greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.

population		
5. An increase in the number of sampling units in the population	Negligible effect	For large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence.

Appendix 3

(Ref. Para. A11)

Examples of Factors Influencing Sample Size for Tests of Details

The following are factors that the auditor may consider when determining the sample size for tests of details. These factors, which need to be considered together, assume the auditor does not modify the approach to tests of controls or otherwise modify the nature or timing of substantive procedures in response to the assessed risks.

Factor	Effect On Sample Size	
1. An increase in the auditor's assessment of the risk of material misstatement	Increase	The higher the auditor's assessment of the risk of material misstatement, the larger the sample size needs to be. The auditor's assessment of the risk of material misstatement is affected by inherent risk and control risk. For example, if the auditor does not perform tests of controls, the auditor's risk assessment cannot be reduced for the effective operation of internal controls with respect to the particular assertion. Therefore, in order to reduce audit risk to an acceptably low level, the auditor needs a low detection risk and will rely more on substantive procedures. The more audit evidence that is obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be.
2. An increase in the use of other substantive procedures directed at the same assertion	Decrease	The more the auditor is relying on other substantive procedures (tests of details or substantive analytical procedures) to reduce to an acceptable level the detection risk regarding a particular population, the less assurance the auditor will require from sampling and, therefore, the smaller the sample size can be.
3. An increase in the auditor's desired level of assurance that tolerable misstatement	Increase	The greater the level of assurance that the auditor requires that the results of the sample are in fact indicative of the actual amount of misstatement in the population, the larger the sample size needs to be.

is not exceeded by actual misstatement in the population		
4. An increase in tolerable misstatement	Decrease	The lower the tolerable misstatement, the larger the sample size needs to be.
5. An increase in the amount of misstatement the auditor expects to find in the population	Increase	The greater the amount of misstatement the auditor expects to find in the population, the larger the sample size needs to be in order to make a reasonable estimate of the actual amount of misstatement in the population. Factors relevant to the auditor's consideration of the expected misstatement amount include the extent to which item values are determined subjectively, the results of risk assessment procedures, the results of tests of control, the results of audit procedures applied in prior periods, and the results of other substantive procedures.
6. Stratification of the population when appropriate	Decrease	When there is a wide range (variability) in the monetary size of items in the population, it may be useful to stratify the population. When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.
7. The number of sampling units in the population	Negligible effect	For large populations, the actual size of the population has little, if any, effect on sample size. Thus, for small populations, audit sampling is often not evidence. (However, when using monetary unit sampling, an increase in the monetary value of the population increases sample size, unless this is offset by a proportional increase in materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures).

Appendix 4

(Ref: Para. A13)

Sample Selection Methods

There are many methods of selecting samples. The principal methods are as follows:

- a. Random selection (applied through random number generators, for example, random number tables).
- b. Systematic selection, in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerised random number generator or random number tables. When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.
- c. Monetary Unit Sampling is a type of value weighted selection (as described in Appendix 1) in which sample size, selection and evaluation results in a conclusion in monetary amounts.
- d. Haphazard selection, in which the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.
- e. Block selection involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

* Earlier known as SA 530 (AAS 15), "Audit Sampling".

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

² The Auditing and Assurance Standards Board has issued the Exposure Draft of Revised SA 500, "Considering the Relevance and Reliability of Audit Evidence", which was published in August, 2008 issue of the Journal for public comments.

³ The Auditing and Assurance Standards Board has issued the Exposure Draft of Proposed Standard on Auditing (SA) 320 (Revised), "Materiality in Planning and Performing an Audit" which has been published in the January, 2009 issue of the Journal and has also been hosted on the website of the Institute for public comments.

⁴ SA 330, "The Auditor's Responses to Assessed Risks", paragraphs 17 and A41.

Standard on Auditing (SA) 220(Revised)*

Quality Control for an Audit of Financial Statements

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Standard on Auditing (SA) 220 (Revised), “Quality Control for an Audit of Financial Statements” should be read in the context of the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services¹”, which sets out the authority of SAs and SA 200 (Revised), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”.

* Earlier known as SA 220 (AAS 17), “Quality Control for Audit Work”.

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

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements. It also addresses, where applicable, the responsibilities of the engagement quality control reviewer. This SA is to be read in conjunction with relevant ethical requirements.

System of Quality Control and Role of Engagement Teams

2. Quality control systems, policies and procedures are the responsibility of the audit firm. Under SQC 1, the firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance that:

- (a) The firm and its personnel comply with professional standards and regulatory and legal requirements; and
- (b) The reports issued by the firm or engagement partners are appropriate in the circumstances².

This SA is premised on the basis that the firm is subject to SQC 1. (Ref: Para. A1)

3. Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement and provide the firm with relevant information to enable the functioning of that part of the firm's system of quality control relating to independence.

4. Engagement teams are entitled to rely on the firm's system of quality control, unless information provided by the firm or other parties suggests otherwise. (Ref: Para. A2)

Effective Date

5. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

6. The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:

- (a) The audit complies with professional standards and regulatory and legal requirements; and
- (b) The auditor's report issued is appropriate in the circumstances.

Definitions

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

- (a) Engagement partner – the partner or other person in the firm who is a member of the Institute of Chartered Accountants of India and is in full time practice and is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.
- (b) Engagement quality control review – a process designed to provide an objective evaluation, before the report is issued, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.

² Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", paragraph 10.

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- (c) Engagement quality control reviewer – a partner, other person³ in the firm, suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate, before the report is issued, the significant judgments the engagement team made and the conclusions they reached in formulating the report. However, in case the review is done by a team of individuals, such team should be headed by a member of the Institute.
- (d) Engagement team – all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.
- (e) Firm – a sole practitioner/proprietor, partnership, or any such entity of professional accountants, as may be permitted by law.
- (f) Inspection – in relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures.
- (g) Listed entity – an entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are traded under the regulations of a recognized stock exchange or other equivalent body.
- (h) Monitoring – a process comprising an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements, designed to enable the firm to obtain reasonable assurance that its system of quality control is operating effectively.
- (i) Network firm – A firm or entity that belongs to a network.
- (j) Network – A larger structure:
 - (i) That is aimed at cooperation, and
 - (ii) That is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.
- (k) Partner – any individual with authority to bind the firm with respect to the performance of a professional services engagement.
- (l) Personnel – partners and staff.
- (m) Professional Standards – Engagement Standards, as defined in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, issued by the Institute of Chartered Accountants of India and relevant ethical requirements as contained in the Code of Ethics issued by the Institute.
- (n) Relevant ethical requirements – Ethical requirements to which the engagement team and engagement quality control reviewer are subject, which ordinarily comprise the Code of Ethics of the Institute of Chartered Accountants of India related to an audit of financial statements.
- (o) Staff – professionals, other than partners, including any experts which the firm employs.
- (p) Suitably qualified external person – an individual outside the firm with the capabilities and competence to act as an engagement partner, for example a partner or an employee⁴ (with appropriate experience) of another firm.

³ Such other person should be a member of the Institute of Chartered Accountants of India.

⁴ Such employee should be a member of the Institute of Chartered Accountants of India.

Requirements

Leadership Responsibilities for Quality on Audits

8. The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned. (Ref: Para. A3)

Relevant Ethical Requirements

9. Throughout the audit engagement, the engagement partner shall remain alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team. (Ref: Para. A4-A5)

10. If matters come to the engagement partner's attention through the firm's system of quality control or otherwise that indicate that members of the engagement team have not complied with relevant ethical requirements, the engagement partner, in consultation with others in the firm, shall determine the appropriate action. (Ref: Para. A5)

Independence

11. The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall:

- (a) Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;
- (b) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and
- (c) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action. (Ref: Para. A5-A7)

Acceptance and Continuance of Client Relationships and Audit Engagements

12. The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate. (Ref: Para. A8-A9)

13. If the engagement partner obtains information that would have caused the firm to decline the audit engagement had that information been available earlier, the engagement partner shall communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action. (Ref: Para. A9)

Assignment of Engagement Teams

14. The engagement partner shall be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to:

- (a) Perform the audit engagement in accordance with professional standards and regulatory and legal requirements; and
- (b) Enable an auditor's report that is appropriate in the circumstances to be issued. (Ref: Para. A10-A12)

Engagement Performance

Quality Control for an Audit of Financial Statements

Direction, Supervision and Performance

15. The engagement partner shall take responsibility for:
- (a) The direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements; and (Ref: Para. A13-A15, A20)
 - (b) The auditor's report being appropriate in the circumstances.

Reviews

16. The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures. (Ref: Para. A16-A17, A20)
17. On or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued. (Ref: Para. A18-A20)

Consultation

18. The engagement partner shall:
- (a) Take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters;
 - (b) Be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm;
 - (c) Be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted; and
 - (d) Determine that conclusions resulting from such consultations have been implemented. (Ref: Para. A21-A22)

Engagement Quality Control Review

19. For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall:
- (a) Determine that an engagement quality control reviewer has been appointed;
 - (b) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and
 - (c) Not date the auditor's report until the completion of the engagement quality control review. (Ref: Para. A23-A25)
20. The engagement quality control reviewer shall perform an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached in formulating the auditor's report. This evaluation shall involve:
- (a) Discussion of significant matters with the engagement partner;
 - (b) Review of the financial statements and the proposed auditor's report;
 - (c) Review of selected audit documentation relating to the significant judgments the engagement team made and the conclusions it reached; and

- (d) Evaluation of the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's report is appropriate. (Ref: Para. A26-A27, A29-A31)
21. For audits of financial statements of listed entities, the engagement quality control reviewer, on performing an engagement quality control review, shall also consider the following:
- (a) The engagement team's evaluation of the firm's independence in relation to the audit engagement;
 - (b) Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations; and
 - (c) Whether audit documentation selected for review reflects the work performed in relation to the significant judgments made and supports the conclusions reached. (Ref: Para. A28-A31)

Differences of Opinion

22. If differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm's policies and procedures for dealing with and resolving differences of opinion.

Monitoring

23. An effective system of quality control includes a monitoring process designed to provide the firm with reasonable assurance that its policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. The engagement partner shall consider the results of the firm's monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the audit engagement. (Ref: Para A32-A34)

Documentation

24. The auditor shall document:
- (a) Issues identified with respect to compliance with relevant ethical requirements and how they were resolved.
 - (b) Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.
 - (c) Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements.
 - (d) The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement. (Ref: Para. A35)
25. The engagement quality control reviewer shall document, for the audit engagement reviewed, that:
- (a) The procedures required by the firm's policies on engagement quality control review have been performed;
 - (b) The engagement quality control review has been completed on or before the date of the auditor's report; and
 - (c) The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

Application and Other Explanatory Material

System of Quality Control and Role of Engagement Teams (Ref: Para. 2)

Quality Control for an Audit of Financial Statements

A1. SQC 1 deals with the firm's responsibilities to establish and maintain its system of quality control for audit engagements. The system of quality control includes policies and procedures that address each of the following elements:

- Leadership responsibilities for quality within the firm;
- Relevant ethical requirements;
- Acceptance and continuance of client relationships and specific engagements;
- Human resources;
- Engagement performance; and
- Monitoring.

Reliance on the Firm's System of Quality Control (Ref: Para. 4)

A2. Unless information provided by the firm or other parties suggest otherwise, the engagement team may rely on the firm's system of quality control in relation to, for example:

- Competence of personnel through their recruitment and formal training.
- Independence through the accumulation and communication of relevant independence information.
- Maintenance of client relationships through acceptance and continuance systems.
- Adherence to regulatory and legal requirements through the monitoring process.

Leadership Responsibilities for Quality on Audits (Ref: Para. 8)

A3. The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise:

- (a) The importance to audit quality of:
 - (i) Performing work that complies with professional standards and regulatory and legal requirements;
 - (ii) Complying with the firm's quality control policies and procedures as applicable;
 - (iii) Issuing auditor's reports that are appropriate in the circumstances; and
 - (iv) The engagement team's ability to raise concerns without fear of reprisals; and
- (b) The fact that quality is essential in performing audit engagements.

Relevant Ethical Requirements

Compliance with Relevant Ethical Requirements (Ref: Para. 9)

A4. The Code of Ethics issued by the Institute of Chartered Accountants of India establishes the fundamental principles of professional ethics, which include:

- (a) Integrity;
- (b) Objectivity;
- (c) Professional competence and due care;

- (d) Confidentiality; and
- (e) Professional behavior.

Definition of “Firm”, “Network” and “Network Firm” (Ref: Para. 9-11)

A5. The definitions of “firm”, “network” or “network firm” in relevant ethical requirements may differ from those set out in this SA. For example, the Code of Ethics of the Institute of Chartered Accountants of India (ICAI) defines the “Network Firm” as:

“Networking amongst two or more firms under common control, ownership or management with the firm or having affiliation with an accounting entity or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally”.

In complying with the requirements in paragraphs 9-11, the definitions used in the relevant ethical requirements apply in so far as is necessary to interpret those ethical requirements.

Threats to Independence (Ref: Para. 11(c))

A6. The engagement partner may identify a threat to independence regarding the audit engagement that safeguards may not be able to eliminate or reduce to an acceptable level. In that case, as required by paragraph 11(c), the engagement partner reports to the relevant person(s) within the firm to determine appropriate action, which may include eliminating the activity or interest that creates the threat, or withdrawing from the audit engagement, where withdrawal is legally permitted.

A7. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), statutory measures may provide safeguards for the independence of auditors of certain entities. However, such auditors or audit firms carrying out audits on behalf of the statutory auditor may, depending on the terms of the applicable legal or regulatory framework, need to adapt their approach in order to promote compliance with the spirit of paragraph 11. This may include, where the auditor's applicable law or regulation does not permit withdrawal of the auditor from the engagement, disclosure through a public report, of circumstances that have arisen that would, have otherwise lead the auditor to withdraw.

Acceptance and Continuance of Client Relationships and Audit Engagements (Ref: Para. 12)

A8. SQC 1 requires the firm to obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client⁵. Information such as the following assists the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate:

- The integrity of the principal owners, key management and those charged with governance of the entity;
- Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
- Whether the firm and the engagement team can comply with relevant ethical requirements; and
- Significant matters that have arisen during the current or previous audit engagement, and their implications for

⁵ SQC 1, paragraph 28.

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continuing the relationship.

A9. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), auditors may be appointed in accordance with statutory procedures. Accordingly, certain of the requirements and considerations regarding the acceptance and continuance of client relationships and audit engagements as set out in paragraphs 12, 13 and A7 may not be relevant. Nonetheless, information gathered as a result of the process described may be valuable to the auditors of such entities in performing risk assessments and in carrying out reporting responsibilities.

Assignment of Engagement Teams (Ref: Para. 14)

A10. An engagement team also includes a member using expertise in a specialised area of accounting or auditing, whether engaged or employed by the firm, if any, who performs audit procedures on the engagement.

A11. When considering the appropriate competence and capabilities expected of the engagement team as a whole, the engagement partner may take into consideration such matters as the team's:

- Understanding of, and practical experience with, audit engagements of a similar nature and complexity through appropriate training and participation.
- Understanding of professional standards and regulatory and legal requirements.
- Technical expertise, including expertise with relevant information technology and specialised areas of accounting or auditing.
- Knowledge of relevant industries in which the client operates.
- Ability to apply professional judgment.
- Understanding of the firm's quality control policies and procedures.

A12. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), additional appropriate competence may include skills that are necessary to discharge the terms of the audit mandate in a particular jurisdiction. Such competence may include an understanding of the applicable reporting arrangements, including reporting to the legislature or other governing body or in the public interest. The wider scope of audit of such entities may include, for example, some aspects of performance auditing or a comprehensive assessment of compliance with legislative authorities and preventing and detecting fraud and corruption.

Engagement Performance

Direction, Supervision and Performance (Ref: Para. 15(a))

A13. Direction of the engagement team involves informing the members of the engagement team of matters such as:

- Their responsibilities, including the need to comply with relevant ethical requirements, and to plan and perform an audit with professional skepticism as required by SA 200⁶.
- Responsibilities of respective partners where more than one partner is involved in the conduct of an audit engagement.

⁶ SA 200 (Revised), "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing".

- The objectives of the work to be performed.
- The nature of the entity's business.
- Risk-related issues.
- Problems that may arise.
- The detailed approach to the performance of the engagement.

Discussion among members of the engagement team allows less experienced team members to raise questions with more experienced team members so that appropriate communication can occur within the engagement team.

A14. Appropriate teamwork and training assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

A15. Supervision includes matters such as:

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

Reviews

Review Responsibilities (Ref: Para. 16)

A16. Under SQC 1, the firm's review responsibility policies and procedures are determined on the basis that work of less experienced team members is reviewed by more experienced team members⁷.

A17. A review consists of consideration whether, for example:

- The work has been performed in accordance with professional standards and regulatory and legal requirements;
- Significant matters have been raised for further consideration;
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- There is a need to revise the nature, timing and extent of work performed;
- The work performed supports the conclusions reached and is appropriately documented;
- The evidence obtained is sufficient and appropriate to support the auditor's report; and
- The objectives of the engagement procedures have been achieved.

The Engagement Partner's Review of Work Performed (Ref: Para. 17)

⁷ SQC 1, paragraph 50.

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A18. Timely reviews of the following by the engagement partner at appropriate stages during the engagement allow significant matters to be resolved on a timely basis to the engagement partner's satisfaction on or before the date of the auditor's report:

- Critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement;
- Significant risks; and
- Other areas the engagement partner considers important.

The engagement partner need not review all audit documentation, but may do so. However, as required by SA 230 (Revised), the partner documents the extent and timing of the reviews⁸.

A19. An engagement partner taking over an audit during the engagement may apply the review procedures as described in paragraphs A17 to review the work performed to the date of a change in order to assume the responsibilities of an engagement partner.

Considerations Relevant Where a Member of the Engagement Team with Expertise in a Specialised Area of Accounting or Auditing Is Used (Ref: Para. 15-17)

A20. Where a member of the engagement team with expertise in a specialised area of accounting or auditing is used, direction, supervision and review of that engagement team member's work may include matters such as:

- Agreeing with that member the nature, scope and objectives of that member's work; and the respective roles of, and the nature, timing and extent of communication between that member and other members of the engagement team.
- Evaluating the adequacy of that member's work including the relevance and reasonableness of that member's findings or conclusions and their consistency with other audit evidence.

Consultation (Ref: Para. 18)

A21. Effective consultation on significant technical, ethical, and other matters within the firm or, where applicable, outside the firm can be achieved when those consulted:

- Are given all the relevant facts that will enable them to provide informed advice; and
- Have appropriate knowledge, seniority and experience.

A22. It may be appropriate for the engagement team to consult outside the firm, for example, where the firm lacks appropriate internal resources. They may take advantage of advisory services provided by other firms, professional and regulatory bodies, or commercial organisations that provide relevant quality control services.

Engagement Quality Control Review

Completion of the Engagement Quality Control Review before Dating of the Auditor's Report (Ref: Para. 19(c))

A23. SA 700 (Revised) requires the auditor's report to be dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence on which to base the auditor's opinion on the financial statements⁹. In cases of an audit of financial statements of listed entities or when an engagement meets the criteria for an engagement quality control review, such a review assists the auditor in determining whether sufficient appropriate evidence has been obtained.

⁸ SA 230 (Revised), "Audit Documentation", paragraph 9(c).

⁹ SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements", paragraph 41.

A24. Conducting the engagement quality control review in a timely manner at appropriate stages during the engagement allows significant matters to be promptly resolved to the engagement quality control reviewer's satisfaction on or before the date of the auditor's report.

A25. Completion of the engagement quality control review means the completion by the engagement quality control reviewer of the requirements in paragraphs 20-21, and where applicable, compliance with paragraph 22. Documentation of the engagement quality control review may be completed after the date of the auditor's report as part of the assembly of the final audit file. SA 230 (Revised) establishes requirements and provides guidance in this regard¹⁰.

Nature, Extent and Timing of Engagement Quality Control Review (Ref: Para. 20)

A26. Remaining alert for changes in circumstances allows the engagement partner to identify situations in which an engagement quality control review is necessary, even though at the start of the engagement, such a review was not required.

A27. The extent of the engagement quality control review may depend, among other things, on the complexity of the audit engagement, whether the entity is a listed entity, and the risk that the auditor's report might not be appropriate in the circumstances. The performance of an engagement quality control review does not reduce the responsibilities of the engagement partner for the audit engagement and its performance.

Engagement Quality Control Review of Listed Entities (Ref: Para. 21)

A28. Other matters relevant to evaluating the significant judgments made by the engagement team that may be considered in an engagement quality control review of a listed entity include:

- Significant risks identified during the engagement in accordance with SA 315¹¹, and the responses to those risks in accordance with SA 330¹², including the engagement team's assessment of, and response to, the risk of fraud in accordance with SA 240 (Revised)¹³.
- Judgments made, particularly with respect to materiality and significant risks.
- The significance and disposition of corrected and uncorrected misstatements identified during the audit.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.

These other matters, depending on the circumstances, may also be applicable for engagement quality control reviews for audits of financial statements of other entities.

Considerations Specific to Smaller Entities (Ref: Para. 20-21)

A29. In addition to the audits of financial statements of listed entities, an engagement quality control review is required for such audit engagements also that meet the criteria established by the firm that subjects engagements to an engagement quality control review. In some cases, none of the firm's audit engagements may meet the criteria that would subject them to such a review.

Considerations Specific to Central/State Governments and Related Government Entities (Ref: Para. 20-21)

A30. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), a statutorily appointed auditor (for example, an Auditor General, or other suitably

¹⁰ SA 230 (Revised), paragraphs 14-16 and A21-A24.

¹¹ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

¹² SA 330, "The Auditor's Responses to Assessed Risks".

¹³ SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".

Quality Control for an Audit of Financial Statements

qualified person appointed on behalf of the Auditor General), may act in a role equivalent to that of engagement partner with overall responsibility for certain entities audits. In such circumstances, where applicable, the selection of the engagement quality control reviewer includes consideration of the need for independence from the audited entity and the ability of the engagement quality control reviewer to provide an objective evaluation.

A31. Certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), may not necessarily be listed entities yet may be significant due to size, complexity or public interest aspects, and which consequently have a wide range of stakeholders. Examples include state owned corporations and public utilities. Ongoing transformations within the certain entities may also give rise to new types of significant entities. There are no fixed objective criteria on which the determination of significance is based. Nonetheless, auditors of such entities evaluate which of these entities may be of sufficient significance to warrant performance of an engagement quality control review.

Monitoring (Ref: Para. 23)

A32. SQC 1 requires the firm to establish a monitoring process designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control is relevant, adequate and operating effectively¹⁴.

A33. In considering deficiencies that may affect the audit engagement, the engagement partner may have regard to measures the firm took to rectify the situation that the engagement partner considers are sufficient in the context of that audit.

A34. A deficiency in the firm's system of quality control does not necessarily indicate that a particular audit engagement was not performed in accordance with professional standards and regulatory and legal requirements, or that the auditor's report was not appropriate.

Documentation

Documentation of Consultations (Ref: Para. 24(d))

A35. Documentation of consultations with other professionals that involve difficult or contentious matters that is sufficiently complete and detailed contributes to an understanding of:

- The issue on which consultation was sought; and
- The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.

Modifications vis-à-vis ISA 220, "Quality Control for an Audit of Financial Statements"

Deletion

Paragraphs A7, A9, A12, A30 and A31 of the Application Section of ISA 220 dealt with the application of the requirements of ISA 220 to the audits of public sector entities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that these requirements may also exist in case of non public sector entities pursuant to a requirement under the statute. Accordingly, the spirit of paragraphs A7, A9, A12, A30 and A31 has, accordingly, been made more generic in its application.

¹⁴ SQC 1, Paragraph 86.

Revised Standard on Auditing (SA) 540

Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures¹

Standard on Auditing (SA) 540 (Revised), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services²", which sets out the authority of SAs.

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how SA 315³ and SA 330⁴ and other relevant SAs are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.

Nature of Accounting Estimates

2. Some financial statement items cannot be measured precisely, but can only be estimated. For purposes of this SA, such financial statement items are referred to as accounting estimates. The nature and reliability of information available to management to support the making of an accounting estimate varies widely, which thereby affects the degree of estimation uncertainty associated with accounting estimates. The degree of estimation uncertainty affects, in turn, the risks of material misstatement of accounting estimates, including their susceptibility to unintentional or intentional management bias. (Ref: Para. A1-A11)

3. The measurement objective of accounting estimates can vary depending on the applicable financial reporting framework and the financial item being reported. The measurement objective for some accounting estimates is to forecast the outcome of one or more transactions, events or conditions giving rise to the need for the accounting estimate. For other accounting estimates, including many fair value accounting estimates, the measurement objective is different, and is expressed in terms of the value of a current transaction or financial statement item based on conditions prevalent at the measurement date, such as estimated market price for a particular type of asset or liability. For example, the applicable financial reporting framework may require fair value measurement based on an assumed hypothetical current transaction between knowledgeable, willing parties (sometimes referred to as "marketplace participants" or equivalent) in an arm's length transaction, rather than the settlement of a transaction at some past or future date.⁵

4. A difference between the outcome of an accounting estimate and the amount originally recognised or disclosed in the financial statements does not necessarily represent a misstatement

of the financial statements. This is particularly the case for fair value accounting estimates, as any observed outcome is invariably affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements.

Effective Date

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

Objective

6. The objective of the auditor is to obtain sufficient appropriate audit evidence whether in the context of the applicable financial reporting framework:

- a. accounting estimates, including fair value accounting estimates, in the financial statements, whether recognised or disclosed, are reasonable; and
- b. related disclosures in the financial statements are adequate.

Definitions

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

- a. **Accounting estimate** - An approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. Where this SA addresses only accounting estimates involving measurement at fair value, the term "fair value accounting estimates" is used.
- b. **Auditor's point estimate or auditor's range** - The amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management's point estimate.
- c. **Estimation uncertainty** - The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.
- d. **Management bias** - A lack of neutrality by management in the preparation and presentation of information.
- e. **Management's point estimate** - The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.
- f. **Outcome of an accounting estimate** - The actual monetary amount which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by the

accounting estimate.

Requirements

Risk Assessment Procedures and Related Activities

8. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, as required by SA 315,⁶ the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates:

(Ref: Para. A12)

- a. The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures. *(Ref: Para. A13-A15)*
- b. How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates. *(Ref: Para. A16-A21)*
- c. How management makes the accounting estimates, and an understanding of the data on which they are based, including: *(Ref: Para. A22-A23)*
 - i. The method, including where applicable the model, used in making the accounting estimate; *(Ref: Para. A24-A26)*
 - ii. Relevant controls; *(Ref: Para. A27-A28)*
 - iii. Whether management has used an expert; *(Ref: Para. A29-A30)*
 - iv. The assumptions underlying the accounting estimates; *(Ref: Para. A31-A36)*
 - v. Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why, and *(Ref: Para. A37)*
 - vi. Whether and, if so, how management has assessed the effect of estimation uncertainty. *(Ref: Para. A38)*

9. The auditor shall review the of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to

identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at that time. (Ref: Para. A39- A44)

Identifying and Assessing the Risks of Material Misstatement

10. In identifying and assessing the risks of material misstatement, as required by SA 315⁷, the auditor shall evaluate the degree of estimation uncertainty associated with an accounting estimate. (Ref: Para. A45-A46)

11. The auditor shall determine whether, in the auditor's judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks. (Ref: Para. A47-A51)

Responses to the Assessed Risks of Material Misstatement

12 Based on the assessed risks of material misstatement, the auditor shall determine: (Ref. Para. A52)

- a. Whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate, and (Ref: Para. A53-A56)
- b. Whether the methods for making the accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances. (Ref: Para. A57-A58)

13. In responding to the assessed risks of material misstatement, as required by SA 330,⁸ the auditor shall undertake one or more of the following, taking account of the nature of the accounting estimate: (Ref: Para. A59-A61)

- a. Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate. (Ref: Para. A62-A67)
- b. Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor shall evaluate whether: (Ref: Para. A68-A70)
 - i. The method of measurement used is appropriate in the circumstances; and (Ref: Para. A71-A76)
 - ii. The assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework. (Ref: Para. A77-A83)

- c. Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures. (Ref: Para. A84-A86)
- d. Develop a point estimate or a range to evaluate management's point estimate. For this purpose: (Ref: Para. A87-A91)
 - i. When the auditor uses assumptions or methods that differ from management's, the auditor shall obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate. (Ref: Para. A92)
 - ii. When the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable. (Ref: Para. A93-A95)

14. In determining the matters identified in paragraph 12 or in responding to the assessed risks of material misstatement in accordance with paragraph 13, the auditor shall consider whether specialised skills or knowledge in relation to one or more aspects of the accounting estimates are required in order to obtain sufficient appropriate audit evidence. (Ref: Para. A96-A101)

Further Substantive Procedures to Respond to Significant Risks

Estimation Uncertainty

15. For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of SA 330,⁹ the auditor shall evaluate the following: (Ref: Para. A102)

- a. How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate. (Ref: Para. A103-A106)
- b. Whether the significant assumptions used by management are reasonable. (Ref: Para A107-A109)
- c. Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so. (Ref: Para. A110)

16. If, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor

shall, if considered necessary, develop a range with which to evaluate the reasonableness of the accounting estimate. (Ref: Para. A111-A112)

Recognition and Measurement Criteria

17. For accounting estimates that give rise to significant risks, the auditor shall obtain sufficient appropriate audit evidence whether the following are in accordance with the requirements of the applicable financial reporting framework:

- a. management's decision to recognise, or to not recognise, the accounting estimates in the financial statements; and (Ref: Para. A113-A114)
- b. the selected measurement basis for the accounting estimates. (Ref: Para. A115)

Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements

18. The auditor shall evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework, or are misstated. (Ref: Para. A 116-A119)

Disclosures Related to Accounting Estimates

19. The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework. (Ref: Para. A120-A121)

20. For accounting estimates that give rise to significant risks, the auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework. (Ref: Para. A122-A123)

Indicators of Possible Management Bias

21. The auditor shall review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias. Indicators of possible management bias do not themselves constitute misstatements for the purposes of drawing conclusions on the reasonableness of individual accounting estimates. (Ref: Para. A124-A125)

Written Representations

22. The auditor shall obtain written representations from management whether management believes significant assumptions used by it in making accounting estimates are reasonable. (Ref: Para. A126-A127)

Documentation

23. The audit documentation shall include:

- a. The basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks; and
- b. Indicators of possible management bias, if any. (*Ref: Para. A128*)

Application and Other Explanatory Material

Nature of Accounting Estimates (*Ref: Para. 2*)

A1. Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item. Some financial reporting frameworks prescribe specific methods of measurement and the disclosures that are required to be made in the financial statements, while other financial reporting frameworks are less specific. The Appendix to this SA discusses fair value measurements and disclosures under different financial reporting frameworks.

A2. Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements, for example:

- Accounting estimates arising in entities that engage in business activities that are not complex.
- Accounting estimates that are frequently made and updated because they relate to routine transactions.
- Accounting estimates derived from data that is readily available, such as published interest rate data or exchange traded prices of securities. Such data may be referred to as "observable" in the context of a fair value accounting estimate.
- Fair value accounting estimates where the method of measurement prescribed by the applicable financial reporting framework is simple and applied easily to the asset or liability requiring measurement at fair value.
- Fair value accounting estimates where the model used to measure the accounting estimate is well-known or generally accepted, provided that the assumptions or inputs to the model are observable.

A3. For some accounting estimates, however, there may be relatively high estimation uncertainty particularly where they are based on significant assumptions, for example:

- Accounting estimates relating to the outcome of litigation.
- Fair value accounting estimates for derivative financial instruments not publicly traded.
- Fair value accounting estimates for which a highly specialised entity developed model is used or for which there are assumptions or inputs that cannot be observed in the marketplace.

A4. The degree of estimation uncertainty varies based on the nature of the accounting estimate, the extent to which there is a generally accepted method or model used to make the accounting estimate, and the subjectivity of the assumptions used to make the accounting estimate. In some cases, estimation uncertainty associated with an accounting estimate may be so great that the recognition criteria in the applicable financial reporting framework are not met and the accounting estimate cannot be made.

A5. Not all financial statement items requiring measurement at fair value, involve estimation uncertainty. For example, this may be the case for some financial statement items where there is an active and open market that provides readily available and reliable information on the prices at which actual exchanges occur, in which case the existence of published price quotations ordinarily is the best audit evidence of fair value. However, estimation uncertainty may exist even when the valuation method and data are well defined. For example, valuation of securities quoted on an active and open market at the listed market price may require adjustment if the holding is significant in relation to the market or is subject to restrictions in marketability. In addition, general economic circumstances prevailing at the time, for example, illiquidity in a particular market, may impact estimation uncertainty.

A6. Additional examples of situations where accounting estimates, other than fair value accounting estimates, may be required include:

- Allowance for doubtful accounts.
- Inventory obsolescence.
- Warranty obligations.
- Depreciation method or asset useful life.
- Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability.
- Outcome of long term contracts.
- Financial Obligations / Costs arising from litigation settlements and judgments.

A7. Additional examples of situations where fair value accounting estimates may be required include:

- Complex financial instruments, which are not traded in an active and open market.
- Share-based payments.
- Property or equipment held for disposal.
- Certain assets or liabilities acquired in a business combination, including goodwill and intangible assets.
- Transactions involving the exchange of assets or liabilities between independent parties without monetary consideration, for example, a non monetary exchange of plant facilities in different lines of business.

A8. Estimation involves judgments based on information available when the financial statements are prepared. For many accounting estimates, these include making assumptions about matters that are uncertain at the time of estimation. The auditor is not responsible for predicting future conditions, transactions or events that, if known at the time of the audit, might have significantly affected management's actions or the assumptions used by management.

Management Bias

A9. Financial reporting frameworks often call for neutrality that is, freedom from bias. Accounting estimates are imprecise, however, and can be influenced by management judgment. Such judgment may involve unintentional or intentional management bias (for example, as a result of motivation to achieve a desired result). The susceptibility of an accounting estimate to management bias increases with the subjectivity involved in making it. Unintentional management bias and the potential for intentional management bias are inherent in subjective decisions that are often required in making an accounting estimate. For continuing audits, indicators of possible management bias identified during the audit of the preceding periods influence the planning and risk identification and assessment activities of the auditor in the current period.

A10. Management bias can be difficult to detect at an account level. It may only be identified when considered in the aggregate of groups of accounting estimates or all accounting estimates, or when observed over a number of accounting periods. Although some form of management bias is inherent in subjective decisions, in making such judgments there may be no intention by management to mislead the users of financial statements. Where, however, there is intention to mislead, management bias is fraudulent in nature.

A11. Certain entities such as, Central/State governments and related government entities (for example, agencies, boards, commissions) may have significant holdings of specialised assets for which there are no readily available and reliable sources of information for purposes of

measurement at fair value or other current value bases, or a combination of both. Often specialised assets held do not generate cash flows and do not have an active market. Measurement at fair value therefore ordinarily requires estimation and may be complex, and in some rare cases may not be possible at all.

Risk Assessment Procedures and Related Activities (Ref: Para. 8)

A12. The risk assessment procedures and related activities required by paragraph 8 of this SA assist the auditor in developing an expectation of the nature and type of accounting estimates that an entity may have. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to identify and assess the risks of material misstatement in relation to accounting estimates, and to plan the nature, timing and extent of further audit procedures.

Obtaining an Understanding of the Requirements of the Applicable Financial Reporting Framework (Ref: Para. 8(a))

A13. Obtaining an understanding of the requirements of the applicable financial reporting framework assists the auditor in determining whether it, for example,

- Prescribes certain conditions for the recognition,¹⁰ or methods for the measurement, of accounting estimates.
- Specifies certain conditions that permit or require measurement at a fair value, for example, by referring to management's intentions to carry out certain courses of action with respect to an asset or liability,
- Specifies required or permitted disclosures.

Obtaining this understanding also provides the auditor with a basis for discussion with management about how management has applied those requirements relevant to the accounting estimate, and the auditor's determination of whether they have been applied appropriately.

A14. Financial reporting frameworks may provide guidance for management on determining point estimates where alternatives exist. Some financial reporting frameworks, for example, require that the point estimate selected be the alternative that reflects management's judgment of the most likely outcome¹¹. Others may require, for example, use of a discounted probability weighted expected value. In some cases, management may be able to make a point estimate directly. In other cases, management may be able to make a reliable point estimate only after considering alternative assumptions or outcomes from which it is able to determine a point estimate.

A15. Financial reporting frameworks may require the disclosure of information concerning the significant assumptions to which the accounting estimate is particularly sensitive. Furthermore, where there is a high degree of estimation uncertainty, some financial reporting frameworks do

not permit an accounting estimate to be recognised in the financial statements, but certain disclosures may be required in the notes to the financial statements.

Obtaining an Understanding of How Management Identifies the Need for Accounting Estimates (Ref. Para. 8(b))

A16. In preparing the financial statements, management has the responsibility to determine whether a transaction, event or condition gives rise to the need to make an accounting estimate, and that all necessary accounting estimates have been recognised, measured and disclosed in the financial statements in accordance with the applicable financial reporting framework.

A17. Management's identification of transactions, events and conditions that give rise to the need for accounting estimates is likely to be based on:

- Management's knowledge of the entity's business and the industry in which it operates.
- Management's knowledge of the implementation of business strategies in the current period.
- Where applicable, management's cumulative experience of preparing the entity's financial statements in prior periods.

In such cases, the auditor may obtain an understanding of how management identifies the need for accounting estimates primarily through inquiry of management. In other cases, where management's process is more structured, for example, when management has a formal risk management function, the auditor may perform risk assessment procedures directed at the methods and practices followed by management for periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting estimates as necessary. The completeness of accounting estimates is often an important consideration for the auditor particularly accounting estimates relating to liabilities.

A18. The auditor's understanding of the entity and its environment obtained during the performance of risk assessment procedures, together with other audit evidence obtained during the course of the audit, assist the auditor in identifying circumstances, or changes in circumstances, that may give rise to the need for an accounting estimate.

A19. Inquiries of management about changes in circumstances may include, for example, inquiries about whether:

- The entity has engaged in new types of transactions that may give rise to accounting estimates.
- Terms of transactions that gave rise to accounting estimates have changed.

- Accounting policies relating to accounting estimates have changed, as a result of changes to the requirements of the applicable financial reporting framework or otherwise.
- Regulatory or other changes outside the control of management have occurred that may require management to revise, or make new, accounting estimates.
- New conditions or events have occurred that may give rise to the need for new or revised accounting estimates.

A20. During the audit, the auditor may identify transactions, events and conditions that give rise to the need for accounting estimates that management failed to identify. SA 315 provides guidance when the auditor identifies a material weakness in the entity's risk assessment processes.

Considerations Specific to Smaller Entities

A21. Obtaining this understanding for smaller entities is often less complex as their business activities are often limited and transactions are less complex. Further, often a single person, for example the owner-manager, identifies the need to make an accounting estimate and the auditor may focus inquiries accordingly

Obtaining an Understanding of How Management Makes the Accounting Estimates (Ref: Para. 8(c))

A22. Management is responsible for establishing financial reporting processes for making accounting estimates, including adequate internal control. Such processes include the following:

- Selecting appropriate accounting policies and prescribing estimation processes, including appropriate estimation or valuation methods, including, where applicable, models.
- Developing or identifying relevant data and assumptions that affect accounting estimates.
- Periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting estimates as necessary

A23. Matters that the auditor may consider in obtaining an understanding of how management makes the accounting estimates include, for example:

- The types of accounts or transactions to which the accounting estimates relate (for example, whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from non-recurring or unusual transactions)

- Whether and, if so, how management has used recognised measurement techniques for making particular accounting estimates.
- Whether the accounting estimates were made based on data available at an interim date and, if so, whether and how management has taken into account the effect of events, transactions and changes in circumstances occurring between that date and the period end.

Method of Measurement, Including the Use of Models (Ref: Para. 8(c)(i))

A24. In some cases, the applicable financial reporting framework may prescribe the method of measurement for an accounting estimate, for example, a particular model that is to be used in measuring a fair value estimate. In many cases, however, the applicable financial reporting framework does not prescribe the method of measurement, or may specify alternative methods for measurement.

A25. When the applicable financial reporting framework does not prescribe a particular method to be used in the circumstances, matters that the auditor may consider in obtaining an understanding of the method or, where applicable the model, used to make accounting estimates include, for example:

- How management selects a particular method considering the nature of the asset or liability being estimated.
- Whether the entity operates in a particular business, industry or environment in which there are methods commonly used to make the particular type of accounting estimate.

A26. There may be greater risks of material misstatement, for example, in cases when management has internally developed a model to be used to make the accounting estimate or is departing from a method commonly used in a particular industry or environment.

Relevant Controls (Ref: Para 8(c) (ii))

A27. Matters that the auditor may consider in obtaining an understanding of relevant controls include, for example, the experience and competence of those who make the accounting estimates, and controls related to:

- How management determines the completeness, relevance and accuracy of the data used to develop accounting estimates.
- The review and approval of accounting estimates, including the assumptions or inputs used in their development, by appropriate levels of management and, where appropriate, those charged with governance.

- The segregation of duties between those committing the entity to the underlying transactions and those responsible for making the accounting estimates, including whether the assignment of responsibilities appropriately takes account of the nature of the entity and its products or services (for example, in the case of a large financial institution, relevant segregation of duties may include an independent function responsible for estimation and validation of fair value pricing of the entity's proprietary financial products staffed by individuals whose remuneration is not tied to such products).

A28. Other controls may be relevant to making the accounting estimates depending on the circumstances. For example, if the entity uses specific models for making accounting estimates, management may put into place specific policies and procedures around such models. Relevant controls may include, for example, those established over:

- The design and development, or selection, of a particular model for a particular purpose.
- The use of the model.
- The maintenance and periodic validation of the integrity of the model.

Management's Use of Experts (Ref: Para. 8(c)(iii))

A29. Management may have, or the entity may employ individuals with, the experience and competence necessary to make the required point estimates. In some cases, however, management may need to engage an expert to make, or assist in making, them. This need may arise because of, for example:

- The specialised nature of the matter requiring estimation, for example, the measurement of mineral or hydrocarbon reserves in extractive industries.
- The technical nature of the models required to meet the relevant requirements of the applicable financial reporting framework, as may be the case in certain measurements at fair value.
- The unusual or infrequent nature, of the condition, transaction or event requiring an accounting estimate.

Considerations specific to smaller entities

A30. In smaller entities, the circumstances requiring an accounting estimate often are such that the owner-manager is capable of making the required point estimate. In some cases, however, an expert will be needed. Discussion with the owner manager early in the audit process about the nature of my accounting estimates, the completeness of the required accounting estimates, and

the adequacy of the estimating process may assist the owner manager in determining the need to use an expert.

Assumptions (Ref: Para. 8(c)(iv))

A31. Assumptions are integral components of accounting estimates. Matters that the auditor may consider in obtaining an understanding of the assumptions underlying the accounting estimates include, for example:

- The nature of the assumptions, including which of the assumptions are likely to be significant assumptions.
- How management assesses whether the assumptions are relevant and complete (that is, that all relevant variables have been taken into account).
- Where applicable, how management determines that the assumptions used are internally consistent.
- Whether the assumptions relate to matters within the control of management (for example, assumptions about the maintenance programs that may affect the estimation of an asset's useful life), and how they conform to the entity's business plans and the external environment, or to matters that are outside its control (for example, assumptions about interest rates, mortality rates, potential judicial or regulatory actions, or the variability and the timing of future cash flows).
- The nature, and extent of documentation, if any, supporting the assumptions.

Assumptions may be made or identified by an expert to assist management in making the accounting estimates. Such assumptions, when used by management, become management's assumptions.

A32. In some cases, assumptions may be referred to as inputs, for example, where management uses a model to make an accounting estimate, though the term inputs may also be used to refer to the underlying data to which specific assumptions are applied.

A33. Management may support assumptions with different types of information drawn from internal and external sources, the relevance and reliability of which will vary. In some cases, an assumption may be reliably based on applicable information from either external sources (for example, published interest rate or other statistical data) or internal sources (for example, historical information or previous conditions experienced by the entity). In other cases, an assumption may be more subjective, for example, where the entity has no experience or external sources from which to draw.

A34. In the case of fair value accounting estimates, assumptions reflect, or are consistent with, what knowledgeable, willing arm's length parties (sometimes referred to as "marketplace

participants" or equivalent) would use in determining fair value when exchanging an asset or settling a liability. Specific assumptions will also vary with the characteristics of the asset or liability being valued, the valuation method used (for example, a market approach, or an income approach) and the requirements of the applicable financial reporting framework.

A35. With respect to fair value accounting estimates, assumptions or inputs vary in terms of their source and bases, as follows:

- a. Those that reflect what marketplace participants would use in pricing an asset or liability developed based on market data obtained from sources independent of the reporting entity (sometimes referred to as "observable inputs" or equivalent).
- b. Those that reflect the entity's own judgments about what assumptions marketplace participants would use in pricing the asset or liability developed based on the best information available in the circumstances (sometimes referred to as "unobservable inputs" or equivalent). In practice, however, the distinction between (a) and (b) is not always apparent. Further, it may be necessary for management to select from a number of different assumptions used by different marketplace participants.

A36. The extent of subjectivity, such as whether an assumption or input is observable, influences the degree of estimation uncertainty and thereby the auditor's assessment of the risks of material misstatement for a particular accounting estimate.

Changes in Methods for Making Accounting Estimates (Ref: Para. 8(c)(v))

A37. In evaluating how management makes the accounting estimates, the auditor is required to understand whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates. A specific estimation method may need to be changed in response to changes in the environment or circumstances affecting the entity or in the requirements of the applicable financial reporting framework. If management has changed the method for making an accounting estimate, it is important that management can demonstrate that the new method is more appropriate, or is itself a response to such changes. For example, if management changes the basis of making an accounting estimate from a mark to market approach to using a model, the auditor challenges whether management's assumptions about the marketplace are reasonable in light of economic circumstances.

Estimation Uncertainty (Ref: Para. 8(c)(vi))

A38. Matters that the auditor may consider in obtaining an understanding of whether and, if so, how management has assessed the effect of estimation uncertainty include, for example:

- Whether and, if so, how management has considered alternative assumptions or outcomes by, for example, performing a sensitivity analysis to determine the effect of changes in the assumptions on an accounting estimate.

- How management determines the accounting estimate when analysis indicates a number of outcome scenarios.
- Whether management monitors the outcome of accounting estimates made in the prior period, and whether management has appropriately responded to the outcome of that monitoring procedure.

Reviewing Prior Period Accounting Estimates (Ref: Para. 9)

A39. The outcome of an accounting estimate will often differ from the accounting estimate recognised in the prior period financial statements. By performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may obtain:

- Information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process.
- Audit evidence that is pertinent to the re estimation, in the current period, of prior period accounting estimates.
- Audit evidence of matters, such as estimation uncertainty that may be required to be disclosed in the financial statements.

A40. The review of prior period accounting estimates may also assist the auditor, in the current period, in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The auditor's attitude of professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.

A41. A retrospective review of management judgments and assumptions related to significant accounting estimates is also required by SA 240 (Revised)¹² That review is conducted as part of the requirement for the auditor to design and perform procedures to review accounting estimates for biases that could represent a risk of material misstatement due to fraud, in response to the risks of management override of controls. As a practical matter, the auditor's review of prior period accounting estimates as a risk assessment procedure in accordance with this SA may be carried out in conjunction with the review required by SA 240 (Revised).

A42. The auditor may judge that a more detailed review is required for those accounting estimates that were identified during the prior period audit as having high estimation uncertainty, or for those accounting estimates that have changed significantly from the prior period. On the other hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.

A43. For fair value accounting estimates and other accounting estimates based on current conditions at the measurement date, more variation may exist between the fair value amount recognised in the prior period financial statements and the outcome or the amount re estimated for the purpose of the current period. This is because the measurement objective for such accounting estimates deals with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. The auditor may therefore focus the review on obtaining information that would be relevant to identifying and assessing risks of material misstatement. For example, in some cases obtaining an understanding of changes in marketplace participant assumptions which affected the outcome of a prior period fair value accounting estimate may be unlikely to provide relevant information for audit purposes. If so, then the auditor's consideration of the outcome of prior period fair value accounting estimates may be directed more towards understanding the effectiveness of management's prior estimation process, that is, management's track record, from which the auditor can judge the likely effectiveness of management's current process.

A44. A difference between the outcome of an accounting estimate and the amount recognised in the prior period financial statements does not necessarily represent a misstatement of the prior period financial statements. However, it may do so if, for example, the difference arises from information that was available to management when the prior period's financial statements were finalised, or that could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed.

Identifying and Assessing the Risks of Material Misstatement

Estimation Uncertainty (Ref: Para. 10)

A45. The degree of estimation uncertainty associated with an accounting estimate may be influenced by factors such as:

- The extent to which the accounting estimate depends on judgment.
- The sensitivity of the accounting estimate to changes in assumptions.
- The existence of recognised measurement techniques that may mitigate the estimation uncertainty (though the subjectivity of the assumptions used as inputs may nevertheless give rise to estimation uncertainty).
- The length of the forecast period, and the relevance of data drawn from past events to forecast future events.
- The availability of reliable data from external sources.

- The extent to which the accounting estimate is based on observable or unobservable inputs.
- The degree of estimation uncertainty associated with an accounting estimate may influence the estimate's susceptibility to bias.

A46. Matters that the auditor considers in assessing the risks of material misstatement may also include:

- The actual or expected magnitude of an accounting estimate.
- The recorded amount of the accounting estimate (that is, management's point estimate) in relation to the amount expected by the auditor to be recorded.
- Whether management has used an expert in making the accounting estimate.
- The outcome of the review of prior period accounting estimates.

High Estimation Uncertainty and Significant Risks (Ref: Para. 11)

A47. Examples of accounting estimates that may have high estimation uncertainty include the following:

- Accounting estimates that are highly dependent upon judgment, for example, judgments about the outcome of pending litigation or the amount and timing of future cash flows dependent on uncertain events many years in the future.
- Accounting estimates that are not calculated using recognised measurement techniques.
- Accounting estimates where the results of the auditor's review of similar accounting estimates made in the prior period financial statements indicate a substantial difference between the original accounting estimate and the actual outcome.
- Fair value accounting estimates for which a highly specialised entity developed model is used or for which there are no observable inputs.

A48. A seemingly immaterial accounting estimate may have the potential to result in a material misstatement due to the estimation uncertainty associated with the estimation, that is, the size of the amount recognised or disclosed in the financial statements for an accounting estimate may not be an indicator of its estimation uncertainty.

A49. In some circumstances, the estimation uncertainty is so high that a reasonable accounting estimate cannot be made. The applicable financial reporting framework may, therefore, preclude

recognition of the item in the financial statements, or its measurement at fair value. In such cases, the significant risks relate not only to whether an accounting estimate should be recognised, or whether it should be measured at fair value, but also to the adequacy of the disclosures. With respect to such accounting estimates, the applicable financial reporting framework may require disclosure of the accounting estimates and the high estimation uncertainty associated with them (see paragraphs A120-A123).

A50. Where the auditor determines that an accounting estimate gives rise to a significant risk, the auditor is required to obtain an understanding of the entity's controls, including control activities.¹³

A51. In some cases, the estimation uncertainty of an accounting estimate may cast significant doubt about the entity's ability to continue as a going concern. SA 570¹⁴ establishes requirements and provides guidance in such circumstances.

Responses to the Assessed Risks of Material Misstatement (Ref: Para. 12)

A52. SA 330 requires the auditor to design and perform audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement in relation to accounting estimates at both the financial statement and assertion levels.¹⁵ Paragraphs A53 A115 focus on specific responses at the assertion level only.

Application of the Requirements of the Applicable Financial Reporting Framework (Ref: Para. 12(a))

A53. Many financial reporting frameworks prescribe certain conditions for the recognition of accounting estimates and specify the methods for making them and required disclosures. Such requirements may be complex and require the application of judgment. Based on the understanding obtained in performing risk assessment procedures, the requirements of the applicable financial reporting framework that may be susceptible to misapplication or differing interpretations become the focus of the auditor's attention.

A54. Determining whether management has appropriately applied the requirements of the applicable financial reporting framework is based, in part, on the auditor's understanding of the entity and its environment. For example, the measurement of the fair value of some items, such as intangible assets acquired in a business combination, may involve special considerations that are affected by the nature of the entity and its operations.

A55. In some situations, additional audit procedures, such as the inspection by the auditor of the current physical condition of an asset, may be necessary to determine whether management has appropriately applied the requirements of the applicable financial reporting framework.

A56. The application of the requirements of the applicable financial reporting framework requires management to consider changes in the environment or circumstances that affect the entity. For example, the introduction of an active market for a particular class of asset or liability

may indicate that the use of discounted cash flows to estimate the fair value of such asset or liability is no longer appropriate.

Consistency in Methods and Basis for Changes (Ref: Para. 12(b))

A57. The auditor's consideration of a change in an accounting estimate, or in the method for making it from the prior period, is important because a change that is not based on a change in circumstances or new information is considered arbitrary. Arbitrary changes in an accounting estimate result in inconsistent financial statements over time and may give rise to a financial statement misstatement or be an indicator of possible management bias.

A58. Management often is able to demonstrate good reason for a change in an accounting estimate or the method for making an accounting estimate from one period to another based on a change in circumstances. What constitutes a good reason, and the adequacy of support for management's contention that there has been a change in circumstances that warrants a change in an accounting estimate or the method for making an accounting estimate, are matters of judgment.

Responses to the Assessed Risks of Material Misstatements (Ref: Para. 13)

A59. The auditor's decision as to which response, individually or in combination, in paragraph 13 to undertake to respond to the risks of material misstatement may be influenced by such matters as:

- The nature of the accounting estimate, including whether it arises from routine or non-routine transactions.
- Whether the procedure(s) is expected to effectively provide the auditor with sufficient appropriate audit evidence.
- The assessed risk of material misstatement, including whether the assessed risk is a significant risk.

A60. For example, when evaluating the reasonableness of the allowance for doubtful accounts, an effective procedure for the auditor may be to review subsequent cash collections in combination with other procedures. Where the estimation uncertainty associated with an accounting estimate is high, for example, an accounting estimate based on a proprietary model for which there are unobservable inputs, it may be that a combination of the responses to assessed risks in paragraph 13 is necessary in order to obtain sufficient appropriate audit evidence.

A61. Additional guidance explaining the circumstances in which each of the responses may be appropriate is provided in paragraphs A62-A95.

Events Occurring Up to the Date of the Auditor's Report (Ref: Para. 13(a))

A62. Determining whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate may be an appropriate response when such events are expected to:

- Occur; and
- Provide audit evidence that confirms or contradicts the accounting estimate.

A63. Events occurring up to the date of the auditor's report may sometimes provide sufficient appropriate audit evidence about an accounting estimate. For example, sale of the complete inventory of a superseded product shortly after the period end may provide audit evidence relating to the estimate of its net realisable value. In such cases, there may be no need to perform additional audit procedures on the accounting estimate, provided that sufficient appropriate evidence about the events is obtained.

A64. For some accounting estimates, events occurring up to the date of the auditor's report are unlikely to provide audit evidence regarding the accounting estimate. For example, the conditions or events relating to some accounting estimates develop only over an extended period. Also, because of the measurement objective of fair value accounting estimates, information after the period end may not reflect the events or conditions existing at the balance sheet date and therefore may not be relevant to the measurement of the fair value accounting estimate. Paragraph 13 identifies other responses to the risks of material misstatement that the auditor may under take.

A65. In some cases, events that contradict the accounting estimate may indicate that management has ineffective processes for making accounting estimates, or that there is management bias in the making of accounting estimates.

A66. Even though the auditor may decide not to undertake this approach in respect of specific accounting estimates, the auditor is required to comply with SA 560.¹⁶ The auditor is required to perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified¹⁷ and appropriately reflected in the financial statements.¹⁸ Because the measurement of many accounting estimates, other than fair value accounting estimates, usually depends on the outcome of future conditions, transactions or events, the auditor's work under SA 560 is particularly relevant.

Considerations specific to smaller entities

A67. When there is a longer period between the balance sheet date and the date of the auditor's report, the auditor's review of events in this period may be an effective response for accounting estimates other than fair value accounting estimates. This may particularly be the case in some smaller owner managed entities, especially when management does not have formalised control procedures over accounting estimates.

Testing How Management Made the Accounting Estimate (Ref: Para. 13(h))

A68. Testing how management made the accounting estimate and the data on which it is based may be an appropriate response when the accounting estimate is a fair value accounting estimate developed on a model that uses observable and unobservable inputs. It may also be appropriate when, for example:

- The accounting estimate is derived from the routine processing of data by the entity's accounting system.
- The auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is likely to be effective.
- The accounting estimate is based on a large population of items of a similar nature that individually are not significant.

A69. Testing how management made the accounting estimate may involve, for example:

- Testing the extent to which data on which the accounting estimate is based is accurate, complete and relevant, and whether the accounting estimate has been properly determined using such data and management assumptions.
- Considering the source, relevance and reliability of external data or information, including that received from external experts engaged by management to assist in making an accounting estimate.
- Re calculating the accounting estimate, and reviewing information about an accounting estimate for internal consistency.
- Considering management's review and approval processes.

Considerations specific to smaller entities

A70. In smaller entities, the process for making accounting estimates is likely to be less structured than in larger entities. Smaller entities with active management involvement may not have extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Even if the entity has no formal established process, it does not mean that management is not able to provide a basis upon which the auditor can test the accounting estimate.

Evaluating the method of measurement (Ref: Para. 13(b)(i))

A71. When the applicable financial reporting framework does not prescribe the method of measurement, evaluating whether the method used, including my applicable model, is appropriate in the circumstances is a matter of professional judgment.

A72. For this purpose, matters that the auditor may consider include, for example, whether:

- Management's rationale for the method selected is reasonable.
- Management has sufficiently evaluated and appropriately applied the criteria, if my, provided in the applicable financial reporting framework to support the selected method.
- The method is appropriate in the circumstances given the nature of the asset or liability being estimated and the requirements of the applicable financial reporting framework relevant to accounting estimates.
- The method is appropriate in relation to the business, industry and environment in which the entity operates.

A73. In some cases, management may have determined that different methods result in a range of significantly different estimates. In such cases, obtaining: an understanding of how the entity has investigated the reasons for these differences may assist the auditor in evaluating the appropriateness of the method selected.

Evaluating the use of models

A74. In some cases, particularly when making fair value accounting estimates, management may use a model. Whether the model used is appropriate in the circumstances may depend on a number of factors, such as the nature of the entity and its environment, including the industry in which it operates, and the specific asset or liability being measured.

A75. The extent to which the following considerations are relevant depends on the circumstances, including whether the model is one that is commercially available for use in a particular sector or industry, or a proprietary model. In some cases, an entity may use an expert to develop and test a model.

A76. Depending on the circumstances, matters that the auditor may also consider in testing the model include, for example, whether:

- The model is validated prior to usage, with periodic reviews to ensure it is still suitable for its intended use. The entity's validation process may include evaluation of:
 - o The model's theoretical soundness and mathematical integrity including the appropriateness of model parameters.

- o The consistency and completeness of the model's inputs with market practices.
 - o The model's output as compared to actual transactions.
- Appropriate change control policies and procedures exist.
- The model is periodically calibrated and tested for validity particularly when inputs are subjective.
- Adjustments are made to the output of the model, including in the case of fair value accounting estimates, whether such adjustments reflect the assumptions marketplace participants would use in similar circumstances.
- The model is adequately documented, including the model's intended applications and limitations and its key parameters, required inputs, and results of my validation analysis performed.

Assumptions used by management (Ref: Para. 13(b)(ii))

A77. The auditor's evaluation of the assumptions used by management is based only on information available to the auditor at the time of the audit. Audit procedures dealing with management assumptions are performed in the context of the audit of the entity's financial statements, and not for the purpose of providing an opinion on assumptions themselves.

A78. Matters that the auditor may consider in evaluating the reasonableness of the assumptions used by management include, for example:

- Whether individual assumptions appear reasonable.
- Whether the assumptions are interdependent and internally consistent.
- Whether the assumptions appear reasonable when considered collectively or in conjunction with other assumptions, either for that accounting estimate or for other accounting estimates.
- In the case of fair value accounting estimates, whether the assumptions appropriately reflect observable marketplace assumptions.

A79. The assumptions on which accounting estimates are based may reflect what management expects will be the outcome of specific objectives and strategies. In such cases, the auditor may perform audit procedures to evaluate the reasonableness of such assumptions by considering, for example, whether the assumptions are consistent with:

- The general economic environment and the entity's economic circumstances.
- The plans of the entity.
- Assumptions made in prior periods, if relevant.
- Experience of, or previous conditions experienced by, the entity to the extent this historical information may be considered representative of future conditions or events.
- Other assumptions used by management relating to the financial statements.

A80. The reasonableness of the assumptions used may depend on management's intent and ability to carry out certain courses of action. Management often documents plans and intentions relevant to specific assets or liabilities and the financial reporting framework may require it to do so. Although the extent of audit evidence to be obtained about management's intent and ability is a matter of professional judgment, the auditor's procedures may include the following:

- Review of management's history of carrying out its stated intentions.
- Review of written plans and other documentation, including, where applicable, formally approved budgets, authorisations or minutes.
- Inquiry of management about its reasons for a particular course of action.
- Review of events occurring subsequent to the date of the financial statements and up to the date of the auditor's report.
- Evaluation of the entity's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its existing commitments.

Certain financial reporting frameworks, however, may not permit management's intentions or plans to be taken into account when making an accounting estimate. This is often the case for fair value accounting estimates because their measurement objective requires that assumptions reflect those used by marketplace participants.

A81. Matters that the auditor may consider in evaluating the reasonableness of assumptions used by management underlying fair value accounting estimates, in addition to those discussed above where applicable, may include, for example:

- Where relevant, whether and, if so, how management has incorporated market specific inputs into the development of assumptions.

- Whether the assumptions are consistent with observable market conditions, and the characteristics of the asset or liability being measured at fair value.
- Whether the sources of market participant assumptions are relevant and reliable, and how management has selected the assumptions to use when a number of different market participant assumptions exist.
- Where appropriate, whether and, if so, how management considered assumptions used in, or information about, comparable transactions, assets or liabilities.

A82. Further, fair value accounting estimates may comprise observable inputs as well as unobservable inputs. Where fair value accounting estimates are based on unobservable inputs, matters that the auditor may consider include, for example, how management supports the following:

- The identification of the characteristics of marketplace participants relevant to the accounting estimate.
- Modifications it has made to its own assumptions to reflect its view of assumptions marketplace participants would use.
- Whether it has incorporated the best information available in the circumstances.
- Where applicable, how its assumptions take account of comparable transactions, assets or liabilities.

If there are unobservable inputs, it is more likely that the auditor's evaluation of the assumptions will need to be combined with other responses to assessed risks in paragraph 13 in order to obtain sufficient appropriate audit evidence. In such cases, it may be necessary for the auditor to perform other audit procedures, for example, examining documentation supporting the review and approval of the accounting estimate by appropriate levels of management and, where appropriate, by those charged with governance.

A83. In evaluating the reasonableness of the assumptions supporting an accounting estimate, the auditor may identify one or more significant assumptions. If so, it may indicate that the accounting estimate has high estimation uncertainty and may, therefore, give rise to a significant risk. Additional responses to significant risks are described in paragraphs A102-A115.

Testing the Operating Effectiveness of Controls (Ref: Para. 13(c))

A84. Testing the operating effectiveness of the controls over how management made the accounting estimate may be an appropriate response when management's process has been well-designed, implemented and maintained, for example:

- Controls exist for the review and approval of the accounting estimates by appropriate levels of management and, where appropriate, by those charged with governance.
- The accounting estimate is derived from the routine processing of data by the entity's accounting system.

A85. Testing the operating effectiveness of the controls is required when:

- a. The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls over the process are operating effectively; or
- b. Substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level.¹⁹

Considerations specific to smaller entities

A86. Controls over the process to make an accounting estimate may exist in smaller entities, but the formality with which they operate varies. Further, smaller entities may determine that certain types of controls are not necessary because of active management involvement in the financial reporting process. In the case of very small entities, however, there may not be many controls that the auditor can identify. For this reason, the auditor's response to the assessed risks is likely to be substantive in nature, with the auditor performing one or more of the other responses in paragraph 13.

Developing a Point Estimate or Range (Ref: Para. 13(d))

A87. Developing a point estimate or a range to evaluate management's point estimate may be an appropriate response when, for example:

- An accounting estimate is not derived from the routine processing of data by the accounting system.
- The auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is unlikely to be effective.
- The entity's controls within and over management's processes for determining accounting estimates are not well designed or properly implemented.
- Events or transactions between the period end and the date of the auditor's report contradict management's point estimate.
- There are alternative sources of relevant data available to the auditor which can be used in making a point estimate or a range.

A88. Even when the entity's controls are well designed and properly implemented, developing a point estimate or a range may be an effective or efficient response to the assessed risks. In other situations, the auditor may consider this approach as part of determining whether further procedures are necessary and, if so, their nature and extent.

A89. The approach taken by the auditor in developing either a point estimate or a range may vary based on what is considered most effective in the circumstances. For example, the auditor may initially develop a preliminary point estimate, and then assess its sensitivity to changes in assumptions to ascertain a range with which to evaluate management's point estimate. Alternatively, the auditor may begin by developing a range for purposes of determining, where possible, a point estimate.

A90. The ability of the auditor to make a point estimate, as opposed to a range, depends on several factors, including the model used, the nature and extent of data available and the estimation uncertainty involved with the accounting estimate. Further, the decision to develop a point estimate or range may be influenced by the applicable financial reporting framework, which may prescribe the point estimate that is to be used after consideration of the alternative outcomes and assumptions, or prescribe a specific measurement method (for example, the use of a discounted probability-weighted expected value).

A91. The auditor may develop a point estimate or a range in a number of ways, for example, by:

- Using a model, for example, one that is commercially available for use in a particular sector or industry, or a proprietary or auditor developed model.
- Further developing management's consideration of alternative assumptions or outcomes, for example, by introducing a different set of assumptions.
- Employing or engaging a person with specialised expertise to develop or execute the model, or to provide relevant assumptions.
- Making reference to other comparable conditions, transactions or events, or, where relevant, markets for comparable assets or liabilities.

Understanding Management's Assumptions or Method (Ref: Para. 13(d)(i))

A92. When the auditor makes a point estimate or a range and uses assumptions or a method different from those used by management, paragraph 13(d) (i) requires the auditor to obtain a sufficient understanding of the assumptions or method used by management in making the accounting estimate. This understanding provides the auditor with information that may be relevant to the auditor's development of an appropriate point estimate or range. Further, it assists the auditor to understand and evaluate any significant differences from management's point estimate. For example, a difference may arise because the auditor used different, but equally valid, assumptions as compared with those used by management. This may reveal that the accounting estimate is highly sensitive to certain assumptions and therefore subject to high

estimation uncertainty indicating that the accounting estimate may be a significant risk. Alternatively, a difference may arise as a result of a factual error made by management. Depending on the circumstances, the auditor may find it helpful in drawing conclusions to discuss with management the basis for the assumptions used and their validity, and the difference, if any, in the approach taken to making the accounting estimate.

Narrowing a Range (Ref: Para. 13(d)(ii))

A93. When the auditor concludes that it is appropriate to use a range to evaluate the reasonableness of management's point estimate (the auditor's range), paragraph 13(d)(ii) requires that range to encompass all "reasonable outcomes" rather than all possible outcomes. The range cannot be one that comprises all possible outcomes if it is to be useful, as such a range would be too wide to be effective for purposes of the audit. The auditor's range is useful and effective when it is sufficiently narrow to enable the auditor to conclude whether the accounting estimate is misstated.

A94. Ordinarily, a range that has been narrowed to be equal to or less than the amount lower than the materiality level for the financial statements as a whole determined for purposes of assessing risks of material misstatement and designing further audit procedures²⁰ is adequate for the purposes of evaluating the reasonableness of management's point estimate. However, particularly in certain industries, it may not be possible to narrow the range to below such an amount. This does not necessarily preclude recognition of the accounting estimate. It may indicate, however, that the estimation uncertainty associated with the accounting estimate is such that it gives rise to a significant risk. Additional responses to significant risks are described in paragraphs A102-A115.

A95. Narrowing the range to a position where all outcomes within the range are considered reasonable may be achieved by:

- a. Eliminating from the range those outcomes at the extremities of the range judged by the auditor to be unlikely to occur; and
- b. Continuing to narrow the range, based on audit evidence available, until the auditor concludes that all outcomes within the range are considered reasonable. In some rare cases, the auditor may be able to narrow the range until the audit evidence indicates a point estimate.

Considering whether Specialised Skills or Knowledge are Required (Ref: Para. 14)

A96. In planning the audit, the auditor is required to ascertain the nature, timing and extent of resources necessary to perform the audit engagement.²¹ This may include, as necessary, the involvement of those with specialised skills or knowledge. In addition, SA 220 requires the engagement partner to be satisfied that the engagement team, and my auditor's external experts, collectively have the appropriate capabilities, competence and time to perform the audit engagement.²² During the course of the audit of accounting estimates the auditor may identify, in

light of the experience of the auditor and the circumstances of the engagement, the need for specialised skills or knowledge to be applied in relation to one or more aspects of the accounting estimates.

A97. Matters that may affect the auditor's consideration of whether specialised skills or knowledge is required include, for example:

- The nature of the underlying asset, liability or component of equity in a particular business or industry (for example, mineral deposits, agricultural assets, complex financial instruments).
- A high degree of estimation uncertainty.
- Complex calculations or specialised models are involved, for example, when estimating fair values when there is no observable market.
- The complexity of the requirements of the applicable financial reporting framework relevant to accounting estimates, including whether there are areas known to be subject to differing interpretation or practice is inconsistent or developing.
- The procedures the auditor intends to undertake in responding to assessed risks.

A98. For the majority of accounting estimates, even when there is estimation uncertainty it is unlikely that specialised skills or knowledge will be required. For example, it is unlikely that specialised skills or knowledge would be necessary for an auditor to evaluate an allowance for doubtful accounts.

A99. However, the auditor may not possess the specialised skills or knowledge required when the matter involved is in a field other than accounting or auditing and may need to obtain it from an auditor's expert. SA 620²³ establishes requirements and provides guidance in determining the need to employ or engage an auditor's expert and the auditor's responsibilities when using the work of an auditor's expert.

A100. Further, in some cases, the auditor may conclude that it is necessary to obtain specialised skills or knowledge related to specific areas of accounting or auditing. Individuals with such skills or knowledge may be employed by the auditor's firm or engaged from an external organisation outside of the auditor's firm. When such individuals perform audit procedures on the engagement, they are part of the engagement team and accordingly, they are subject to the requirements in SA 220.

A101. Depending on the auditor's undemanding and experience of working with the auditor's expert or those other individuals with specialised skills or knowledge, the auditor may consider it appropriate to discuss matters such as the requirements of the applicable financial reporting framework with the individuals involved to establish that their work is relevant for audit purposes.

Further Substantive Procedures to Respond to Significant Risks (Ref: Para. 15)

A102. In auditing accounting estimates that give rise to significant risks, the auditor's further substantive procedures are focused on the evaluation of:

- a. How management has assessed the effect of estimation uncertainty on the accounting estimate, and the effect such uncertainty may have on the appropriateness of the recognition of the accounting estimate in the financial statements; and
- b. The adequacy of related disclosures.

Estimation Uncertainty

Management's Consideration of Estimation Uncertainty (Ref: Para. 15(a))

A103. Management may evaluate alternative assumptions or outcomes of the accounting estimates through a number of methods, depending on the circumstances. One possible method used by management is to undertake a sensitivity analysis. This might involve determining how the monetary amount of an accounting estimate varies with different assumptions. Even for accounting estimates measured at fair value there can be variation because different market participants will use different assumptions. A sensitivity analysis could lead to the development of a number of outcome scenarios, sometimes characterised as a range of outcomes by management, such as "pessimistic" and "optimistic" scenarios.

A104. A sensitivity analysis may demonstrate that an accounting estimate is not sensitive to changes in particular assumptions. Alternatively, it may demonstrate that the accounting estimate is sensitive to one or more assumptions that then become the focus of the auditor's attention.

A105. This is not intended to suggest that one particular method of addressing estimation uncertainty (such as sensitivity analysis) is more suitable than another, or that management's consideration of alternative assumptions or outcomes needs to be conducted through a detailed process supported by extensive documentation. Rather, it is whether management has assessed how estimation uncertainty may affect the accounting estimate that is important, not the specific manner in which it is done. Accordingly, where management has not considered alternative assumptions or outcomes, it may be necessary for the auditor to discuss with management, and request support for, how it has addressed the effects of estimation uncertainty on the accounting estimate.

Considerations specific to smaller entities

A106. Smaller entities may use simple means to assess the estimation uncertainty. In addition to the auditor's review of available documentation, the auditor may obtain other audit evidence of management consideration of alternative assumptions or outcomes by inquiry of management. In addition, management may not have the expertise to consider alternative outcomes or otherwise address the estimation uncertainty of the accounting estimate. In such cases, the auditor may

explain to management the process or the different methods available for doing so, and the documentation thereof This would not, however, change the responsibilities of management for the preparation and presentation of the financial statements.

Significant Assumptions (Ref: Para. 15(b))

A107. An assumption used in making an accounting estimate may be deemed to be significant if a reasonable variation in the assumption would materially affect the measurement of the accounting estimate.

A108. Support for significant assumptions derived from management's knowledge may be obtained from management's continuing processes of strategic analysis and risk management. Even without formal established processes, such as may be the case in smaller entities, the auditor may be able to evaluate the assumptions through inquiries of and discussions with management, along with other audit procedures in order to obtain sufficient appropriate audit evidence.

A109. The auditor's considerations in evaluating assumptions made by management are described in paragraphs A77-A83.

Management Intent and Ability (Ref: Para. 15(c))

A110. The auditor's considerations in relation to assumptions made by management and management's intent and ability are described in paragraphs A13 and A80.

Development of a Range (Ref: Para. 16)

A111. In preparing the financial statements, management may be satisfied that it has adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks. In some circumstances, however, the auditor may view the efforts of management as inadequate. This may be the case, for example, where, in the auditor's judgment:

- Sufficient appropriate audit evidence could not be obtained through the auditor's evaluation of how management has addressed the effects of estimation uncertainty.
- It is necessary to explore further the degree of estimation uncertainty associated with an accounting estimate, for example, where the auditor is aware of wide variation in outcomes for similar accounting estimates in similar circumstances.
- It is unlikely that other audit evidence can be obtained, for example, through the review of events occurring up to the date of the auditor's report.
- Indicators of management bias in the making of accounting estimates may exist.

A112. The auditor's considerations in determining a range for this purpose are described in paragraphs A87-A95.

Recognition and Measurement Criteria

Recognition of the Accounting Estimates in the Financial Statements (Ref: Para. 17(a))

A113. Where management has recognised an accounting estimate in the financial statements, the focus of the auditor's evaluation is on whether the measurement of the accounting estimate is sufficiently reliable to meet the recognition criteria of the applicable financial reporting framework.

A114. With respect to accounting estimates that have not been recognised, the focus of the auditor's evaluation is on whether the recognition criteria of the applicable financial reporting framework have in fact been met. Even where an accounting estimate has not been recognised, and the auditor concludes that this treatment is appropriate, there may be a need for disclosure of the circumstances in the notes to the financial statements. The auditor may also determine that there is a need to draw the reader's attention to a significant uncertainty by adding an Emphasis of Matter paragraph to the auditor's report. SA 706²⁴ establishes requirements and provides guidance concerning such paragraphs.

Measurement Basis for the Accounting Estimates (Ref: Para. 17(b))

A115. With respect to fair value accounting estimates, some financial reporting frameworks presume that fair value can be measured reliably as a prerequisite to either requiring or permitting fair value measurements and disclosures. In some cases, this presumption may be overcome when, for example, there is no appropriate method or basis for measurement. In such cases, the focus of the auditor's evaluation is on whether management's basis for overcoming the presumption relating to the use of fair value set forth under the applicable financial reporting framework is appropriate.

Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements (Ref: Para. 18)

A116. Based on the audit evidence obtained, the auditor may conclude that the evidence points to an accounting estimate that differs from management's point estimate. Where the audit evidence supports a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. Where the auditor has concluded that using the auditor's range provides sufficient appropriate audit evidence, a management point estimate that lies outside the auditor's range would not be supported by audit evidence. In such cases, the misstatement is no less than the difference between management's point estimate and the nearest point of the auditor's range.

A117. Where management has changed an accounting estimate, or the method in making it, from the prior period based on a subjective assessment that there has been a change in circumstances, the auditor may conclude based on the audit evidence that the accounting estimate is misstated as

a result of an arbitrary change by management, or may regard it as an indicator of possible management bias (see paragraphs A124-A125).

A118. SA 450²⁵ provides guidance on distinguishing misstatements for purposes of the auditor's evaluation of the effect of uncorrected misstatements on the financial statements. In relation to accounting estimates, a misstatement, whether caused by fraud or error, may arise as a result of:

- Misstatements about which there is no doubt (factual misstatements)
- Differences arising from management's judgments concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate (judgmental misstatements).
- The auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn (projected misstatements)

In some cases involving accounting estimates, a misstatement could arise as a result of a combination of these circumstances, making separate identification difficult or impossible.

A119. Evaluating the reasonableness of accounting estimates and related disclosures included in the notes to the financial statements, whether required by the applicable financial reporting framework or disclosed voluntarily, involves essentially the same types of considerations applied when auditing an accounting estimate recognised in the financial statements.

Disclosures Related to Accounting Estimates

Disclosures in Accordance with the Applicable Financial Reporting Framework (Ref: Para. 19)

A120. The presentation of financial statements in accordance with the applicable financial reporting framework includes adequate disclosure of material matters. The applicable financial reporting framework may permit, or prescribe, disclosures related to accounting estimates, and some entities may disclose voluntarily additional information in the notes to the financial statements. These disclosures may include, for example:

- The assumptions used.
- The method of estimation used, including my applicable model.
- The basis for the selection of the method of estimation.
- The effect of my changes to the method of estimation from the prior period.

- The sources and implications of estimation uncertainty.

Such disclosures are relevant to users in understanding the accounting estimates recognised or disclosed in the financial statements, and sufficient appropriate audit evidence needs to be obtained about whether the disclosures are in accordance with the requirements of the applicable financial reporting framework.

A121. In some cases, the applicable financial reporting framework may require specific disclosures regarding uncertainties. For example, some financial reporting frameworks prescribe:

- The disclosure of key assumptions and other sources of estimation uncertainty that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities. Such requirements may be described using terms such as "Key Sources of Estimation Uncertainty" or "Critical Accounting Estimates".
- The disclosure of the range of possible outcomes, and the assumptions used in determining the range.
- The disclosure of information regarding the significance of fair value accounting estimates to the entity's financial position and performance,
- Qualitative disclosures such as the exposures to risk and how they arise, the entity's objectives, policies and procedures for managing the risk and the methods used to measure the risk and any changes from the previous period of these qualitative concepts.
- Quantitative disclosures such as the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel, including credit risk, liquidity risk and market risk.

Disclosures of Estimation Uncertainty for Accounting Estimates that give Rise to Significant Risks (Ref: Para. 20)

A122. In relation to accounting estimates having significant risk, even where the disclosures are in accordance with the applicable financial reporting framework, the auditor may conclude that the disclosure of estimation uncertainty is inadequate in light of the circumstances and facts involved. The auditor's evaluation of the adequacy of disclosure of estimation uncertainty increases in importance the greater the range of possible outcomes of the accounting estimate is in relation to materiality (see related discussion in paragraph A95).

A123. In some cases, the auditor may consider it appropriate to encourage management to describe, in the notes to the financial statements, the circumstances relating to the estimation uncertainty. SA 705²⁶ provides guidance on the implications for the auditor's report when the auditor believes that management's disclosure of estimation uncertainty in the financial statements is inadequate or misleading.

Indicators of Possible Management Bias (Ref: Para. 21)

A124. During the audit, the auditor may become aware of judgments and decisions made by management which give rise to indicators of possible management bias. Such indicators may affect the auditor's conclusion as to whether the auditor's risk assessment and related responses remain appropriate, and the auditor may need to consider the implications for the rest of the audit. Further, they may affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement, as discussed in SA 700²⁷

A125. Examples of indicators of possible management bias with respect to accounting estimates include:

- Changes in an accounting estimate, or the method for making it, where management has made a subjective assessment that there has been a change in circumstances.
- Use of an entity's own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions.
Selection or construction of significant assumptions that yield a point estimate favourable for management objectives.
Selection of a point estimate that may indicate a pattern of optimism or pessimism.

Written Representations (Ref: Para. 22)

A126. SA 580²⁸ discusses the use of written representations. Depending on the nature, materiality and extent of estimation uncertainty written representations about accounting estimates recognised or disclosed in the financial statements may include representations:

- About the appropriateness of the measurement processes, including related assumptions and models, used by management in determining accounting estimates in the context of the applicable financial reporting framework, and the consistency in application of the processes.
- That the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity where relevant to the accounting estimates and disclosures.
- That disclosures related to accounting estimates are complete and appropriate under the applicable financial reporting framework.
That no subsequent event requires adjustment to the accounting estimates and disclosures included in the financial statements.

A127. For those accounting estimates not recognised or disclosed in the financial statements, written representations may also include representations about:

- The appropriateness of the basis used by management for determining that the recognition or disclosure criteria of the applicable financial reporting framework have not been met (See paragraph A1 14).
- The appropriateness of the basis used by management to overcome the presumption relating to the use of fair value set forth under the entity's applicable financial reporting framework, for those accounting estimates not measured or disclosed at fair value (see paragraph A115).

Documentation (Ref: Para. 23)

A128. Documentation of indicators of possible management bias identified during the audit assists the auditor in concluding whether the auditor's risk assessment and related responses remain appropriate, and in evaluating whether the financial statements as a whole are free from material misstatement. See paragraph A125 for examples of indicators of possible management bias.

Material Modifications to ISA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"

Deletions

1. Paragraph All of the Application Section of ISA 540 deals with the application of the requirements of ISA 540 to the audits of public sector entities regarding significant holdings of specialised assets for which there are no readily available and reliable sources of information for purposes of measurement at fair value or other current value bases, or a combination of both. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even non public sector entities, may have significant holdings of specialised assets for which there are no readily available and reliable sources of information for purposes of measurement. Accordingly, the spirit of erstwhile All, highlighting the fact that in case of certain entities, there may be a requirement of estimation at fair value in case of specialised assets, has been retained.

Appendix

(Ref: Para. A1)

Fair Value Measurements and Disclosures Under Different Financial Reporting Frameworks

The purpose of this appendix is only to provide a general discussion of fair value measurements and disclosures under different financial reporting frameworks, for background and context.

1. Different financial reporting frameworks require or permit a variety of fair value measurements and disclosures in financial statements. They also vary in the level of guidance that they provide on the basis for measuring assets and liabilities or the related disclosures. Some financial reporting frameworks give prescriptive guidance, others give general guidance, and some give no guidance at all. In addition, certain industry specific measurement and disclosure practices for fair values also exist.

2. Definitions of fair value may differ among financial reporting frameworks, or for different assets, liabilities or disclosures within a particular framework. For example, Accounting Standard (AS) 30²⁹ defines fair value as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction". The concept of fair value ordinarily assumes a current transaction, rather than settlement at some past or future date. Accordingly, the process of measuring fair value would be a search for the estimated price at which that transaction would occur. Additionally, different financial reporting frameworks may use such terms as "entity specific value," "value in use," or similar terms, but may still fall within the concept of fair value in this SA.

3. Financial reporting frameworks may treat changes in fair value measurements that occur over time in different ways. For example, a particular financial reporting framework may require that changes in fair value measurements of certain assets or liabilities be reflected directly in equity while such changes might be reflected in income under another framework. In some frameworks, the determination of whether to use fair value accounting or how it is applied is influenced by management's intent to carry out certain courses of action with respect to the specific asset or liability.

4. Different financial reporting frameworks may require certain specific fair value measurements and disclosures in financial statements and prescribe or permit them in varying degrees. The financial reporting frameworks may:

- Prescribe measurement, presentation and disclosure requirements for certain information included in the financial statements or for information disclosed in notes to financial statements or presented as supplementary information;
- Permit certain measurements using fair values at the option of an entity or only when certain criteria have been met;
- Prescribe a specific method for determining fair value, for example, through the use of an independent appraisal or specified ways of using discounted cash flows;
- Permit a choice of method for determining fair value from among several alternative methods (the criteria for selection may or may not be provided by the financial reporting framework); or

- Provide no guidance on the fair value measurements or disclosures of fair value other than their use being evident through custom or practice, for example, an industry practice.

5. Some financial reporting frameworks presume that fair value can be measured reliably for assets or liabilities as a prerequisite to either requiring or permitting fair value measurements or disclosures. In some cases, this presumption may be overcome when an asset or liability does not have a quoted market price in an active market and for which other methods of reasonably estimating fair value are clearly inappropriate or unworkable. Some financial reporting frameworks may specify a fair value hierarchy that distinguishes inputs for use in arriving at fair values ranging from those that involve clearly "observable inputs" based on quoted prices and active markets and those "unobservable inputs" that involve an entity's own judgments about assumptions that marketplace participants would use.

6. Some financial reporting frameworks require certain specified adjustments or modifications to valuation information, or other considerations unique to a particular asset or liability. For example, accounting for investment properties may require adjustments to be made to an appraised market value, such as adjustments for estimated closing costs on sale, adjustments related to the property's condition and location, and other matters. Similarly, if the market for a particular asset is not an active market, published price quotations may have to be adjusted or modified to arrive at a more suitable measure of fair value. For example, quoted market prices may not be indicative of fair value if there is infrequent activity in the market, the market is not well established, or small volumes of units are traded relative to the aggregate number of trading units in existence. Accordingly, such market prices may have to be adjusted or modified. Alternative sources of market information may be needed to make such adjustments or modifications. Further, in some cases, collateral assigned (for example, when collateral is assigned for certain types of investment in debt) may need to be considered in determining the fair value or possible impairment of an asset or liability.

7. In most financial reporting frameworks, underlying the concept of fair value measurements is a presumption that the entity is a going concern without any intention or need to liquidate, curtail materially the scale of its operations, or undertake a transaction on adverse terms. Therefore, in this case, fair value would not be the amount that an entity would receive or pay in a forced transaction, involuntary liquidation, or distress sale. On the other hand, general economic conditions or economic conditions specific to certain industries may cause illiquidity in the marketplace and require fair values to be predicated upon depressed prices, potentially significantly depressed prices. An entity however, may need to take its current economic or operating situation into account in determining the fair values of its assets and liabilities if prescribed or permitted to do so by its financial reporting framework and such framework may or may not specify how that is done. For example, management's plan to dispose of an asset on an accelerated basis to meet specific business objectives may be relevant to the determination of the fair value of that asset.

Prevalence of Fair Value Measurements

8. Measurements and disclosures based on fair value are becoming increasingly prevalent in financial reporting frameworks. Fair values may occur in, and affect the determination of, financial statements in a number of ways, including the measurement at fair value of the following:

- Specific assets or liabilities, such as marketable securities or liabilities to settle an obligation under a financial instrument, routinely or periodically "marked to market".
- Specific components of equity, for example when accounting for the recognition, measurement and presentation of certain financial instruments with equity features, such as a bond convertible by the holder into common shares of the issuer.
- Specific assets or liabilities acquired in a business combination. For example, the initial determination of goodwill arising on the purchase of an entity in a business combination usually is based on the fair value measurement of the identifiable assets and liabilities acquired and the fair value of the consideration given.
- Specific assets or liabilities adjusted to fair value on a onetime basis. Some financial reporting frameworks may require the use of a fair value measurement to quantify an adjustment to an asset or a group of assets as part of an asset impairment determination, for example, a test of impairment of goodwill acquired in a business combination based on the fair value of a defined operating entity or reporting unit, the value of which is then allocated among the entity's or unit's group of assets and liabilities in order to derive an implied goodwill for comparison to the recorded goodwill.
- Aggregations of assets and liabilities. In some circumstances, the measurement of a class or group of assets or liabilities calls for an aggregation of fair values of some of the individual assets or liabilities in such class or group. For example, under an entity's applicable financial reporting framework, the measurement of a diversified loan portfolio might be determined based on the fair value of some categories of loans comprising the portfolio.
- Information disclosed in notes to financial statements or presented as supplementary information, but not recognised in the financial statements.

¹ Hitherto known as AAS 18, "Audit of Accounting Estimates".

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

³ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment". Published in February, 2008 issue of the Journal.

⁴ SA 330, "The Auditor's Responses to Assessed Risks". Published in February, 2008 issue of the Journal.

⁵ Different definitions of fair value may exist among financial reporting frameworks.

⁶ SA 315, paragraphs 5-6 and 11-12.

⁷ SA 315, paragraph 24.

⁸ SA 330, paragraph 5.

⁹ SA 330, paragraph 20.

¹⁰ Most financial reporting frameworks require incorporation in the balance sheet or income statement of items that satisfy their criteria for recognition. Disclosure of accounting policies or adding notes to the financial statements does not rectify a failure to recognise such items, including accounting estimates.

¹¹ Different financial reporting frameworks may use different terminology to describe point determined in this way.

¹² SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", paragraph 32(b)(ii).

¹³ SA 315, paragraph 28.

¹⁴ Revised SA 570, "Going Concern" has been published in the December, 2008 issue of the Journal. Revised SA 570 is applicable for audits of financial statements for periods beginning on or after April 1, 2009.

¹⁵ SA 330, paragraphs 5-6.

¹⁶ Standard on Auditing (SA) 560, "subsequent Events" has been published in January, 2009 issue of the Journal. Revised SA 560 is applicable or audits of financial statements for periods beginning on or after April 1, 2009.

¹⁷ SA 560 (AAS 19), paragraph 4. See footnote 16.

¹⁸ SA 560 (AAS 19), paragraph 5. See footnote 16.

¹⁹ SA 330, paragraph 8.

²⁰ The Exposure Draft of SA 320 (Revised), "Audit Materiality" has been published in January, 2009 issue of the Journal. The last date for sending the comments is March 1, 2009.

²¹ SA 300, "Planning an Audit of Financial Statements", paragraph 7(c).

²² Paragraph 10 of the existing SA 220 (AAS 17), "Quality Control for Audit Work", issued in July, 1999 states "Any delegation of work to assistants would be in a manner that provides reasonable assurance that such work will be performed with due care by persons having the degree of professional competence required in the circumstances". The Standard is being revised in the light of the corresponding International Standard.

²³ SA 620 (AAS 9), "Using the Work of an Expert", paragraph 2. The Standard is being revised in the light of the corresponding International Standard.

²⁴ At present, there is no separate Standard on Auditing (SA) corresponding to International Standards on Auditing (ISA) 706, "Emphasis of Matter Paragraphs and Other Matter(s) Paragraphs in the Independent Auditor's Report". However, the concept of 'emphasis of matter paragraph' has been discussed in SA 700, "The Auditor's Report on Financial Statements". The Standard is being revised in the light of the corresponding International Standard. The Auditing and Assurance Standards Board will issue the Exposure Draft of SA 706 corresponding to ISA 706 in the near future.

²⁵ The Exposure Draft of SA 450, "Evaluation of Misstatements Identified during the Audit", has been published in January, 2009 issue of the Journal. The last date for sending the comments is March 1, 2009.

²⁶ At present, there is no separate Standard on Auditing (SA) corresponding to International Standards on Auditing (ISA) 705, "Modifications to the Opinion in the Independent Auditor's Report". However, the concept of 'modified audit report' has been discussed in SA 700, "The Auditor's Report on Financial Statements". The Standard is being revised in the light of the corresponding International Standard. The Auditing and Assurance Standards Board will issue the Exposure Draft of SA 705 corresponding to ISA 705 in the near future.

²⁷ Hitherto known as SA 700 (AAS 28), "The Auditor's Report on Financial Statements". The Standard is being revised in the light of the corresponding International Standard.

²⁸ Standard on Auditing (SA) 580 (Revised), "Representations by Management" has been published in the October, 2008 issue of the Journal. Revised SA 580 is effective for audits of financial statements for periods beginning on or after 7as April, 2009.

²⁹ AS 30, "Financial Instruments: Recognition and Measurement".

SA 560 (AAS 19)

SUBSEQUENT EVENTS

(Effective for all audits commencing on or after 1st April, 2000)

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Standard on Auditing (SA) 560*, “Subsequent Events”, should be read in the context of the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”¹, which sets out the authority of SAs.

* Issued in April, 2000.

¹ Published in the July 2007 issue of the Journal.

Introduction

1. The purpose of this Standard on Auditing (SA) is to establish standards on the auditor's responsibility regarding subsequent events. In this SA, the term "subsequent events" is used to refer to significant events occurring between the balance sheet date and the date of the auditor's report. In the context of audit of a component, such as a branch or division, of an entity "subsequent events" would refer to significant events upto the date of the report of the auditor of that component of the entity.
2. The auditor should consider the effect of subsequent events on the financial statements and on the auditor's report.
3. Accounting Standard (AS) 4, "Contingencies and Events Occurring After the Balance Sheet Date", issued by the Institute of Chartered Accountants of India, deals with the treatment in financial statements of events, both favourable and unfavourable, occurring between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company, and, by the corresponding approving authority in the case of any other entity. AS 4 identifies two types of events:
 - (a) those which provide further evidence of conditions that existed at the balance sheet date; and
 - (b) those which are indicative of conditions that arose subsequent to the balance sheet date.

Audit Procedures

4. The auditor should perform procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified. These procedures are in addition to routine procedures which may be applied to specified transactions occurring after the balance sheet date to obtain audit evidence as to account balances as at the balance sheet date, for example, the testing of inventory cut-off and payments to creditors. The auditor is not, however, expected to conduct a continuing review of all matters to which previously applied procedures have provided satisfactory conclusions.
5. The procedures to identify events that may require adjustment of, or

Subsequent Events

disclosure in, the financial statements would be performed as near as practicable to the date of the auditor's report and ordinarily include the following:

- ◆ Reviewing procedures that the management has established to ensure that subsequent events are identified.
- ◆ Reading minutes of the meetings of shareholders, the board of directors and audit and executive committees held after the balance sheet date and inquiring about matters discussed at meetings for which minutes are not yet recorded.
- ◆ Reading the entity's latest available interim financial statements and, as considered necessary and appropriate, budgets, cash flow forecasts and other related management reports.
- ◆ Inquiring, or extending previous oral or written inquiries, of the entity's lawyers concerning litigation and claims.
- ◆ Inquiring of management as to whether any subsequent events have occurred after the balance sheet date which might affect the financial statements. Examples of inquiries of management on specific matters are:
 - The current status of items that were accounted for on the basis of preliminary or inconclusive data.
 - Whether there have been any developments regarding risk areas and contingencies.
 - Whether any unusual accounting adjustments have been made or are contemplated.
 - Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.

6. When a component, such as a division or a branch, of an entity, has already been audited by another auditor, the principal auditor would make similar enquiries as set out in para 5 in respect of events, occurring between the date of signing of the report of the auditor of the component of the entity and signing of his report.

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7. When the auditor becomes aware of events which materially affect the financial statements, the auditor should consider whether such events are properly accounted for in the financial statements. When the management does not account for such events that the auditor believes should be accounted for, the auditor should express a qualified opinion or an adverse opinion, as appropriate.

Effective Date

8. This Standard on Auditing becomes operative for all audits commencing on or after 1st April, 2000.

AAS 20

KNOWLEDGE OF THE BUSINESS

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The following is the text of the Auditing and Assurance Standard (AAS) 20, “Knowledge of the Business”, issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in conjunction with the “Preface to the Statements on Standard Auditing Practices”, issued by the Institute.*

Introduction

1. The purpose of this Standard is to establish standards on what is knowledge of the business, why it is important to the auditor and to members of the audit staff working on an engagement, why it is relevant to all phases of an audit, and how the auditor obtains and uses that knowledge.
2. **In performing an audit of financial statements, the auditor should have or obtain knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions and practices that, in the auditor's judgment, may have a significant effect on the financial statements or on the examination or audit report.** Such knowledge is used by the auditor in assessing inherent and control risks and in determining the nature, timing and extent of audit procedures.
3. The auditor's level of knowledge for an engagement would include a general knowledge of the economy and the industry within which the entity operates, and a more particular knowledge of how the entity operates. The level of knowledge required by the auditor would, however, ordinarily be less than that possessed by management. A list of matters to be considered in a specific engagement is set out in the Appendix.

Obtaining the Knowledge

4. Prior to accepting an engagement, the auditor would obtain a preliminary knowledge of the industry and of the nature of ownership, management and operations of the entity to be audited, and would consider whether a level of knowledge of the business adequate to perform the audit can be obtained.
5. Following acceptance of the engagement, further and more detailed information would be obtained. To the extent practicable, the auditor would obtain the required knowledge at the start of the engagement. As the audit progresses, that information would be assessed and updated and more information would be obtained.

6. 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 example, although information is gathered at the planning stage, it is ordinarily refined and added to in later stages of the audit as the auditor and the members of his audit staff learn more about the business.

7. For continuing engagements, the auditor would update and re-evaluate information gathered previously, including information in the prior year's working papers. The auditor would also perform procedures designed to identify significant changes that have taken place since the last audit.

8. The auditor can obtain knowledge of the industry and the entity from a number of sources. For example:

- ◆ Previous experience with the entity and its industry.
- ◆ Discussion with people with the entity (for example, directors and senior operating personnel).
- ◆ Discussion with internal audit personnel and review of internal audit reports.
- ◆ Discussion with other auditors and with legal and other advisors who have provided services to the entity or within the industry.
- ◆ Discussion with knowledgeable people outside the entity (for example, industry economists, industry regulators, customers and suppliers).
- ◆ Publications related to the industry (for example, government statistics, surveys, texts, trade journals, reports prepared by banks and institutions and financial newspapers).
- ◆ Legislation and regulations that significantly affect the entity.
- ◆ Visits to the entity premises and plant facilities.
- ◆ Documents produced by the entity (for example, minutes of meetings, material sent to shareholders or furnished to regulatory authorities, promotional literature, prior years' annual and financial reports, budgets, internal management reports, interim financial reports, management policy manual, manuals of accounting and internal control systems, chart of accounts, job descriptions, marketing and sales plans).

Using the Knowledge

9. Knowledge of the business is a frame of reference within which the auditor exercises professional judgment. Understanding the business and using this information appropriately assists the auditor in:

- ◆ Assessing risks and identifying problems.
- ◆ Planning and performing the audit effectively and efficiently.
- ◆ Evaluating audit evidence.
- ◆ Providing better service to the client.

10. The auditor makes judgments about many matters throughout the course of the audit where knowledge of the business is important. For example:

- ◆ Assessing inherent risk and control risk.
- ◆ Considering business risks and management's response thereto.
- ◆ Developing the overall audit plan and the audit programme.

- ◆ Determining a materiality level and assessing whether the materiality level chosen remains appropriate.
- ◆ Assessing audit evidence to establish its appropriateness and the validity of the related financial statement assertions.
- ◆ Evaluating accounting estimates and management representations.
- ◆ Identifying areas where special audit consideration and skills may be necessary.
- ◆ Identifying related parties and related party transactions.
- ◆ Recognising conflicting information (for example, contradictory representations).
- ◆ Recognising unusual circumstances (for example, fraud and non-compliance with laws and regulations, unexpected relationships of statistical operating data with reported financial results).
- ◆ Making informed inquiries and assessing the reasonableness of answers.
- ◆ Considering the appropriateness of accounting policies and financial statement disclosures.

11. The auditor should ensure that the audit staff assigned to an audit engagement obtain sufficient knowledge of the business to enable them to carry out the audit work delegated to them. The auditor would also ensure that the audit staff understand the need to be alert for additional information and the need to share that information with the auditor and other audit staff.

12. To make effective use of knowledge about the business, the auditor should consider how it affects the financial statements taken as a whole and whether the assertions in the financial statements are consistent with the auditor's knowledge of the business.

Effective Date

13. This Auditing and Assurance Standard becomes operative for all audits commencing on or after 1st April, 2000.

Appendix

Knowledge of the Business - Matters to Consider

This list covers a broad range of matters applicable to many engagements; however, not all matters will be relevant to every engagement and the listing is only illustrative.

A. General Economic Factors

General level of economic activity (for example, recession, growth)

- ◆ Interest rates and availability of finance
- ◆ Inflation, currency revaluation
- ◆ Government policies :-
 - monetary
 - fiscal
 - taxation-corporate and other
 - financial incentives (for example, government grants and subsidies)
 - tariffs, trade restrictions
- ◆ Foreign currency rates and controls

B. The Industry - Important Conditions Affecting the Client's Business

- ◆ The market and competition
- ◆ Cyclical or seasonal activity
- ◆ Changes in product technology
- ◆ Business risk (for example, high technology, high fashion, ease of entry for competition)
- ◆ Declining or expanding operations
- ◆ Adverse conditions (for example, declining demand, excess capacity, serious price competition)
- ◆ Key ratios and operating statistics
- ◆ Specific accounting practices and problems
- ◆ Environmental requirements and problems
- ◆ Legislation and Regulatory framework
- ◆ Energy supply and cost
- ◆ Specific or unique practices (for example, relating to labour contracts, financing methods, accounting methods)

C. The Entity

1. Management and ownership - important characteristics

- ◆ Structure of entity (corporate and non-corporate) - private, public, government (including any recent or planned changes)
- ◆ Beneficial owners and related parties (local, foreign, business reputation and experience)
- ◆ Capital structure (including any recent or planned changes)
- ◆ Organizational structure
- ◆ Management objectives, philosophy, strategic plans
- ◆ Business restructuring - Acquisitions, mergers or disposals of business activities (planned or recently executed)
- ◆ Sources and methods of financing (current, historical)
- ◆ Board of directors - Corporate form
 - composition
 - business reputation and experience of individuals
 - independence from and control over operating management
 - frequency of meetings
 - existence of audit committee and scope of its activities
 - existence of policy on corporate conduct
- ◆ Members of the Managing Committee (by whatever name called) - non-corporate entities
 - composition and election of members
 - business reputation and experience of individuals
 - independence from and control over operating management
 - frequency of meetings
 - existence of policy on conduct of business by the enterprise
- ◆ Operating Management
 - experience and reputation
 - turnover
 - key financial personnel and their status in the organization
 - staffing of accounting department
 - incentive or bonus plans as part of remuneration (for example, based on profit)
 - use of forecasts and budgets
 - pressures on management (for example, over-extended dominance by one individual, unreasonable deadlines for announcing results)
 - management information systems
- ◆ Internal audit function (existence, quality)

- ◆ Attitude to internal control environment
2. The entity's business - products, markets, suppliers, expenses, operations.
 - ◆ Nature of business(es) (for example, manufacturer, wholesaler, financial services, import/export)
 - ◆ Location of production facilities, warehouses, offices
 - ◆ Employment (for example, by location, supply, wage levels, union contracts, pension commitments, government regulation)
 - ◆ Products or services and markets (for example, major customers and contracts, terms of payment, profit margins, market share, competitors, exports, pricing policies, reputation of products, warranties, order book, trends, marketing strategy and objectives, manufacturing processes)
 - ◆ Important suppliers of goods and services (for example, long-term contracts, stability of supply, terms of payment, imports, methods of delivery such as "just-in-time")
 - ◆ Inventories (for example, locations, quantities)
 - ◆ Franchises, licenses, patents
 - ◆ Important expense categories
 - ◆ Research and development
 - ◆ Foreign currency assets, liabilities and transactions - by currency hedging
 - ◆ Legislation and regulation that significantly affect the entity
 - ◆ Information systems - current, plans to change
 3. Financial performance - factors concerning the entity's financial condition and profitability
 - ◆ Key ratios and operating statistics
 - ◆ Trends
 - ◆ Debt structure, including covenants and restrictions
 4. Reporting environment - external influences which affect management in the preparation of the financial statements
 5. Legislation
 - ◆ Regulatory environment and requirements
 - ◆ Taxation, both direct and indirect
 - ◆ Measurement and disclosure issues peculiar to the business
 - ◆ Audit reporting requirements
 - ◆ Users of the financial statements

* Issued in April, 2000.

AAS 28

THE AUDITOR'S REPORT ON FINANCIAL STATEMENTS

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The following is the text of the Auditing and Assurance Standard (AAS) 28, "The Auditor's Report on Financial Statements" issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in conjunction with the "Preface to the Statements on Standard Auditing Practices" issued by the Institute.

Introduction

1. The purpose of this Auditing and Assurance Standard (AAS) is to establish standards on the form and content of the auditor's report issued as a result of an audit performed by an auditor of the financial statements of an entity. Much of the standards laid down by this AAS can be adapted to auditor's reports on financial information other than financial statements.
2. **The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements.**
3. This review and assessment involves considering whether the financial statements have been prepared in accordance with an acceptable financial reporting framework applicable to the entity under audit. It is also necessary to consider whether the financial statements comply with the relevant statutory requirements.
4. **The auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole.**

Basic Elements of the Auditor's Report

5. The auditor's report includes the following basic elements, ordinarily, in the following layout:
 - (a) Title;

- (b) Addressee;
- (c) Opening or introductory paragraph
 - (i) identification of the financial statements audited;
 - (ii) a statement of the responsibility of the entity's management and the responsibility of the auditor;
- (d) Scope paragraph (describing the nature of an audit)
 - (i) a reference to the auditing standards generally accepted in India;
 - (ii) a description of the work performed by the auditor;
- (e) Opinion paragraph containing
 - (i) a reference to the financial reporting framework used to prepare the financial statements; and
 - (ii) an expression of opinion on the financial statements;
- (f) Date of the report;
- (g) Place of signature; and
- (h) Auditor's signature.

A measure of uniformity in the form and content of the auditor's report is desirable because it helps to promote the reader's understanding of the auditor's report and to identify unusual circumstances when they occur.

6. A statute governing the entity or a regulator may require the auditor to include certain matters in the audit report or prescribe the form in which the auditor should issue his report. In such a case, the auditor should incorporate in his audit report, the matters specified by the statute or regulator and/or report in the form prescribed by them in addition to the requirements of this AAS.

Title

7. **The auditor's report should have an appropriate title.** It may be appropriate to use the term "Auditor's Report" in the title to distinguish the auditor's report from reports that might be issued by others, such as by the officers of the entity, the board of directors, or from the reports of others.

Addressee

8. **The auditor's report should be appropriately addressed as required by the circumstances of the engagement and applicable laws and regulations.** Ordinarily, the auditor's report is addressed to the authority appointing the auditor.

Opening or Introductory Paragraph

9. **The auditor's report should identify the financial statements¹¹ of the entity that have been audited, including the date of and period covered by the financial statements.**

10. **The report should include a statement that the financial statements are the responsibility of the entity's management and a statement that the responsibility of the auditor is to express an opinion on the financial statements based on the audit.**

11. Financial statements are the representations of management. The preparation of such statements requires management to make significant accounting estimates and judgments, as well as to determine the appropriate accounting principles and methods used in preparation of the financial statements. This

determination will be made in the context of the financial reporting framework that management chooses, or is required to use. In contrast, the auditor's responsibility is to audit these financial statements in order to express an opinion thereon.

12. An illustration of these matters in an opening (introductory) paragraph is:

"We have audited the attached Balance Sheet of (Name of the entity) as at 31st March 2XXX and also the Profit and Loss Account for the year ended on that date annexed thereto. These financial statements are the responsibility of the entity's management. Our responsibility is to express an opinion on these financial statements based on our audit."

Scope Paragraph

13. **The auditor's report should describe the scope of the audit by stating that the audit was conducted in accordance with auditing standards generally accepted in India.** The reader needs this as an assurance that the audit has been carried out in accordance with established standards.

14. "Scope" refers to the auditor's ability to perform audit procedures deemed necessary in the circumstances. Auditing and Assurance Standard (AAS) 2, "Objective and Scope of the Audit of Financial Statements", with regard to the determination of the "scope" states (paragraph 5):

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

15. The Auditing and Assurance Standards issued by the Institute of Chartered Accountants of India establish the auditing standards generally accepted in India.

16. **The report should include a statement that the audit was planned and performed to obtain reasonable assurance whether the financial statements are free of material misstatement.**

17. **The auditor's report should describe the audit as including:**

- (a) **examining, on a test basis, evidence to support the amounts and disclosures in financial statements;**
- (b) **assessing the accounting principles used in the preparation of the financial statements;**
- (c) **assessing the significant estimates made by management in the preparation of the financial statements; and**
- (d) **evaluating the overall financial statement presentation.**

18. **The report should include a statement by the auditor that the audit provides a reasonable basis for his opinion.**

19. An illustration of these matters in a scope paragraph is:

"We conducted our audit in accordance with the auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by

management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.”

Opinion Paragraph

20. **The opinion paragraph of the auditor’s report should clearly indicate the financial reporting framework used to prepare the financial statements and state the auditor’s opinion as to whether the financial statements give a true and fair view in accordance with that financial reporting framework and, where appropriate, whether the financial statements comply with the statutory requirements.**

21. The term used to express the auditor’s opinion, “give a true and fair view”, indicates, amongst other things, that the auditor considers only those matters that are material to the financial statements.

22. Paragraph 3 of Framework of Statements on Standard Auditing Practices and Guidance Notes on Related Services, issued by the Institute of Chartered Accountants of India, discusses the financial reporting framework. The paragraph reads as under:

“Financial Reporting Framework

Financial statements are ordinarily prepared and presented annually and are directed towards the common information needs of a wide range of users. Many of those users rely on financial statements as their major source of information because they do not have the power to obtain additional information to meet their specific information needs. Thus, financial statements need to be prepared in accordance with one, or a combination of:

- (a) relevant statutory requirements, e.g., the Companies Act, 1956, for companies;
- (b) accounting standards issued by the Institute of Chartered Accountants of India; and
- (c) other recognised accounting principles and practices, e.g., those recommended in the Guidance Notes issued by the Institute of Chartered Accountants of India.”

23. An illustration of these matters in an opinion paragraph is:

“In our opinion and to the best of our information and according to the explanations given to us, the financial statements give a true and fair view in conformity with the accounting principles generally accepted in India:

- (a) in the case of the Balance Sheet, of the state of affairs of the (name of the entity) as at 31st March 2XXX; and
- (b) in the case of the Profit and Loss Account, of the profit/loss for the year ended on that date.”

24. In addition to an opinion on the true and fair view, the auditor’s report may need to include an opinion as to whether the financial statements comply with other requirements specified by relevant statutes or law. For example, in the case of companies incorporated under the Companies Act, 1956, section 227(2) of the said Act requires that the auditor’s report should state in his audit report, whether in the auditor’s opinion and to the best of his information and according to the explanations given to the auditor, the financial statements give the information required by the Companies Act, 1956 in the manner so required^[2].

Date of Report

25. **The date of an auditor’s report on the financial statements is the date on which the auditor signs the report expressing an opinion on the financial statements.** The date of report informs the reader that

the auditor has considered the effect on the financial statements and on the report of the events and transactions of which the auditor became aware and that occurred up to that date.

26. **Since the auditor's responsibility is to report on the financial statements as prepared and presented by management, the auditor should not date the report earlier than the date on which the financial statements are signed or approved by management.**

Place of Signature

27. **The report should name specific location, which is ordinarily the city where the audit report is signed.**

Auditor's Signature

28. **The report should be signed by the auditor in his personal name. Where the firm is appointed as the auditor, the report should be signed in the personal name of the auditor and in the name of the audit firm. The partner/proprietor signing the audit report should also mention the membership number assigned by the Institute of Chartered Accountants of India.**

The Auditor's Report

29. **An *unqualified opinion* should be expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the financial statements.** An unqualified opinion indicates, implicitly, that any changes in the accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements. An unqualified opinion also indicates that:

- (a) the financial statements have been prepared using the generally accepted accounting principles, which have been consistently applied;
- (b) the financial statements comply with relevant statutory requirements and regulations; and
- (c) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

30. The following is an illustration of a complete auditor's report incorporating the basic elements set forth and illustrated above. This report illustrates the expression of an unqualified opinion.

"Auditor's Report

(Appropriate Addressee)

We have audited the attached Balance Sheet of (*Name of the entity*) as at 31st March 2XXX and also the Profit and Loss Account for the year ended on that date annexed thereto³. These financial statements are the responsibility of the entity's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management,

as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion and to the best of our information and according to the explanations given to us, the financial statements give a true and fair view in conformity with the accounting principles generally accepted in India^[4].

- (a) in the case of the Balance Sheet, of the state of affairs of (Name of the entity) as at 31st March 2XXX; and
- (b) in the case of the Profit and Loss Account, of the profit/loss for the year ended on that date.

For ABC and Co.,
Chartered Accountants

Auditor's Signature
(Name of Member signing the Audit Report)
(Designation^[5])
(Membership Number)

Place of Signature

Date

An illustration of auditor's report on the financial statements in the case of a company incorporated under the Companies Act, 1956 to which AS 3 is applicable is given in the Appendix.

Modified Reports^[6]

31. An auditor's report is considered to be modified when it includes:

(a) Matters That Do Not Affect the Auditor's Opinion

- ◆ emphasis of matter

(b) Matters That Do Affect the Auditor's Opinion

- ◆ qualified opinion
- ◆ disclaimer of opinion
- ◆ adverse opinion

Uniformity in the form and content of each type of modified report will enhance the user's understanding of such reports. Accordingly, this AAS includes suggested wordings to express an unqualified opinion as well as examples of modifying phrases for use when issuing modified reports.

Matters That Do Not Affect the Auditor's Opinion

32. In certain circumstances, an auditor's report may be modified by adding an emphasis of matter paragraph to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such an emphasis of matter paragraph does not affect the auditor's opinion. The paragraph would preferably be included preceding the opinion paragraph and would ordinarily refer to the fact that the auditor's opinion is not qualified in this respect.

33. The auditor should modify the auditor's report by adding a paragraph to highlight a material matter regarding a going concern problem where the going concern question is not resolved and adequate disclosures have been made in the financial statements.

34. The auditor should consider modifying the auditor's report by adding a paragraph if there is a significant uncertainty (other than going concern problem), the resolution of which is dependent upon future events and which may affect the financial statements. An uncertainty is a matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements.

35. An illustration of an emphasis of matter paragraph for a significant uncertainty in an auditor's report is as follows:

"Without qualifying our opinion, we draw attention to Note X of Schedule to the financial statements. The entity is the defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The entity has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.

In our opinion *(remaining words are the same as illustrated in the opinion paragraph — paragraph 30 above).* "

(An illustration of an emphasis of matter paragraph relating to going concern is set out in AAS 16, "Going Concern.")

36. The addition of a paragraph emphasising a going concern problem or significant uncertainty is ordinarily adequate to meet the auditor's reporting responsibilities regarding such matters. However, in extreme cases, such as situations involving multiple uncertainties that are significant to the financial statements, the auditor may consider it appropriate to express a disclaimer of opinion instead of adding an emphasis of matter paragraph.

Matters that Do Affect the Auditor's Opinion

37. An auditor may not be able to express an unqualified opinion when either of the following circumstances exists and, in the auditor's judgment, the effect of the matter is or may be material to the financial statements:

- (a) there is a limitation on the scope of the auditor's work; or
- (b) there is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.

The circumstances described in (a) could lead to a qualified opinion or a disclaimer of opinion. The circumstances described in (b) could lead to a qualified opinion or an adverse opinion. These circumstances are discussed in paragraphs 42 - 47.

38. **A qualified opinion should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management is not so material and pervasive as to require an adverse opinion, or limitation on scope is not so material and pervasive as to require a disclaimer of opinion. A qualified opinion should be expressed as being 'subject to' or 'except for' the effects of the matter to which the qualification relates.**

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

40. **An adverse opinion** should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

41. **Whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s), individually and in aggregate, on the financial statements should be mentioned in the auditor's report.** In circumstances where it is not practicable to quantify the effect of modifications made in the audit report accurately, the auditor may do so on the basis of estimates made by the management after carrying out such audit tests as are possible and clearly indicate the fact that the figures are based on management estimates. Ordinarily, this information would be set out in a separate paragraph preceding the opinion or disclaimer of opinion and may include a reference to a more extensive discussion, if any, in a note to the financial statements.

Circumstances That May Result in Other Than an Unqualified Opinion

Limitation on Scope

42. A limitation on the scope of the auditor's work may sometimes be imposed by the entity, for example, when the terms of the engagement specify that the auditor will not carry out an audit procedure that the auditor believes is necessary. However, when the limitation in the terms of a proposed engagement is such that the auditor believes the need to express a disclaimer of opinion exists; the auditor should ordinarily not accept such a limited engagement as an audit engagement, unless required by statute. Also, a statutory auditor should not accept such an audit engagement when the limitation infringes on the auditor's statutory duties.

43. A scope limitation may be imposed by circumstances, for example, when the timing of the auditor's appointment is such that the auditor is unable to observe the counting of physical inventories. It may also arise when, in the opinion of the auditor, the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed to be desirable. In these circumstances, the auditor would attempt to carry out reasonable alternative procedures to obtain sufficient appropriate audit evidence to support an unqualified opinion.

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

45. Illustrations of these matters are set out below :

Limitation on Scope — Qualified Opinion

"We have audited (remaining words are the same as illustrated in the introductory paragraph —paragraph 30 above).

Except as discussed in the following paragraph, we conducted our audit in accordance with *(remaining words are the same as illustrated in the scope paragraph — paragraph 30 above)*.

We did not observe the counting of the physical inventories as at 31st March 2XXX since that date was prior to the time we were appointed as auditors of*(Name of the entity)*. Owing to the nature of the entity's records, we were unable to satisfy ourselves as to inventory quantities by other audit procedures.

In our opinion and to the best of our information and according to the explanations given to us, subject to the effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to physical inventory quantities, the financial statements give a *(remaining words are the same as illustrated in the opinion paragraph —paragraph 30 above).*"

Limitation on Scope — Disclaimer of Opinion

"We were engaged to audit the attached Balance Sheet of*(Name of the entity)* as at 31st March 2XXX and also the Profit and Loss Account for the year ended on that date annexed thereto. These financial statements are the responsibility of the entity's management. (Omit the sentence stating the responsibility of the auditor).

(The paragraph discussing the scope of the audit would either be omitted or amended according to the circumstances.)

(Add a paragraph discussing the scope limitation as follows:)

We were not able to observe all physical inventories and confirm accounts receivable due to limitations placed on the scope of our work by the entity.

Because of the significance of the matters discussed in the preceding paragraph, we do not express an opinion on the financial statements. "

Disagreement with Management

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

47. Illustrations of these matters are set out below:

Disagreement on Accounting Policies-Inappropriate Accounting Method—Qualified Opinion

"We have audited *(remaining words are the same as illustrated in the introductory paragraph — paragraph 30 above)*.

We conducted our audit in accordance with *(remaining words are the same as illustrated in the scope paragraph—paragraph 30 above)*.

As stated in Note X of Schedule to the financial statements, no depreciation has been provided for the period in the financial statements. This is contrary to Accounting Standard (AS) 6 on "Depreciation Accounting", issued by the Institute of Chartered Accountants of India

and the accounting policy being followed by the entity according to which depreciation is provided on straight line basis. Had this accounting policy been followed, the provision for depreciation for the period would have been Rs..... This short provisioning for depreciation has resulted into the profit for the year, fixed assets and reserves and surplus being overstated by Rs.....

Or

As stated in Note X of Schedule to the financial statements, hire purchase sales have been treated as outright sales by the entity and contrary to accepted accounting practice, the entire profit thereon has been taken into account. The profit relating to installment not due as at the date of the Balance Sheet and included in profit for the year amounted to Rs..... This has resulted in the profit for the year, inventories and reserve and surplus being overstated by Rs

In our opinion and to the best of our information and according to the explanations given to us, subject to the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements give a true and ... *(remaining words are the same as illustrated in the opinion paragraph-paragraph 30 above).*"

Disagreement on Accounting Policies—Inadequate Disclosure-Qualified Opinion

"We have audited *(remaining words are the same as illustrated in the introductory paragraph — paragraph 30 above).*

We conducted our audit in accordance with *(remaining words are the same as illustrated in the scope paragraph—paragraph 30 above).*

On 15th January 2XXX, the *(Name of the entity)* issued debentures in the amount of Rs.XXX for the purpose of financing plant expansion. The debentures agreement restricts the payment of future cash dividends to earnings after 31st March 2XXX. In our opinion, disclosure of this information is required by

In our opinion and to the best of our information and according to the explanations given to us, subject to the omission of the information included in the preceding paragraph, the financial statements give a true and *(remaining words are the same as illustrated in the opinion paragraph, paragraph 30 above).*"

Disagreement on Accounting Policies - Inadequate Disclosure - Adverse Opinion

"We have audited the attached Balance Sheet of *(Name of the entity)*, as at 31st March 2XXX, and also the Profit and Loss Account for the year ended on that date annexed thereto. These financial statements are the responsibility of the entity's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with (remaining words are the same as illustrated in the scope paragraph—paragraph 30 above).

(Paragraph(s) discussing the disagreement).

In our opinion and to the best of our information and according to the explanations given to us, because of the effects of the matters discussed in the preceding paragraph(s), the financial

statements do not give a true and fair view in conformity with the accounting principles generally accepted in India^[9].

- (a) in the case of the Balance Sheet, of the state of affairs of the company as at 31st March 2XXX; and
- (b) in the case of the Profit and Loss Account, of the profit/loss for the year ended on that date.

Effective Date

48. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods beginning on or after 1st April 2003. Earlier application of the AAS is encouraged.

Compatibility with the International Standard on Auditing (ISA) 700

The auditing standards established in this Auditing and Assurance Standard are generally consistent in all material respects with those set out in the International Standard on Auditing (ISA) 700, The Auditor's Report on Financial Statements, except the following:

- (a) Due to the practices prevailing in India, the AAS requires the auditor to mention the "Place of Signature" instead of the "Auditor's Address" in the auditors report. The place of signature is the name of specific location, which is ordinarily the city where the audit report is signed [see paragraph 27]. According to ISA 700, the expression "Auditor's Address" means the name of a specific location, which is ordinarily the city where the auditor maintains the office that has the responsibility for the audit.
- (b) The AAS requires the auditor to mention the membership number assigned by the Institute of Chartered Accountants of India [see paragraph 28]. ISA 700, however, does not contain any corresponding requirement.
- (c) The AAS requires that whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s), individually and in aggregate, on the financial statements should be mentioned in the auditor's report [see paragraph 41]. ISA 700 does not require the auditor to quantify the possible effect(s) in aggregate on the financial statements.

Appendix

Illustrative Auditor's Report on the Financial Statements in the Case of a Company Incorporated Under the Companies Act, 1956 to which AS 3 is applicable^[9]

[see paragraph 30]

Auditor's Report

The Members of(name of the Company)^[10]

We have audited the attached Balance Sheet of (name of the company), as at 31st March 2XXX, and also the Profit and Loss Account and the cash flow statement for the year ended on that date annexed thereto. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

As required by the Manufacturing and Other Companies (Auditor's Report) Order, 1988^[11] issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Companies Act, 1956, we enclose in the Annexure^[12] a statement on the matters specified in paragraphs 4 and 5 of the said Order.

Further to our comments in the Annexure referred to above, we report that:

(i) We have obtained all the information and explanations, which to the best of our knowledge and belief were necessary for the purposes of our audit;

(ii) In our opinion, proper books of account as required by law have been kept by the company so far as appears from our examination of those books (and proper returns adequate for the purposes of our audit have been received from the branches not visited by us. The Branch Auditor's Report(s) have been forwarded to us and have been appropriately dealt with); ^[13]

(iii) The Balance Sheet, Profit and Loss Account and cash flow statement dealt with by this report are in agreement with the books of account (and with the audited returns from the branches);^[14]

(iv) In our opinion, the Balance Sheet, Profit and Loss Account and cash flow statement dealt with by this report comply with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956;

(v) On the basis of written representations received from the directors, as on 31st March 2XXX and taken on record by the Board of Directors, we report that none of the directors is disqualified as on 31st March 2XXX from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956;

(vi) In our opinion and to the best of our information and according to the explanations given to us, the said accounts give the information required by the Companies Act, 1956, in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India^[15]:

(a) in the case of the Balance Sheet, of the state of affairs of the company as at 31st March 2XXX;

- (b) in the case of the Profit and Loss Account, of the profit / loss^[16] for the year ended on that date; and
- (c) in the case of the cash flow statement, of the cash flows for the year ended on that date.

For ABC and Co.
Chartered Accountants

Signature
(Name of the Member Signing the Audit Report)
(Designation^[17])
Membership Number

Place of Signature

Date

* Issued in January, 2003. From the date this AAS becomes effective, the Format of Audit Report (Revised), (published in April, 2002 issue of the 'The Chartered Accountant', p.1229) and the Announcement regarding revision of Format of Audit Report, (published in December, 2002 issue of the 'The Chartered Accountant', p.616) shall stand withdrawn.

^[1] The Council of the Institute has made Accounting Standard (AS) 3, Cash Flow Statements, mandatory for certain entities in respect of accounting periods commencing on or after 1.4.2001. Further, the Council has also decided that AS 3 should also be treated as a "specified" accounting standard for the purpose of section 211 of the Companies Act, 1956 thereby making the Cash Flow Statements a part of the Balance Sheet and Profit and Loss Account. However, irrespective of the fact that the cash flow statement is considered to be a part of the Balance Sheet and Profit and Loss Account, the opening or the introductory paragraph of the auditor's report on financial statements of such companies and other entities for which AS 3 has been made mandatory, would also identify the Cash Flow Statement as a part of the financial statements audited apart from the Balance Sheet and Profit and Loss Account. Similar reporting considerations would also apply to the entities which, though not required to comply with AS 3 in view of its not being mandatory for them, voluntarily prepare the cash flow statements. Further, in the above mentioned cases, the auditor's report on financial statements would also contain an expression of opinion on the true and fair view of the cash flows for the period under audit (refer to Appendix for an illustrative auditor's report on the financial statements in the case of a company for which AS 3 has been made mandatory).

^[2] Refer to Appendix for an illustration of the opinion paragraph in the case of a company incorporated under the Companies Act, 1956. Also refer footnote 1 for applicability of AS 3 to an entity and the auditor's duties and responsibilities in this regard.

^[3] Refer to footnote 1.

^[4] *ibid.*

^[5] Partner or proprietor, as the case may be.

^[6] This AAS lays down the basic principles that govern the auditor's report on financial statements. The reporting requirements contained in other AASs issued by the Council of the Institute would also be applicable.

^[7] Refer to footnote 3.

^[8] *ibid.*

^[9] In case AS 3 is not applicable to a company and such company also does not voluntarily prepare the cash flow statement, the references to cash flow statement should be deleted from the entire report.

^[10] Reference may also be made to the Statement on Qualifications in Auditor's Report and the Guidance Note on Section 227(3)(e) and (f) of the Companies Act, 1956 issued by the Council of the Institute of Chartered Accountants of India.

^[11] The Manufacturing and Other Companies (Auditor's Report) Order, 1988 has since been replaced by the Companies (Auditor's Report) Order, 2003 vide Department of Company Affairs' Notification dated June 12, 2003.

^[12] Alternatively, instead of giving the comments on Companies (Auditor's Report) Order, 2003 in an Annexure, the comments may be contained in the body of the main report. Members' attention in this regard is invited to the Statement on the Companies (Auditor's Report) Order, 2003, issued by the Institute of Chartered Accountants of India. It may also be noted that requirements of the Companies (Auditor's Report) Order, 2003 have not been reproduced in this illustration.

^[13] Wherever applicable.

^[14] *ibid.*

^[15] *ibid.*

^[16] Whichever is applicable.

^[17] Partner or Proprietor, as the case may be.

AAS 30

EXTERNAL CONFIRMATIONS

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The following is the text of the Auditing and Assurance Standard (AAS) 30, "External Confirmations", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in conjunction with the "Preface to the Statements on Standard Auditing Practices", issued by the Institute.*

Introduction

1. The purpose of this Auditing and Assurance Standard (AAS) is to establish standards on the auditor's use of external confirmations as a means of obtaining audit evidence.
2. **The auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence to support certain financial statement assertions. In making this determination, the auditor should consider materiality, the assessed level of inherent and control risk, and how the evidence from other planned audit procedures will reduce audit risk to an acceptably low level for the applicable financial statement assertions. The auditor should employ external confirmation procedures in consultation with the management.**
3. Auditing and Assurance Standard (AAS) 5, "Audit Evidence" states that the reliability of audit evidence is influenced by its source and nature. It indicates that, in general, audit evidence from external sources is more reliable than audit evidence generated internally, and that written (documentary) audit evidence is more reliable than audit evidence in oral form. Accordingly, audit evidence in the form of written responses to confirmation

requests received directly by the auditor from third parties who are not related to the entity being audited, when considered individually or cumulatively with audit evidence from other procedures, may assist in reducing audit risk for the related financial statement assertions to an acceptably low level.

4. External confirmation is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item affecting assertions made by management in the financial statements. In deciding to what extent to use external confirmations, the auditor considers the characteristics of the environment in which the entity being audited operates and the practice of potential respondents in dealing with requests for direct confirmation.

5. The process of external confirmations, ordinarily, consists of the following:

- ◆ Selecting the items for which confirmations are needed.
- ◆ Designing the form of the confirmation request.
- ◆ Communicating the confirmation request to the appropriate third party.
- ◆ Obtaining response from the third party.
- ◆ Evaluating the information or absence thereof.

6. External confirmations are frequently used in relation to account balances and their components, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements or transactions an entity has with third parties. The confirmation request is designed to ask if any modifications have been made to the agreement, and if so, the relevant details thereof. Other examples of situations where external confirmations may be used include the following:

- ◆ Bank balances and other information from bankers.
- ◆ Accounts receivable balances.
- ◆ Stocks held by third parties.
- ◆ Property title deeds held by third parties.
- ◆ Investments purchased but delivery not taken.
- ◆ Loans from lenders.
- ◆ Accounts payable balances.
- ◆ Long outstanding share application money.

7. The reliability of the evidence obtained by external confirmations depends, among other factors, upon the application of appropriate procedures by the auditor in designing the external confirmation request, performing the external confirmation procedures, and evaluating the results of the external confirmation procedures. Factors affecting the reliability of confirmations include the control which the auditor exercises over confirmation requests and responses, the characteristics of the respondents, and any restrictions included in the response or imposed by management.

Relationship of External Confirmation Procedures to the Auditor's Assessments of Inherent Risk and Control Risk

8. Auditing and Assurance Standard (AAS) 6 (Revised), "Risk Assessments and Internal Control" discusses audit risk and the relationship between its components: inherent risk, control risk, and detection risk. It outlines

the process of assessing inherent and control risk to determine the nature, timing, and extent of substantive procedures to reduce detection risk, and therefore, audit risk, to an acceptable level.

9. AAS 6 (Revised) also indicates that the nature and extent of evidence to be obtained from the performance of substantive procedures varies depending on the assessment of inherent and control risks, and that the assessed levels of inherent and control risk cannot be sufficiently low to eliminate the need to perform any substantive procedures. These substantive procedures may include the use of external confirmations for specific financial statement assertions.

10. Paragraph 48 of AAS 6 (Revised) indicates that the higher the assessment of inherent and control risk, the more audit evidence the auditor needs to obtain from the performance of substantive procedures. Consequently, as the assessed level of inherent and control risk increases, the auditor designs substantive procedures to obtain more evidence, or more persuasive evidence, about a financial statement assertion. In these situations, the use of confirmation procedures may be effective in providing sufficient appropriate audit evidence.

11. The auditor should assess whether the evidence provided by the confirmations reduces audit risks for the related assertions to an acceptably low level. In making that assessment, the auditor should consider the materiality of the account balance and the auditor's assessment of the inherent and control risk. If the auditor concludes that the evidence provided by the confirmations alone is not sufficient, he should perform additional procedures.

12. The lower the assessed level of inherent and control risk, the less assurance the auditor needs from substantive procedures to form a conclusion about a financial statement assertion. For example, an entity may have a loan that it is repaying according to an agreed repayment schedule, the terms of which the auditor has confirmed in previous years. If the other work carried out by the auditor (including such tests of controls as are necessary) indicates that the terms of the loan have not changed and has led to the level of inherent and control risk over the balance of the loan outstanding being assessed as low, the auditor might limit substantive procedures to testing details of the payments made, rather than again confirming the balance directly with the lender.

13. Unusual or complex transactions may be associated with higher levels of inherent or control risk than simple transactions. If the entity has entered into an unusual or complex transaction and the level of inherent and control risk is assessed as high, the auditor considers confirming the terms of transaction with the other parties in addition to examining documentation held by the entity.

Assertions Addressed by External Confirmations

14. AAS 5, "Audit Evidence", categorises the assertions contained in the financial statements as existence, rights and obligations, occurrence, completeness, valuation, measurement, and presentation and disclosure. While external confirmations may provide audit evidence regarding these assertions, the ability of an external confirmation to provide evidence relevant to a particular financial statement assertion varies.

15. External confirmation of an account receivable provides strong evidence regarding the existence of the account as at a certain date. Confirmation also provides evidence regarding the operation of cut-off procedures. However, such confirmation does not ordinarily provide all the necessary audit evidence relating to the assertion regarding valuation, since it is not practicable to ask the debtor to confirm detailed information relating to its ability to pay the account.

16. Similarly, in the case of goods held on consignment, external confirmation is likely to provide strong evidence to support the assertions related to existence and the rights and obligations, but might not provide evidence that supports the assertions related to valuation.

17. The relevance of external confirmations to auditing a particular financial statement assertion is also affected by the objective of the auditor in selecting information for confirmation. For example, when auditing the assertion regarding the completeness of accounts payable, the auditor also needs to obtain evidence that there is no material unrecorded liability. Accordingly, sending confirmation requests to an entity's principal suppliers, asking them to provide copies of their statements of account directly to the auditor, even if the entity's records show no amount currently owing to them, will usually be more effective in detecting unrecorded liabilities than selecting accounts for confirmation based on the larger amounts recorded in the accounts payable subsidiary ledger.

18. When obtaining evidence for assertions not adequately addressed by confirmations, the auditor considers other audit procedures to complement confirmation procedures or to be used instead of confirmation procedures.

Timing of External Confirmations

19. The auditor may request external confirmations either as at the date of the financial statements or as at any other selected date which is reasonably close to the date of financial statements. The date may be, alternatively, settled by the auditor in consultation with the management. Where the auditor decides to request for confirmations as at date which is other than the date of the financial statements, the auditor would need to examine the movement in the concerned account(s) that occur between the date of the confirmations and the date of the financial statements. For example, when the auditor uses confirmation as at a date prior to the balance sheet to obtain evidence to support a financial statement assertion, the auditor would obtain sufficient appropriate audit evidence that transactions relevant to the assertions in the intervening period have not been materially misstated. For practical reasons, when the level of inherent and control risk is assessed at less than high, the auditor may decide to confirm balances at a date other than the period end, for example, when the audit is to be completed within a short time after the balance sheet date. As with all types of pre-year-end work, the auditor would consider the need to obtain further audit evidence relating to the remainder of the period also.

Design of the External Confirmation Request

20. The auditor should design external confirmation requests to the specific audit objective. When designing the request, the auditor considers the assertions being addressed and the factors that are likely to affect the reliability of the confirmations. Factors such as the form of the external confirmation request, prior experience on the audit or similar engagements, the nature of the information being confirmed, and the intended respondent, affect the design of the requests because these factors have a direct effect on the reliability of the evidence obtained through external confirmation procedures. The other factors which have an effect on the design of an external confirmation request include effectiveness of the internal control system of the entity, apparent possibility of disputes, inaccuracies and irregularities in the accounts, the possibility that the request will receive a consideration and the materiality of the amount involved.

Nature of Information Being Confirmed

21. In designing the request, the auditor considers the type of information respondents will be able to confirm readily since this may affect the response rate and the nature of the evidence obtained. For example, certain respondents' accounting systems may facilitate the external confirmation of single transactions rather than of

entire account balances. In addition, respondents may not always be able to confirm certain types of information, such as the overall accounts receivable balance, but may be able to confirm individual invoice amounts within the total balance.

22. The auditor's understanding of the client's arrangements and transactions with the third parties is important in determining the information to be confirmed. **The auditor should obtain an understanding of the substance of such transactions and arrangements to decide about the information to be included in the request for confirmation.** The auditor also considers the possibility of oral modifications in the arrangements and transactions and, accordingly, requests the management to provide him the details thereof.

23. Confirmation requests ordinarily include authorization of the entity's management to the respondent to disclose the information to the auditor. Respondents may be more willing to respond to a confirmation request containing management's authorization, and in some cases may be unable to respond unless the request contains such authorization.

Prior Experience

24. **The auditor should consider the information from audits of earlier years.** This information would, normally, include the misstatements, inaccuracies or irregularities identified by the auditor or those pointed out by the third parties in the earlier years, the response rate etc.

Form of Confirmation Request—Use of Positive and Negative Confirmations

25. The auditor may use positive or negative external confirmation requests or a combination of both.

26. A positive external confirmation request asks the respondent to reply to the auditor in all cases either by indicating the respondent's agreement with the given information, or by asking the respondent to fill in information. The use of a positive confirmation is preferable when individual account balances are large, or where the internal controls are weak, or where the auditor has reasons to believe that there may be a substantial number of accounts in dispute or inaccurate or irregular. A response to a positive confirmation request is ordinarily expected to provide reliable audit evidence. There is a risk, however, that a respondent may reply to the confirmation request without verifying that the information is correct. The auditor is not ordinarily able to detect whether this has occurred. The auditor may reduce this risk, however, by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, but ask the respondent to fill in the amount or furnish other information. On the other hand, use of this type of "blank" confirmation request may result in lower response rates because additional effort is required of the respondents.

27. A negative external confirmation request asks the respondent to reply only in the event of disagreement with the information provided in the request. However, when no response has been received to a negative confirmation request, the auditor remains aware that there will be no explicit evidence that intended third parties have received the confirmation requests and verified that the information contained therein is correct or that the confirmation was sent by the respondent but not received by him. Accordingly, the use of negative confirmation requests ordinarily provides less reliable evidence than the use of positive confirmation requests, and the auditor considers performing other substantive procedures to supplement the use of negative confirmations.

28. Negative confirmation requests may be used to reduce audit risk to an acceptable level when:

- (a) the assessed level of inherent and control risk is low;
- (b) a large number of small balances is involved;

- (c) a substantial number of errors is not expected; and
- (d) the auditor has no reason to believe that respondents will disregard these requests.

29. A combination of positive and negative external confirmations may be used. For example, where the total accounts receivable balance comprises a small number of large balances and a large number of small balances, the auditor may decide that it is appropriate to confirm all or a sample of the large balances with positive confirmation requests and a sample of the small balances using negative confirmation requests.

Characteristics of Respondents

30. The reliability of evidence provided by a confirmation is affected by the respondent's competence, independence, authority to respond, knowledge of the matter being confirmed, and objectivity. For this reason, the auditor attempts to ensure, where practicable, that the confirmation request is directed to an appropriate individual. For example, when confirming that a covenant related to an entity's long-term debt has been waived, the auditor directs the request to an official of the creditor who has knowledge about the waiver and has the authority to provide the information.

31. The auditor also assesses whether certain parties may not provide an objective or unbiased response to a confirmation request. Information about the respondent's competence, knowledge, motivation, ability or willingness to respond may come to the auditor's attention. The auditor considers the effect of such information on designing the confirmation request and evaluating the results, including determining whether additional procedures are necessary. The auditor also considers whether there is sufficient basis for concluding that the confirmation request is being sent to a respondent from whom the auditor can expect a response that will provide sufficient appropriate evidence. For example, the auditor may encounter significant unusual year-end transactions that have a material effect on the financial statements, the transactions being with a third party that is economically dependent upon the entity. In such circumstances, the auditor considers whether the third party may be motivated to provide an inaccurate response.

The External Confirmation Process

32. **When performing confirmation procedures, the auditor should maintain control over the process of selecting those to whom a request will be sent, the preparation and sending of confirmation requests, and the responses to those requests.** Maintaining control means maintaining direct communications between the intended recipients and the auditor to minimize the possibility that the results of the confirmation process will be biased because of the interception and alteration of confirmation requests or responses. The auditor may give a list of accounts selected for confirmation to the management for preparing requests for confirmations, which should be properly addressed and stamped, alternatively, the auditor may request the management to furnish duly authorised confirmation letters and fill in the names, addresses and other relevant details relating to the accounts selected by him. **The auditor should, however, ensure that it is the auditor who sends out the confirmation requests, that the requests are properly addressed, and that it is requested that all replies and the undelivered confirmations are delivered directly to the auditor. The auditor considers whether replies have come from the purported senders.**

No Response to a Positive Confirmation Request

33. The auditor should perform alternative procedures where no response is received to a positive external confirmation request. The alternative audit procedures should be such as to provide the evidence about the financial statement assertions that the confirmation request was intended to provide.

34. When using a confirmation request other than a negative confirmation request, the auditor, generally, follows up with a second and sometimes third request to those parties from whom replies have not been received or, alternatively, contact the recipient of the request to elicit a response. Where the auditor is unable to obtain a response, the auditor would need to use alternative audit procedures. The nature of alternative procedures varies according to the account and assertion in question. In the examination of accounts receivable, alternative procedures may include examination of subsequent cash receipts, examination of shipping documentation or other client documentation to provide evidence for the existence assertion, and sales cut-off tests to provide evidence for the assertion related to completeness. In the examination of accounts payable, alternative procedures may include examination of subsequent cash disbursements or correspondence from third parties to provide evidence of the existence assertion, and examination of other records, such as goods received notes, to provide evidence of the assertion regarding completeness.

Reliability of Responses Received

35. **The auditor should consider whether there is any indication that external confirmations received may not be reliable. The auditor should also consider the authenticity of the response and perform appropriate procedures to dispel any doubts.** The auditor may choose to verify the source and contents of a response in a telephone call to the purported sender. In addition, the auditor would also request the purported sender to mail the original confirmation directly to the auditor. With ever-increasing use of technology, the auditor needs to consider validating the source of replies received in electronic format (for example, fax or electronic mail). **Oral confirmations should be documented in the work papers.** If the information in the oral confirmations or that received though a fax is significant, the auditor requests the parties involved to submit written confirmation of the specific information directly to the auditor since in such cases it is difficult to ascertain the source of the response.

Causes and Frequency of Exceptions

36. **When the auditor forms a conclusion that the confirmation process and alternative procedures have not provided sufficient appropriate audit evidence regarding an assertion, the auditor should undertake additional procedures to obtain sufficient appropriate audit evidence.** In forming the conclusion, the auditor considers the:

- (a) reliability of the confirmations and alternative procedures;
- (b) nature of any exceptions, including the implications, both quantitative and qualitative of those exceptions; and
- (c) evidence provided by other procedures.

Based on this evaluation, the auditor would determine whether additional audit procedures are needed to obtain sufficient appropriate audit evidence.

37. Any discrepancies revealed by the external confirmations received or by the additional procedures carried out by the auditor might have a bearing on the assertions and the accounts within the given assertion not selected for external confirmation. **The auditor, in such a case, should request the management to verify and reconcile the discrepancies. The auditor should also consider what further tests can be carried out to satisfy himself as to the correctness of related assertion.**

38. **The auditor should also consider the causes and frequency of exceptions reported by respondents.** An exception might indicate a misstatement in the entity's records, in which case, the auditor determines the reasons for the misstatement and assesses whether it has a material effect on the financial statements. If an exception indicates a misstatement, the auditor would reconsider the nature, timing and extent

of audit procedures necessary to provide the evidence required. **If the responses received indicate a pattern of misstatements, the auditor should reconsider his assessment of inherent and control risk and also consider the effect on his audit procedures.**

Evaluating the Results of the Confirmation Process

39. The auditor should evaluate whether the results of the external confirmation process together with the results from any other procedures performed, provide sufficient appropriate audit evidence regarding the financial statement assertion being audited. In conducting this evaluation, the auditor considers the guidance provided by AAS 15, "Audit Sampling".

Management Requests

40. When the auditor seeks to confirm certain balances or other information, and management requests the auditor not to do so, the auditor should consider whether there are valid grounds for such a request and obtain evidence to support the validity of management's requests. The auditor should also ask the management to submit its request in a written form, detailing therein the reasons for such request. The management, for example, might make such a request on the grounds that due to a dispute with the particular debtor, the request for confirmation might aggravate the sensitive negotiations between the entity and the debtor. The auditor, in such a case, would examine any available evidence to support management's request, say, examining the correspondence between the management and the debtor. **If the auditor agrees to management's request not to seek external confirmation regarding a particular matter, the auditor should document the reasons for acceding to the management's request and should apply alternative procedures to obtain sufficient appropriate evidence regarding that matter.**

41. If the auditor does not accept the validity of management's request and is prevented from carrying out the confirmations, there has been a limitation on the scope of the auditor's work and the auditor should consider the possible impact on the auditor's report. The auditor should, however, in this case also, document the request made by the management along with the reasons given by the management therefor as well as his own reasons for not acceding to the management's request.

42. When considering the reasons provided by management, the auditor would apply professional skepticism and consider whether the request has any implications regarding management's integrity. The auditor would also consider whether management's request might indicate the possible existence of fraud or error. If the auditor believes that fraud or error exists, the auditor would consider the requirements of AAS 4, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements". The auditor would also need to consider whether the alternative procedures will provide sufficient appropriate evidence regarding that matter.

Effective Date

43. This Auditing and Assurance Standard is effective for audits related to accounting periods beginning on or after 1st April, 2003.

Compatibility with International Standard on Auditing (ISA) 505

The auditing standards established in this AAS are generally consistent in all material respects with the International Standard on Auditing (ISA) 505, "External Confirmations", except the following:

- (a) The AAS requires the auditor to obtain an understanding of the substance of transactions and agreement with the third parties to decide about the information to be included in the request for confirmation (see paragraph 22). ISA 505 does not contain any requirements in this regard.

- (b) The AAS requires the auditor to consider the information from audits of earlier years (see paragraph 24). This requirement is not present in ISA 505.
- (c) The AAS requires the auditor to request the management to verify and reconcile the discrepancies revealed by the external confirmations received or by the additional procedures carried out by the auditor. The AAS further requires the auditor to consider what further tests can be carried out to satisfy him self as to the correctness of related assertions (see paragraph 37). This requirement is not present in ISA 505.

* Issued in August, 2003.