SAPs WITHOUT TEARS
FOR C. A. FINAL

AAS 1: BASIC PRINCIPLES GOVERNING AN AUDIT

Q.1) What are the Basic Principles governing an audit?

Ans. *(a) Integrity, Objectivity and Independence:* A professional accountant should be straightforward and honest in performing his professional work. A professional accountant should be fair and should not allow prejudice or bias or conflict of interest to override his objectivity. He should maintain an impartial attitude and both be and appear to be free from any interest.
(some explanation on independence on last page of this chapter)

(b) Confidentiality: The auditor should respect the confidentiality of information acquired during the discharge of his duties. He should under no circumstances reveal this to any party unless there is a duty to disclose or permitted by law.

(c) Skill & Confidence: Persons who possess due professional training and expertise generally carry out Audit. After the qualification he has to regularly update himself with matters of professional importance. For this he to devote certain time towards education program conducted by ICAI.

(d) Work performed by others: See AAS 9 + 10

(e) *Documentation*: See AAS 3

(f) Audit Planning: See AAS 8

(g) Audit Evidence: See AAS 5

(h) Accounting System and Internal Control: See AAS 6

(i) Audit Conclusions and Reporting: The end result of auditing is the audit report and conclusion. The auditor conclusion and report should be based on audit evidence obtained and should normally include:

- The financial accounts are prepared as per AS and AAS.
- Compliance with relevance laws and regulations.
- Adequately disclose all material facts.

As far as Audit Report is concerned the audit report may be of four types as follows:

(i) Clean Report
(ii) Qualified Report
(iii) Adverse Report
(iv) Disclaimer Report

Q2) Write Short Notes on Independence?

Ans. Independence is the keystone upon which the respect and dignity of a profession is based. Independence stands for the strength of individuals to adopt an unbiased view on the matters undaunted by favour or frown. The Guidance Notes on Independence issued by ICAI on independence of Auditors contemplates that the judgment of a person is not subordinate to the wishes or directions of another person who might have engaged him or to his self –

interest. It stipulates that independence is condition of mind and personal character and should not be confused with the superficial and visible standards of independence which are sometimes imposed by law. These legal standards may be relaxed or strengthened but the quality of independence remains the same.

Legal provisions for independence:
To maintain independence of the auditor Section 226(3) of Companies Act 1956 prescribes some disqualifications for the appointment of auditors. Following persons cannot be appointed as the auditor of a company:

- An officer or employee
- Partner
- Person indebted to company > Rs. 1,000
- Person holding any shares.

Provisions for independence in code of ethics:
It is also provided in ethics of profession regarding independence like: No contingent fee is to be charged, Auditor should not disclose matters other than to his clients.

Management services and independence:
While providing management services also auditee may some times becomes too dependent on the auditor or vice – versa. So an auditor should not be totally dependent on his client for management services.

AAS 2: OBJECTIVE AND SCOPE OF AUDIT

Q.1) What do you mean by General Purpose Financial Statements?

Ans. It includes: Balance Sheet, P & L Accounts, Notes to Accounts, Cash Flow Statements, schedules, Notes to accounts, Disclosures of Accounting policies.

Q.2) What are the objectives of an Audit?

Ans. *(a) Reporting:* The primary objective is to report – whether the financial statement is true and fair.

(b) Expression of opinion: The financial statement is prepared in such a manner that the auditor can form an opinion on the financial statement.

(c) True and Fair View: The Auditor of a limited company has to report to the shareholders whether the accounts give true and fair view:
(i) in the case of Balance Sheet the state of company's affairs at the end of financial year, and (ii) in the case of P/L A/C., profit or loss for the financial year
However the Co. Act 1956 does not define any where True and Fair. But According to section 211(3) all the matters which are required to be disclosed as per schedule VI of the Companies Act, 1956, should be disclosed. Financial statements should be drawn up in conformity with the law. The Auditor gives an opinion whether the financial accounts give the true picture as at the year end. It means all the material facts, Assets & Liabilities, significant disclosures, Items of exceptional nature, non – recurring items is to be disclosed. The General Accounting principles are to be followed consistently.
Even in CARO 2003, it is stated that where in the Auditors Report the answer to the questions referred to is unfavorable or qualified the Auditors Report should also state the reasons for such unfavorable or qualified answer. Where the auditor is unable to express any opinion in answer to a particular question, his report shall indicate such facts together with the reasons why it is not possible for him to give answer to such question.
Following are the points to be considered for True and Fair view:
1. Assets should be valued as per accounting principles.
2. Contingent liabilities should be properly disclosed.
3. Adequate provision should be made for depreciation and actual liabilities.
4. Proper distinction between capital and revenue expenditure.
5. Items of unusual nature to be disclosed separately.

(d) Management duty: The duty of preparing and maintaining financial statements is that of the management.

Q.3) What are inherent limitations of an Audit?
Or
Some material misstatements remain unreported by auditors …….. Comment.

Ans. Forming an opinion on the FS by an auditor is neither an assurance of future viability of the enterprise and nor the efficiency with which management has conducted its affairs. This is because auditing suffers from the following defects:
1) Audit evidence is not conclusive but pervasive in nature.
2) An auditor may not possess technical knowledge of the business. In such a case he has to rely on the certificates and explanations given by the lawyers and engineers etc.
3) Fraud committed systematically may not be able to detect by the auditor.
4) Due to constraints of time and money an auditor may not be able to test all the 100% data. Either he has to test check selected areas or he has to go for sampling techniques.
5) Audit process is generally dependent on the existence of effective internal controls. But the internal controls itself suffers from many limitations.

Q. 4) Outline the scope of audit.

Ans.

(a) Scope: The Scope of an audit is determined by the following:

(a) Terms of engagements
(b) Requirements of Law – if auditee is an insurance company then Insurance Act 1938+ IRDA requirements are to be complied with.
(c) Pronouncements of ICAI – AS + Guidance Notes + SAPs.

(b) Work Coverage: Audit should be organized in such a way that all the aspects of the audit should be covered. The Auditor should ensure that the accounting data and the other source data from which financial data are prepared are reliable.

(c) Disclosure Analysis: The Auditor should endure that all the relevant information, as per statutory requirements are properly disclosed in the financial statements.

(d) Judgement: Absolute certainty is not attainable in auditing because of the need to exercise judgement. Judgement is very much necessary while selecting appropriate accounting policies and preparing financial statements.

(e) Effect of Inherent Limitations: An Auditor should always be ready to face any problems arises due to the limitations of Audit like fraud, errors, weak internal control etc. He should use proper auditing tools.

(f) Materiality: See SAP 13

(g) Technical Aspects: An Auditor may not be an expert in field other than auditing. Example the physical conditions can only be assessed by the technical experts and not by the statutory auditors.

(h) Restrictions on the scope of audit: The terms of audit may place restrictions on the scope of audit. The restrictions may be even placed on matters prescribed by legislature or by the pronouncement of the Institute.
Where the restriction on the scope of audit work impairs the auditors ability to express an unqualified opinion on such financial statements, he state such restrictions and issue a qualified opinion or disclaimer of opinion, as the case may be.

AAS 3: DOCUMENTATION
or
AAS 3: WORKING PAPERS

Q. 1) What are Audit Working Papers?

Ans.

Audit Working Papers are the written records kept by the auditor as regards evidence accumulated during the course of audit, methods, procedures followed and the conclusions drawn. These are a type of working notes or explanatory notes prepared by the audit.

Q. 2) Bring out the composition of Audit Working Papers?

Ans. Audit working papers includes the following:

(a) Trial balance prepared by the client
(b) Various Schedules viz. Schedules of fixed assets, debtors, creditors, investments etc.
(c) Correspondence between the auditor and the outsiders viz. Banks, Debtors, Creditors etc.
(d) Various certificates from the management e.g. stock or cash certificates
(e) B.R.S. + S.R.S. (Stock Reconciliation)
(f) Adjusting entries and closing entries.
(g) Depreciation provided on F.A.
(h) Extracts of minutes books.
(i) Audit programme.
(j) Contingent liabilities.
(k) Certificate from the bank confirming the balances.
(l) Certificate from the management regarding accrued liabilities.
(m) Letter of engagement.

Q. 3) Explain the importance of Audit Working Papers?

Ans. Working papers are useful for the following purposes:

(a) The auditor can understand the sincerity of his assistance.
(b) These papers help the auditor to finalize the audit report without any delay.
(c) In case of change of staff audit working papers are very useful for new staff to maintain continuity.
(d) It provides training to the audit staff.
(e) It helps the auditor in planning for the next years audit.
(f) The auditor can protect himself from a suit brought against him for negligence.
(g) The auditor can understand the weakness of the Internal Control of the company.
(h) The auditor can answer the questions of some earlier years easily.
(i) It is a means of good control on audit work.
(j) Facilitate delegation of work.
(k) Aid (helps) in planning + supervision +review of audit work.

Q. 4) What are the Requisites of Good Audit Working Papers?

Or

What are the features of Good Audit Working Papers?

Ans. Following is the requirements of Good Working papers:

(a) *Completeness:* The working papers should contain all the necessary information that they may be great help and of maximum utility. The unimportant matters should be avoided. Professional judgement is required that what to include and what not to include. Each and every observation or conclusions need not be included.
(b) *Organization and Arrangement:* Arrangement of working papers should be in such a way that the auditor need not search paper when required. Standardization of papers is very essential to improve the overall efficiency of the audit.
(c) *Record of plan:* Audit planning and conclusions drawn from the evidence obtained is to be properly incorporated in the working papers.
(d) *Evidence furnished by clients:* In formations / Certificates / Schedules provided by the clients can be very well utilized by the auditor in the working papers.
(e) *Classification:* Audit working papers can be classified into: *(i)* Permanent Audit Files and *(ii)* Current Audit Files.

Q. 5) How are Audit Working Papers classified?

Ans. Working papers are classified as follows:
(I) PERMANENT AUDIT FILES: These are audit files, which are updated currently and may includes information regarding succeeding audits also.

Contents of Permanent Audit Files:

- Memorandum and Articles of association of the company.
- Byelaws or regulations in case of co-operative societies.
- Record of study and evaluation of internal control (questionnaires or flow charts)
- Copies of audited financial statements of earlier years.
- Notes regarding significant accounting policies.
- Analysis of significant accounting ratios and trends.
- Communication with retiring auditors.

(II) CURRENT AUDIT FILES: These are audit files, which relate to a single period only.

Contents of Current Audit Files:

- Trial balance prepared by the client
- Various Schedules viz. Schedules of fixed assets, debtors, creditors, investments etc.
- Correspondence between the auditor and the outsiders viz. Banks, Debtors, Creditors etc.
- Various certificates from the management e.g. stock or cash certificates
- B.R.S. + S.R.S. (Stock Reconciliation)
- Adjusting entries and closing entries.
- Depreciation provided on F.A.
- Extracts of minutes books.
- Audit programme.
- Contingent liabilities.
- Certificate from the bank confirming the balances.
- Certificate from the management regarding accrued liabilities.
- Letter of engagement.

Do you know → Contents of Current Audit Files is same as Question No.: 2 above.

Q. 6) Whose property is the Audit Working Papers?

Or

Write short note on Auditor's Lien

Ans. *Meaning of Audit Lien:* An Auditor can take in his possession books, documents etc. for non – payment of fees by his clients for the work done by him.

(i) Preservation of Working Papers: The working papers should be kept in a safe custody until the Audit Report is delivered to the client. The papers in no case should be shown to the third party without the permission of the client. In case of missing working papers the persons in whose custody it was kept will be held liable. After the completion of the Audit the papers will be preserve under a safe custody for a period of at least 5 years.

(ii) Ownership of Audit Working Papers or Audit Note Book: A dispute arises on many occasions as to who is entitled to get all the working papers, audit note book etc.

Contentions of client:
The client in that case urges that he is the owner of these Audit papers because the auditor acts on behalf of him in making queries, entering into correspondence with banks, Debtors etc. The auditor receives fees in consideration for the work done.

Contentions of Auditor:
But on the other hand the auditor claims the ownership of those documents and urges that he has prepared those documents to discharge his duties. Considering those papers he has drafted his audit report. Moreover, those working papers are the documentary evidence in favor of auditor that he has done his duties properly. Even after several years by which time the auditor might have every thing about a particular audit such papers will help him in defending the suit. Thus the auditor claims the ownership of such documents because no right on those papers is vested on the client and in no case is the auditor willing to hand it over to the client.

Conclusion:
(1) It is sometimes urged that as a professional etiquette, the outgoing auditor, should hand over all such documents to the incoming auditor especially when his term is completed, so that the latter may be benefited at the time of his audit.
(2) In any case, if the auditor comes to know that fraud has been committed or facts has been suppressed he refuses to hand over such papers to the new auditor.
(3) The question of lien in regard to working papers arose in the case of Sockockinsky Vs. Bright Graham & Co. in England. The question was whether the auditors had a right to retain the working papers as their own property even after the payment of the audit fee. In that case the judgement was in the favor of the auditors, on the ground that the auditors were the independent contractors and not the agents of the clients.
(4) Again in the case of Chantrey Martin & Co. Vs. Martin quoted by Spicer and Pegler, it was held that the working papers prepared to draw up a Balance Sheet by the accoutant on behalf of his clients, should be retained in the hands of accountant and not to be handed over to his client.
(5) Pronouncements of Institute of Chartered Accountants of England and Wales:
- Documents retained must belong to the client who owes money.
- Auditor should not take possession of such documents by some illegal or irregular means.
- Work must have been done on such documents.
- Fees for such work must be outstanding.

AAS 4: AUDITORS DUTY FOR FRAUD AND ERROR IN PRESENTING FINANCIAL STATEMENTS

Q.1) What do you mean by " Error "?

Ans. Error may be defined as a mistake, due to negligence but without any intention to cheat. Detection of errors by the auditors is very essential, otherwise the financial statements will not show true and fair view.
Types of Errors:
(1) Clerical Errors: These are the errors committed by the clerks while writing the books of accounts. Again clerical errors can be further divided into the following:
a) Errors of Omission: Here the clerks ommit either fully or partly of a transaction. In case of full omission the trial balance will still agree. For example: Not recording Sales to Mr. X of Rs. 2,000. In case of partial omission the trial balance will not agree. Hence partial ommission can be spotted out easily.
b) Errors of Commission: Wrong totalling, wrong c/f., Posting errors, Casting errors, recording a particular amount to a wrong account are some of the example of Errors of Commission.
c) Errors of Duplication: A particular entry is recorded twicely. Trial Balance will tally here also.
d) Compensating Errors: It is an error which compensates one error by the other. Obviously here compensating doesn't mean that the error is rectified. But both the errors have to be rectified. For ex.: Undercasting total of Ledger of Debtor X is compensated by overrcasting total of Ledger of Debtor Y.

(2) Errors of Principle: These are serious errors which are more of a technical error in nature. The accountant do not properly follow principles or rules of accountancy. For ex.: Revenue expenses wrongly capitalised.

Q.2) What do you mean by " Fraud "?

Ans. Fraud is an intentional misstatement or omission or disclosure of the financial statements. Frauds can be committed by the persons among the management, employees or third parties. Fraud can done in the following three ways:
- Misappropriation of assets.
- Fraudulent Financial reporting.
- Teeming and lading.

a) *Misappropriation of Assets:* It includes misappropriation of cash + goods mostly. Misappropriation of cash can be done by either suppressing cash receipts, inflating cash payments etc. Misappropriation of goods can be done by stealing the goods from the store room or by showing false dispatches and suppressing invoices.
b) *Fraudulent Financial Reporting:* It may even be named as Window Dressing. This type of fraud is committed by the higher level authorities like Directors. In case of Window Dressing the profits are either inflated or deflated for the following purposes: (i) To avoid Tax, (ii) To go for amalgamations, (iii) To get more remuneration as a % of profits, (iv) To attract lenders and creditors etc.
c) *Teeming and Lading:* It is committed at the time of receipt of cash from debtors. In this amount collected from a debtor is misappropriated and amount subsequently received by another debtor is adjusted (credited) in the previous debtors account. This process of adjustment continues so that no debtors account is kept outstanding for a long time.

Q. 3) Its whose responsibility for preventing frauds and errors?

Ans. The primary responsibility for prevention of frauds and errors *is that of the Management and with those charged with governance.* So the management assumes the responsibility for fraud and errors.
Following are some of the steps the management should take to detect and prevent fraud and errors.

- Maintaining culture of honesty and ethics.
- Setting of proper tone.
- Establishing Code of Conduct and of its compliance.
- Implementing Internal Controls and marching towards control environment.
- Incorporating of rules and regulations in internal control procedures.

- Checking and assessing the working of various departments including accounts deparment.
- Taking timely action against defaulter employees.
- Reporting of frauds and errors to internal auditor.
- Reporting of fraud and errors to the audit committee.

Q. 4) Can auditor be held responsibility for preventing frauds and errors?

Ans. Though the auditor is not responsible for the prevention of frauds and errors but to avoid any mess in normal auditing process the auditor is also required to play some role in prevention of frauds and errors.
i) Objects of Auditing: The main object of audit is to find whether financial statements are properly drawn up and whether they show true and fair view of the state of affairs & working results of the organisation. His main duty is to report on financial statement and express an opinion whether they show true and fair view of the state of affairs & working results of the organisation.
ii) As per AAS – 2: As per AAS-2 the responsibility of the auditor is to provide reasonable assurance that the financial statements are free from material misstatement.
iii) Audit may act as a deterrent: The fact that the audit is being carried out can be a deterrent, but the auditor is not responsible for the prevention of frauds and errors.
iv) Conclusion: Thus the auditor is not responsible for the prevention of frauds and errors. Auditor's duty is to perform audit procedures to enable him / her to express an opinion on the financial statement. Also whether the auditor is held responsible for the frauds and errors is to be determined by some of the factors which are explained below:

(1) Inherent limitations of an audit.
(2) Professional Skepticism.
(3) Audit Planning.
(4) Inquiries from the Management.
(5) Discussion with those charged with governance.
(6) Audit Risk.

Note: Each of the above points are discussed in detailed in the succeeding paras.

Q. 5) What are the inherent limitations of an audit?

Ans. Forming an opinion on the FS by an auditor is neither an assurance of future viability of the enterprise and nor the efficiency with which management has conducted its affairs. This is because auditing suffers from the following defects:
1) Audit evidence is not conclusive but pervasive in nature.
2) An auditor may not possess technical knowledge of the business. In such a case he has to rely on the certificates and explanations given by the lawyers and engineers etc.
3) Fraud committed systematically may not be able to detect by the auditor.
4) Due to constraints of time and money an auditor may not be able to test all the 100% data. Either he has to test check selected areas or he has to go for sampling techniques.
5) Audit process is generally dependent on the existence of effective internal controls. But the internal controls itself suffers from many limitations.
6) There is an unavoidable risk that some material misstatements in the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the auditing standards generally accepted in India. It is similar to Normal loss in process accounts.
7) Risk of not detecting fraud > Risk of not detecting errors. This is because frauds are deeply laid down.
8) Auditors ability to detect a fraud depends on factors such as skillfulness of the perpetrator, frequency of manipulation, the degree of collusion involved.
9) Risk of not detecting fraud by Management > Risk of not detecting fraud by employees. Those charged with governance and management are in a position of assumed integrity which enables them to override the formally established control procedures. The subordinates very well assist their seniors in laying down the fraud structure.

Q. 6) Write short notes on Professional Skepticismt?

Or

Auditor is a watchdog and not a blood hound……. Comment.

Ans. Skepticism means doubt, disbelief etc.

While processing the audit work of a company the auditor has to use reasonable care and caution. What is the degree of care and caution depends upon the facts and circumstances of the cases. But the auditor need not behave like a detective. He need not approach his work with a foregone conclusion that the transactions are fraudulent. But if there is anything suspicious, he has to probe deeper. Otherwise reasonable care will do. "He is **watchdog and not a blood hound". However, unless the audit process makes the auditor suspicious, he is entitled to accept the records and documents as genuine. Also the audit performed as per AAS is not assumed to be authenticated by the auditor. Not the auditors are supposed to be experts in authentification of the documents.**

Q. 7) Explain the planning discussions?

Ans. While planning the audit the auditor should discuss the following matters with its audit team:

1) The possible material misstatements on the financial statements due to fraud and errors.
2) Results of such procedures shared among the audit team.
3) Job allocation.
4) Rights and responsibilities attached to the job allocated.

Q. 8) What are the inquiries made by the auditor of the management?

Ans. The audit process requires close liaison with the management. Also the accounting transactions are after all prepared by the management. So it is necessary for the auditor to get the total information regarding the management.

Purpose behind inquiry?

1) To obtain an understanding of:

* Management's assessment of risk in financial statement on account of frauds.
* Accounting and internal control system laid by the management.

2) To determine whether the management is aware of frauds in the company.

3) To determine whether the management has discovered any frauds in the company.

Matters to inquire?

1) The function of internal audit department. Whether the department is able to identify the frauds and weaknesses in the internal control system.

2) Risk assessment frequency.

3) How the management communicates its views to its employees regarding responsibilities of business practices and ethical behaviour.

4) Whether there are any business segments, subsidiary locations, account balances or financial statement categories where the possibility of errors or frauds are high. And how are these addressed to the management.

Q. 9) What are the discussions by the auditor with the persons charged with governance?

Ans. For meaning of persons charged with governance refer SAP 27.

Benefits from the discussions:

- Auditor will have more updation in his scope and work of audit.
- Provides insights regarding the susceptibility of the entity to management fraud.
- Provides those charged with governance the opportunity to bring matters of concern to the auditors attention.

Following are the discussions:

1) A failure by management to address appropriately material weaknesses in internal control identified during previous audits.

2) The nature of management's assessment of risk, the extent of management's assessment of risk and the frequency of management's assessment of risk.

3) How the frauds and errors have misstated the financial statements.

4) The environment of internal control laid by the management.
5) The integrity and competence of the management regarding the assessment and detection of frauds and errors.
6) Additional audit procedures which the auditor is yet to perform.

Q. 10) What is Audit Risk? Enumerate the components of Audit Risk?

Ans. *Meaning of Audit Risk:* Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statement are materially misstated. Such misstatement of financial statement is due to frauds and errors.
Audit risk is composed of: **(Inherent risk + Control risk + Detection risk).**
(Refer SAP – 6 for further detailed discussion).

Q. 11) What are the procedures to be followed by the Auditor in case of possible misstatement?

Ans. Following are the procedures to be followed by the Auditor in case of possible misstatement.
1) The auditor has to perform procedures to determine whether actually financial statements are impaired due to frauds and errors.
2) If yes, then the auditor has to perform additional procedures. In other words the auditor may consider modifications in the nature, timing and extent of audit procedures.
3) Consider the effect of frauds and errors in the audit report.
4) May make a change in the members of audit team and their assignment.

Q. 12) Bring out the effect of frauds and errors in the Audit report?

Ans. As soon as the auditor smells frauds and errors in the accounts etc., irrespective of suspicion has aroused or not, the auditor has to report. Whether the matter is material or not will be guided by AAS – 13 (Audit Materiality) and how to report such matters will be guided by AAS – 28 (Audit Report).

Q. 13) Bring out the documentation aspect of frauds and errors?

Ans. Following is to be documented:
1) Frauds risk factors identified. 2) Applying additional procedures to prevent in future frauds etc. 3) Auditors responses towards the FRF. 4) Managements reactions thereof. 5) Total inquiries made from the management. 6) Whether management is aware of FRF. 7) Arrangements and preparations by management to prevent frauds and errors.

Q. 14) Bring out areas of significant for Management Representations?

Ans. Please Refer SAP – 11.

Q. 15) Explain how the auditor will communicate about fraud and errors?

Ans. Please Refer SAP – 11.

Q. 16) Explain how the auditor will communicate about fraud and errors to outsider authorities?

Ans. It is not the duty of the auditor to communicate about frauds and errors to the outside parties. But due to the following circumstances the auditor can discuss the matters with the outsiders:
1) To comply with legal or regulatory requirement such as NBFC audit the auditor has to report RBI.
2) The outgoing auditor can discuss regarding the client with the incoming auditor.

Q. 17) When should an auditor discontinue his audit engagement? Also bring out the responsibilities and duties of an auditor in such a case?

Ans. The auditor should discontinue the audit in the following circumstances:

1) The management fails to take any action against the frauds and errors by the clients.
2) There is deeply laid down frauds through all the departments.
3) Serious doubt on the competence or integrity of management by the auditor.

Responsibilities of the auditor in the following circumstances:
1) Auditor should fulfill his Professional responsibilities.
2) Reporting with the person who has appointed him.
3) Reporting to the regulatory authority
4) Consider the possibility of withdrawing from the audit.
5) If the auditor decides to withdraw then he should –
i) Discuss with the appropriate level of management and with those charged with governance, the reason of withdrawal.
ii) State the facts of frauds and errors to the incoming auditor, but with the permission of the client.

AAS asked for 20 – 30 marks in Final and 30-40 marks in PCC

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AAS 5: AUDIT EVIDENCE

Q. 1) What is Audit Evidence?
Ans.
Auditing is a logical process. An Auditor is called upon to comment upon the actualities of the statement of accounts and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the statement objectively. He needs evidence and information for arriving at his judgment.
All the items in the balance sheet and profit and loss account should be subjected to various tests to ascertain ownership, existence, qualitative conditions, arithmetical accuracy etc.
For putting through these tests, we need evidence to support the contentions. The evidence can be gathered through one or more of the following means:

i) Physical examination by the auditor of the thing presented in the accounts.
ii) Statements by independent third parties.
iii) Statement by officers and employees of the company may be formal or informal.
iv) Calculations performed by the auditor.
v) Satisfactory internal control procedures.
vi) Inter – relationship within the data examined.

Q. 2) Distinguish between Internal Evidence and External Evidence ?
Ans.

Particulars	Internal Evidence	External Evidence
Meaning	Evidence, which originates within the organization being audited, is internal evidence.	Evidence, which originates outside the clients organization is External Evidence.
Examples	Sales invoice, copies of sales challans, goods received note, debit notes or credit notes, Wage Sheets etc.	Purchase invoice, debit notes or credit notes, quotations, confirmations, Bank Statement, Insurance Policies etc.
Use for Accounting	It forms a direct source documents for accounts.	It may serve the accounting purpose or may be kept as a record.
Reliability	It is not so reliable.	It is more reliable than Internal Evidence.

Q. 3) Is External Evidence more reliable than Internal Evidence…..Prove it.

Ans. First give the distinction points as per Q.2). Then refer the following para…….

In an audit situation, the bulk of evidence that an auditor gets is internal in nature. However, substantial external evidence is available to the auditor. Since any organization, the client and his staff have the control on the internal evidence, the auditor should be careful in putting reliance on such evidence. It is not suggested that they are to be suspected but an auditor has to be alert to the possibilities of manipulation and creation of false evidence. The external evidence is generally considered more to be more reliable as they come from third parties who are not normally interested in manipulation of the accounting information of others. However, if the auditor has any reason to doubt the independence of third party who has provided any material evidence e.g. an invoice of an associated concern, he should exercise greater vigilance in that matter. As an ordinary rule, the auditor should try to match internal and external evidence as far as practicable. Where external evidence is not readily available to match, the auditor should see, to what extent the various internal evidence corroborate each other.

Q. 4) Enumerate the factors by which the auditor is satisfied regarding the appropriateness of audit evidence?

Ans. Factors are as follows:

i) Risk of Misstatement: The degree of misstatement which may be affected by factors such as (1) nature of item, (2) adequacy of internal control, (3) nature or size of business, (4) financial position of the entity.

Higher the risk higher will be the possibility of fraud or error, the auditor would seek more robust evidence and *vice – versa*.

ii) Materiality: The materiality of item.

iii) Previous experience: Experience gained during previous audits.

iv) Information: The type of information available.
v) Results of work: Results of auditing procedures.

vi) Analytical Review: Significant accounting ratios and analysis.

Q. 5) Briefly state the audit procedures adopted in obtaining audit evidence?

or

Distinguish between Compliance Tests and Substantive Tests?

*Ans.*Particulars	Compliance Tests	Substantive Tests
Meaning	As it is difficult or in some cases impossible to check each and every transaction of the auditee client the auditor rely upon the internal control system or procedures of the auditee client. Whether the auditee is complying with the prescribed procedures the auditor test it with what is called Compliance procedures. Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is placed are in effect.	Substantive procedures are designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system.
Types	These constitute the general tests of the internal control system. After the compliance procedures the auditor moves on to substantive procedures.	There are two types: *i)* Tests of details and transactions i.e. vouching and verification. *ii)* Analytical reviews i.e. study of significant ratios and trends.
Sequence	First an auditor goes for compliance tests.	Substantive procedures are next to compliance tests.
Coverage	It covers only the internal control section.	It covers the complete financial statements items.
What it shows	It shows the efficiency of internal control system.	It shows the whether the items in financial statements are accurate.
Assertions	The audi tor is concerned with the following assertions: • *Existence*- That the internal control exists. • *Effectiveness*- That the internal control is operating effectively. • *Continuity*- That the internal control has operated throughout the period of internal reliance.	The auditor is concerned with the following assertions: • *Existence* –That an asset or liability exists at a given date. • *Rights and obligations*- that an asset is an asset of an entity and liability is an obligation at a given date. • *Occurrence*- that a transaction took place which pertains to the entity. • *Completeness*-that there are no unrecorded assets or liabilities or transactions. • *Valuation*- that an asset or liability is recorded at an appropriate carrying value. • *Measurement*- that a transaction is recorded at a proper amount and bifurcating between revenue or capital expense. • *Presentation*- that an item is properly disclosed / classified using acceptable accounting policies.

Q. 6) Explain, how much reliance an Auditor should keep on Compliance Tests and Substantive Tests?

Ans. *(i)* We know that the auditor first place its reliance on internal control system of the entity. Where any significant assertion relating to internal control (Compliance Tests) cannot be relied upon then consequently the auditor would not tests controls and instead switches over to substantive tests. *For example:* If suppose the internal control department do not provide for high value items of stock in case of perpetual inventory control (Item A in case of ABC analysis). Then in such a case internal control is itself defective. So here the auditor will perform a high degree of substantive tests i.e. he will carry out physical verification as well valuation of stock.

(ii) The extent and nature of substantive procedures to be performed will vary for every assertion. It means evidence relating to any assertion will not compensate for failure to do so with respect to another matter concerning the same item. For example: Auditor might have carried out verification (existence assertion) but this will not compensate the valuation aspect. Thus, the auditor has to apply a mixture of assertion.

(iii) Auditor should rely on the information, which is pervasive, and not which is conclusive.

(iv) Auditor has to collect evidence as far as possible from different sources to support the same assertions. For example: In addition to visit for the fixed asset verification auditor may also go through the internal audit report.

(v) The auditor has to obtain as much as corroborative evidence as possible.

(vi) The audit evidence in total should be enough for an auditor to form an opinion on financial statements.

Q. 7) Discuss the methods of obtaining audit evidence?

or

How is audit evidence obtained?

or

What are the various Auditing Techniques?

Ans. The auditor fulfills the Compliance procedures and substantive procedures baskets by the following techniques:

(i) Inspection: Inspection consists of examining records, documents or tangible assets. Inspection of records provides various degree of reliability of the evidence collected. For example: Verifying physical existence of fixed assets will serve the existence purpose and not the valuation. Four categories of documentary evidence, which is available, are:

Origin	Held by	Example
Third party	Third party	F. D. receipts till the date of maturity
Entity	Entity	Journal Vouchers
Third party	Entity	Purchase invoices
Entity	Third party	Sales invoices

Inspection includes (vouching + verification).

(ii) Observations: It is witnessing a process or procedure performed by others. Hence in case of observations physical presence is but natural. For example: The auditor may observe the physical stock counting done by the entities staff.

(iii) Inquiry and Confirmations: Inquiry means obtaining appropriate information from the knowledgeable people from inside as well as outside the entity. Inquiry may range from formal written inquiries from third parties to oral inquiries from persons inside the entity.

Conformations on the other hand means acknowledgment towards the inquiry made or response towards the inquiry made.

Both inquiry as well as confirmations provides the auditor with corroborative evidence.

(iv)Computations: Computations consists of arithmetical accuracy of source documents or other accounting records or performing independent calculations. Some of the areas where the computation process carries on is Depreciation.

(v) Analytical procedures: Refer SAP

Q. 8) Write short notes on Auditing in depth.

Ans. It is the examination of the system applied within the business including tracing of certain transactions right from their origin till their conclusion. The investigation is made at every stage. All the records and documents pertaining to the transaction is checked in detail. Thus certain items are traced right form the beginning till their end. Audit in depth is also known as *'cradle to grave approach'*.

Purpose of Auditing in depth:

- Whether the internal control system is effective or not.
- To suggest the management a more better way of recording the transactions.
- To avoid any loopholes for committing frauds.

Q. 9) Write short notes on Cut – off Procedures.

Ans. In an audit programme, the cut off period has its own importance. Cut off procedures are mainly undertaken for cash, bank balances, inventories, sales, purchases etc. Cut off procedures means procedures employed to ensure the separation of transactions at the end of one year from those in the commencement of the next year. Usually the problem of overlapping is found in inventory accounting since quite often goods are sold in one year and recorded as sales but the actual dispatches to the buyer is done in the beginning of next year. Cut off would enable the auditor to see that the transactions are recorded in the appropriate year.

Cut off enables the auditor to determine consistency in the treatment of related item and also in matching revenue against cost.

Cut off procedures also helps in establishing the accuracy of the outstanding balances as on the balance sheet date. Scrutiny of bank statements of a period subsequent to the date of balance sheet for a Cut off period would help in finding out the details of cash and cheques in transit. Similarly, following the Cut off procedures the auditor can find out the outstanding liabilities. Also income receivable in one year may be received in next year. Normally such types of outstanding income are reversed backed in the year of receipt. These and such other irregularities can be located by the auditor while following the cut off procedures.

Q. 10) Write short notes on: Verification of Ownership Flats.

Ans. Ownership Flats can be verified *(i)* By reference to the letter of allotment received from the co-operative society or the enterprise, which has constructed the flats *(ii)* registered agreement between the buyer and the seller. Since one is entitled to the allotment of flats only because of his membership of the society or the enterprise, the shares held for the purpose should also be verified. The flats allotted will be shown under the head fixed assets. Depreciation has to be charged from the date of purchase of the flat. Even shares acquired for the purpose of flat will also be shown under the head fixed assets. If the shares are held in the name of others, conformity letters should be obtained.

Q. 11) Explain the guidance note issued by ICAI regarding Surprise Checks.

Ans. *(i)* Surprise checks are important part of normal audit procedures.

(ii) An element of surprise can significantly improve the effectiveness of an audit and, therefore wherever practicable, 'an element of surprise checks has to be incorporated into the audit programme".

(iii) Surprise checks are intended to ascertain whether the system of internal control is operating effectively and whether accounting and other records are prepared concurrently and kept upto date.

(iv) Surprise checks is very appropriate in the following cases mainly:

1) Where the internal control is very weak.
2) Where the company is very large.
3) Areas of Cash, Stock, E.D.P. etc.

(v) The need and frequency of surprise checks is to be decided by the auditor having regard to the nature and circumstances of the audit.

(vi) The results of the surprise checks need not be incorporated in the audit report. However it is to be included when it is material.

Give me your suggestions for the book on AAS at
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AAS 6: RISK ASSESSMENTS AND INTERNAL CONTROL

Q. 1) What is Audit Risk? Enumerate the components of Audit Risk?

Ans. *Meaning of Audit Risk:* Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statement are materially misstated. Such misstatement of financial statement is due to frauds and errors. In other words he gives an unqualified report on FS that are materially misstated.

OR

Audit risk is the risk that monetary error is > than tolerable limit will remain undetected and the auditor fails to detect it. Tolerable error is an error that would not materially mistake the financial statements.
Audit risk is composed of: **(Inherent risk x Control risk x Detection risk).**

Q. 2) Explain Inherent Risk? Discuss the Auditors duties regarding Inherent Risk ?

Ans. *Meaning of Inherent Risk:*
Assumption: No related internal control exists.
It is the risk of material error in accounting process in the absence of internal control. It is the chances or probability or suspectibility of an account balance or class of transaction being misstated + It should be material enough + Account balance or class of transaction individually or in aggregate with other account balances or class of transactions make the misstatement material.
Features:
1) Such type of risks are inherent in nature, i.e. it will exists irrespective of audit done.
2) Such risk can only be assessed but not reduced.
3) Errors are material.
4) It is independent of audit.
Example: Cash is more prone to misappropriate as compared to fixed asset. Cash has got natural inherent feature of being defalcated.

Factors to be considered for assessing risk:
<u>At Financial Statement level:</u>
1) Integrity of the management.
2) Experience and knowledge of the management – Example: Inherent risk reduces if the management well qualified.
3) Nature of the entity's business – For example Type of products Geographical segments, Technological obsolescence .
4) Unusual pressures on the management - For example: Influence of related parties on decisions of management, Lack of capital resources to continue business.

<u>At Individual account balance and Class of transactions:</u>
1) Quality of the accounting system – If the accounting system is not properly designed then wrong classification, wrong posting, casting errors etc can arise.
2) Complexity of a transaction or account balance – For example Retirement benefits require help of actuary.
3) Suspectibility of a asset for defalcation - Cash is more prone to misappropriate as compared to fixed asset.
4) Isolated transactions. In other words transactions that are not ordinarily processing.
5) Degree of judgement involved in determining account balance.

<u>Auditors duties towards inherent risk:</u>
1) Stitch in time saves nine. Auditor has to consider ans assess the inherent risk while planning the audit itself.
2) An auditor assesses the inherent risk by studying the business environment + by his previous audits knowledge.
3) Documentation of inherent risk assessement.

Q. 3) Explain Control Risk? Discuss the Auditors duties regarding Control Risk ?

Ans. *Meaning of Control Risk:*
It is the assessment of risk which is material mistatement that arises in account balance or class of transactions individually or in aggregate with other account balances + Internal control could not detect it. Thus such types of risks are dependent on Internal control in the company. Also Control risk is inversely proportion to Internal control. More effective the Internal control lesser the chances of Control risk.

Features:
1) Such type of risks are due to weak internal control.
2) Such risk can only be assessed but not reduced by the auditor.
3) Errors are material.
4) It is independent of audit.

Example: Weak internal control in wage payments section may lead to overstatement of wage bills though actually it may have paid lesser than the bill.

Following are the auditors duties:
(1) Understanding the Systems: At this first stage, the auditor should well understand the structure and design of IC system which is also known as Control Environment. Control environment means overall attitude, behaviour, actions and reactions of the management regarding the IC. He should also obtain an understanding of the accounting system, like: Major class of transactions, accounting records, Financial reporting. In short auditor should be able to understanding the flow of transactions. For this he may perform Walk Through test (He may actually trace a few transactions through the system. Following are the sources of obtaining an understanding of the accounting and internal control system by the auditor:
* Previous experience with the clients.
* Discussions with the management and other persons.
* Observing the data operation activities.
* Reference to documents like: Manuals, Organisation Charts, Flow Charts of various activities.

(2) Preliminary Assessment of Control Risk: After understanding the control environment the auditor should make the preliminary assessment of control risk. He should see the effectiveness of such internal control systems implemented whether they could properly detect + correct material misstatement on timely basis. At this stage the auditor should decide whether to rely on IC systems or not. Hence his substantive tests will depend on the extent of reliance.

(3) Tests of Control: Tests of Control are performed to obtain audit evidence about the effectiveness of accounting system and internal control –
* Whether accounting system and internal control were properly designed and implemented.
* Whether accounting system and internal control were in operation throughout the year.

Some of the substantive 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. Thus one can say that substantive procedures helps to make effective tests of control and so also vice – versa is very much true. In case of computerised systems the objectives of tests of control do not change as compared to manual procedures.

Examples of Tests of Control:
1) Inspection of documents, vouchers etc.
2) Inquiries from management.
3) Re – performance of IC for example: Reconciliation of Bank Accounts.
4) Applying Walk through tests. For ex.: Selecting a few purchase invoices at random and examining them in depth, from purchase requisition slip to payment to suppliers.

(4) Documentation of control risks: The auditor should document in his working papers the following:
a) The understanding obtained regarding the Control Environment.

b) The Preliminary assessment of accounting system and internal control system.
c) The defects in internal controls observed.

The form and content of documentation depends upon the size and complexity of the entity.

5) Final Assessment of control risks: Before concluding the audit the auditor should confirm about the control risks. If required the auditor may even revise the control risks. If control risks are revised the auditor may even modify timing, extent and nature of substantive procedures.

Q. 4) Explain the Quality and Timeliness of Audit Evidence ?
Ans.
1) Quality based Audit Evidence: It means the audit evidence differs in terms of quality. Hence degree of reliability by auditor even differs. Certain types of audit evidence obtained by the auditor are more reliable than the others. Lets take two audit procedures. Consider evidence collected from observation is more reliable than audit inquiry. This is because audit quality of observation is > than audit quality of inquiry. For example: Audit evidence collected from observing the stock taking is more effective than Audit evidence collected through inquiry regarding the stock taking.

2) Timeliness based Audit Evidence: The audit evidence collected from prior audits by the auditor is very much helpful to the auditor in gathering total audit evidence. In case of continuing audit engagement the auditor knows and is aware of various accounting and internal control procedures Just what is required is updation of existing audit eivdence. But how much reliance is to be kept on such audit evidence depends on the following factors:
1) Time span between two audits. The longer the time elapsed since the performance of such procedures the less reliance may be kept on previous collected evidence.
2) Whether accounting and internal controls were in use throughout the year.
3) Frequency of Tests of controls during interim visits.

Q. 5) Explain Detection Risk? Discuss the Auditors duties regarding Detection Risk ?

Ans. *Meaning of Detection Risk:*
It is the assessment of risk which is material mistatement that arises in account balance or class of transactions individually or in aggregate with other account balances + Auditors substantive procedures could not detect it. Thus such types of risks are dependent on extent and nature of substantive procedures applied by the auditor. Also Detection risk is inversely proportion to substantive procedures applied by the auditor. More effective the substantive procedures lesser the chances of Detection risk.

Features:
1) Such type of risks are due to weak substantive procedures.
2) Such risk will be present even if audit is made 100%.
3) Errors are material.
4) It is very much dependent on audit.

Example: If suppose only 70% test checks are applied on debtors balances may give rise to detection risk on the balance 30% debtors. Even within 70%, chances of such risks are there but at a lesser degree.

Following are the auditors duties:
(1) Understanding Inherent and Control Risks: At the first stage, the auditor should well understand and should be able to compute the degree of IR and CR. Because DR depends upon the IR and CR.

(2) Revisions in Inherent and Control Risks: If there are changes in IR and CR then substantive procedures will have to be revised.

(3) Strengthening Substantive procedures: Definetly substantive procedures contribute to the reduction in risks. However the auditor should be able to strengthen substantive procedures as follows:
* *Improving nature of substantive procedures:* Calling for audit evidence from outside the party instead of evidence within the entity.

* *Improving timing of substantive procedures:* Performing substantive procedures at the year end instead of at an earlier date.
* *Improving extent of substantive procedures:* Using a larger sample size.

(4) Level of Inherent and Control risks: Irrespective of the level and degree of IR and CR application of substantive procedures is must on the account balances or class of transactions. But if the level of risk is very high then more audit evidence is to be collected.

(5) Reporting Requirements: When detection risks regarding financial statements could not be reduced to acceptable level then the auditor should express either qualified opinion or disclaimer opinion as the case may be.

Q. 6) Bring out the relationship between Detection Risk and combined Inherent Risk and Control Risk ?

Ans.
Rule:1: There is an inverse relationship between DR and combined (IR + CR).
Rule:2: If IR + CR are kept at high level then DR should be kept at a low level to reduce overall audit risk. For example: Cash transactions is already prone to Inherent risk and suppose even there is weak internal control on cash. In other words IR and CR both are high here. In such case the auditor will make his substantive procedures more intense to reduce DR and hence reduce total risk. He will not take any chance to take any risk.
Rule:3: If IR + CR are kept at low level then DR may be kept at a high level and still reduce overall audit risk. For example: If there is strict internal control and internal audit. In other words IR and CR both are low. In such case the auditor will concentrate more on high value items and may leave low value items for detection risk.

Q. 7) Bring out the Audit Risks in small business ?

Ans. In case of big companies irrespective of joint stock companies or partnership firms the owners should be assured of lower audit risk. Hence we found internal checks, internal controls, internal audit, segregation of duties, checks and cross checks.
In a small company whether *Audit Risk* is at high level or kept low is determined from the following factors:

1) How strong the management is.
2) Direct personal knowledge of the entity to the proprietor.
3) Degree of supervisions.
4) Number of employees appointed.
5) Audit intensity + Audit frequency.
6) Appointment of relatives as employees.

Factors contributing towards reduction in Audit Risks in small companies:

1) As the work quantity is less therefore there is direct personal knowledge of the entity to the proprietor. So risks are under the control.
2) Appointment of relatives as employees makes the proprietor more secure that audit risks will be kept at low level.
3) As the work quantity is less the auditor may even be able to manage and control audit risks.
4) Organisational hierarchy may be very simple to understand.

Factors contributing towards increase in Audit Risks in small companies:

1) Managing and maintaining Internal Control System requires huge cost. Thus such small companies may not install internal control etc.
2) If at all there is Control systems laid down that too in the hands persons having no knowledge or persons not bothered.
3) No clear cut division of duties and responsibilities.
4) Shortage of employees may pose problems. In other words checks may not be comprehensive means a particular work will be allotted to a single person.
5) Appointment of relatives as employees makes though make the proprietor secure but on the other hand they themselves override rules and policies based on the influence factor.

Auditors duties in to reduce risks in small companies:

1) The Auditor should increase his substantive procedures.
2) He should acquire more and more Management Representation letter.
3) Collection of extensive audit evidence.
4) If the auditor finds that proper books and records are maintained then the auditor may put reliance on such true and fair accounts. If this is not the case then reservations are open in audit reports.

Q. 8) Outline the inherent limitations of Internal Control ?

Ans. Following are the limitations of IC:

1) Managing and maintaining Internal Control System requires huge cost. Such costs may exceeds its benefits derived.
2) Human errors, mistakes, carelessness, mischief are always present in system of controls.
3) Mostly IC laid down are for routine and regular transactions. Thus unusual transactions gets escape from the IC.
4) When two or more persons join hands it poisons the very environment of IC.
5) The IC setting management may themselves override the IC system. Rakshak become Bhakshak.
6) IC may not be updated and carry forward without any change. IC should be adjusted with the changing environment.
7) Even after laying down strict IC system management may change accounting transactions and accounting estimates.

Q. 9) Write short note on Communications of weakness in Internal Control ?

Ans. *Meaning of Letter of Weakness:*

1) While studying and evaluating the internal control system the auditor may become aware of weakness in internal control.

2) He has to calculate the effect of such weakness in IC on the nature, extent and timing of substantive procedures and consequently on financial statements.

3) The inadequacies may or may not have resulted into frauds and errors.

4) Nevertheless the auditor is bound to report such loopholes in IC through a "Letter of Weakness" to the management.

Significance of Letter of Weakness:

Letter of Weakness serves two purposes:

1) It highlights weakness so the management take corrective steps.

2) Such a letter becomes a tool to get auditor protected from charges of negligence. But one should note that such a Letter of Weakness does not absolve the auditor from his responsibility. The auditor cannot take shelter behind the Letter of Weakness.

Points to be considered while drafting Letter of Weakness:

1) The Letter of Weakness should be drafted carefully.

2) The deficiencies and weakness that has came to the auditor should only be reported.

3) The implications should be listed seperately.

4) Significant weaknessess should be highlighted and kept separately from insignificant ones.

5) Suitable suggestions by the auditor to improve internal control systems will add feature to a cap.

6) To whom the letter is addressed is also to be mentioned. Whether to management, BOD, people charged with governance, audit committee.

AAS 7: RELYING UPON THE WORK OF AN INTERNAL AUDITOR

Q. 1) Distinction between Internal Audit and External Audit.

Ans.

Particulars	External or Statutory Audit	Internal Audit
Compulsion	External Audit is compulsory under the Companies Act 1956.	Internal Audit is not compulsory; it is at the discretion of the management.
Appointment	By the Shareholders	By the Management
Qualification	Qualification under section 226 of the Companies Act, 1956.	No prescribed qualification.
Remuneration	Fixed by shareholders	Fixed by BOD / Management.
Status	He is an independent person.	He is the employee of the company.
Scope of Work	Determined by law.	Determined by the management.
Responsible to	Shareholders	Management.
Report	Report submitted to the shareholders.	Report submitted to the management.
Time of appointment	At the Annual general meeting.	At any time during the year.
Checking	Test checks are generally applied.	All transactions are checked without using test checks.

Q. 2) What is Internal Audit? What is the scope and objective of Internal Audit?

Ans. Internal Audit has been defined as "a review or an audit of Operation and records sometimes continuously undertaken within a business, by a specially assigned staff or by the employees of the organization." Prof. Walter of USA says 'Internal Auditing consists of a continuous critical review of financial and operating activities by a staff of auditors'.

The salaried employees of a concern generally carry out the work of an Internal Audit. They may not be professionally qualified. In other words, they may not be Chartered Accountants. He has to do the same job as the statutory auditor. He should see that there is no inefficiency and wastage in the organization.

Objects of Internal Audit:

1. To see that there is no wastage and inefficiency in the organization.
2. To facilitate the annual audit conducted by a statutory auditor.
3. To report the management whether the internal checks and internal control systems are in operations. And if there are some loopholes he has to suggest some improvements.
4. He has to review the completed and recorded transactions and try to detect any frauds and errors in those transactions. He has to review historical data for interpretation purpose. Thus internal audit is also known as a 'post transaction review'.
5. To ascertain that every transaction has been properly authorized.
6. To ascertain whether the internal checks established are adequate.
7. To confirm that the liabilities have been incurred for legitimate operations of the organization.
8. To find out that there is a proper authority for the acquisition and disposal of the assets.
9. Economy, Efficiency and effectiveness is one of the primary objective of Internal Audit.

Q. 3) What are the aspects to be considered while evaluating Internal Audit function?

Ans. With the introduction of CARO 2003, internal audit function has acquired special significance, as the statutory auditor has to state, in relation to a company having a paid – up capital exceeding Rs. 25,00,000 or having an average annual turnover exceeding Rs. 2 crores for a period of three consecutive financial years immediately preceding the F.Y. concerned to which the order applies, whether the internal audit system is commensurate with the size and nature of its business.

In addition to the reporting function for CARO 2003 the statutory auditor has also to see whether he can place reliance on the internal auditors work.
The important points to be taken into account by the statutory auditor are:

(a) Specialization: He should see the qualification and experience of the internal auditor. If the qualified staff is employed for internal audit he can be sure that the quality of work is good.

(b) Purpose: He should also see the purpose of internal audit and to whom the internal auditor is supposed to report if the purpose is limited, the objective of such an audit should be examined in detail.

(c) Evaluation: He should evaluate the work of internal auditor in the light of his performance. He should also check the working of the audit manuals, audit programmes, working papers and interpretation reached under a given situation.

(d) Authority: He should also consider authority given to internal auditor by the management. He should see the manner of reporting and period of reporting and the management reactions and approach to such reporting.
(e) Status: External Auditor should see whether the internal auditor is given sufficient importance in the hierarchy. The internal auditor should be free to communicate with the statutory auditor.

(f) Scope: External Auditor should obtain list of departments with functions and geographical spread. And he should also see whether the internal auditor is able to cover all or some of the departments.

(g) Follow – up Action: The external Auditor should see whether the errors reported by the internal auditor are properly rectified by the management or not.

Q. 4) What are areas of Co-operation and Co-ordination between Internal Auditor and External Auditor?
or
To what extent does a statutory auditor can rely on the work of an Internal Auditor?

Ans. Write some important points from Q.3) + Other points are as follows:
Most of the duties of Internal and statutory auditor are similar. If an internal audit department is efficient in carrying outs its duties properly, then it helps a statutory auditor in saving time. However following are some of the areas of common interests of both:

1) To examine books of accounts and documents.
2) To detect and prevent frauds.
3) To ensure an efficient system of internal check and control.

Thus in many cases the statutory auditor may be closely connected as an advisor in installing and operating the internal audit department.
The Co-operation between internal auditor and statutory auditor can be achieved in the following ways:

1) The statutory auditor may be asked by his clients to advice them in connection with the installation and the subsequent operation of an internal audit.

2) The internal and statutory auditor may plan their respective audits with mutual assistance.

3) The statutory auditor may get some knowledge and information from the internal auditor like technical knowledge of the business in connection with stock – in – trade, fixed assets, depreciation etc.

4) The statutory auditor may reduce detailed checking wherever he feels that the internal audit is adequate and effective.

5) The statutory auditor may not do it again what the internal auditor has already done, as it would amount to duplication of work.

The Co-ordination between internal auditor and statutory auditor can be arranged in the following ways:

1) The programme of an internal auditor may include by agreement, the work that has the effect of giving direct assistance to the statutory auditor.
2) The internal and statutory auditor may discuss the areas of reliance.
3) Coordination with the internal auditor is usually more effective when meetings are held at appropriate intervals during the year.
4) The statutory auditor has also to inform the internal auditor of any significant matters, which may affect his work.

However the statutory auditor may reduce or even ignore some of the areas of audit if:

- Work is repetitive and routine.
- Internal audit is adequate and efficient.
- Examination of the same set of accounting documents.

Can statutory auditor escape the liability:
How far the statutory auditor depends upon the work of internal auditor depends upon his own judgement and past experience. The ultimate financial reporting lies with the statutory auditor. Thus, statutory auditor cannot take the excuse that he blindly relied on the work of the internal auditor. He cannot reduce his liability by taking excuse of internal auditor. He cannot share his responsibility with the internal auditor as he shares his work. Similarly, the internal auditor is under no compulsion to assist the statutory auditor in his work. He is only liable to report to the management. But he can be of specific help to the statutory only if the management wants him to help the statutory auditor. So it is possible only if there is clear-cut instruction for the management.

AAS 8: AUDIT PLANNING

Q. 1) What is Audit Planning?

Ans. 1) Every Auditor should plan his work so that he can complete his work in an efficient and timely manner.

2) While planning auditor should cover the following:

- Client's accounting policies, policies, internal controls.
- Coordinating the work to be performed.
- Establishing the degree of reliance to be placed on internal controls.

3) Audit planning should be continuous throughout the period of engagement.

4) Plans should be flexible enough to accommodate development and changes whenever required.

Q. 2) Enumerate the factors to be considered while drawing an Audit Plan?

Ans. *1) Complexity of Audit:* The work load, the scope of audit work, the responsibilities and rights given.
2) Environment in which the entity: It enables the auditor to understand various operational aspects of audit, example extent of computerization, attitude of internal staff etc.
3) Previous experience with the client: In the previous years audit the auditor might have found some loopholes in the audit in which case those provisions might not have been incorporated in the audit plan. So this year the audit plan has to be more updated.
4) Requirements of Clients: Though the overall audit plan and audit programme is the sole responsibility of the auditor. He is the only author of the audit programme but some special considerations are also to be heard of. In short some requirements of the clients are also to be incorporated in the programme.

Q. 3) What are the points to be discussed with the clients while drawing an Audit Plan?
Ans. Following are some of the matters to be discussed with the clients:

- Changes in the management, organizational structure.
- Changes in Government, rules, regulations etc.
- Current business developments.
- Significant events.
- Related parties and the nature of transactions.
- New / discontinued operations.
- Changes in accounting policies.
- Scope and timing of examination.
- System of internal control.
- Current accounting problems and loopholes.
- Co-operation and Co-ordination expected from the clients.
- Assistance of client personnel in data preparation.

AAS 9: USING THE WORK OF AN EXPERT

Q. 1) Who is an Expert?

Ans. An expert (or a specialist), is a person, or firm of persons possessing special skill, knowledge and experience in a particular field other than accounting and auditing. The field may be in the form of Valuation of assets, Provision of liabilities, Legal opinion.
An expert may be:

- Engaged by the client, Employed by the client, Engaged by the auditor, Employed by the auditor.

Q. 2) Why an Expert is needed for a company?

Ans. The auditors education and experience make him expert in general business matters i.e. accounting and auditing. The auditor is not required to have technical expertise in case of any other occupation. Some professionals in their respective fields will possess such expertise. For example: An actuary is expert in computing pension liability.
During the audit period the auditor collects as much as audit evidence as possible in the form of report, opinion, valuation reports, statements from expert etc. Examples are:
(a) Valuations of certain types of assets, for example, land and buildings, plant and machinery, work of art and precious stones.

(b) Determination of quantities or physical condition of assets, for example: minerals stored in stockpiles, mineral and petroleum reserves, and the remaining life of the assets.

(c) Determination of amounts using specialized techniques or methods, for example: an actuarial valuation.

(d) The measurement of work completed and to be completed on contracts in progress for the purpose of revenue recognition.

(e) Legal opinions concerning interpretations of agreements, rules, orders, notifications, statutes, circulars.

Q. 3) What are the responsibilities of the auditor for the work done by the expert?
Ans.
1) As per SAP 1, *Basic Principles governing an audit* states; "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 the 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. We know that in case of branch audits also the auditor should reflect in its report the fact of reliance on the branch auditors report. The auditor should obtain reasonable assurance that work performed by other auditors or experts is adequate for his purpose.

2) Though the work is delegated to the experts or assistance but the auditor should direct, supervise and review their work.

3) If the auditor has exercised due skill and care then the auditor can rely on the work done by the experts. But if the auditor fails to exercise due diligence and care he will be guilty of professional misconduct and negligence.

4) How much an auditor should place reliance on the work of auditor?
Let us understand this with the help of an example:
An auditor while determining the amount for accrued liabilities for retirements or group gratuity schemes has to rely on the work done by the expert i.e. actuary or the insurer. In such case whether the auditor can simply rely on the report or certificate issued by the actuary without establishing the reasonable or appropriateness of assumptions made.

General Clarification 2002 issued by the ICAI clarifies that the auditor should while relying on the report or certificates should obtain an understanding of the methods used by the actuary in arriving at the amount. Also the auditor should judge the reasonableness of the assumptions made like for example: *(a)* number of employees, *(b)* retirement age, *(c)* salaries, *(d)* promotion policies etc. If the auditor is satisfied regarding the appropriateness and reasonableness of assumptions made he can very well rely on the experts report.

5) The auditor is not required to reform the calculations made by the expert.

Q. 4) List out the factors to be considered while evaluating the work of an expert?

Ans.

1) Skills and Competence: When the auditor plans to use an external expert's work as audit evidence, he should satisfy himself as to the skills and competence by considering the expert's: Professional Qualifications, license or membership in an appropriate professional body, and Experience and reputation in the field in which the audit evidence is sought. But if the auditor himself appoints the expert then he may not inquire regarding the skills and competence.

2) Objectivity or Independence: The auditor should also consider the objectivity of the expert. Objectivity means Independence in work. The expert's opinion will be impaired when: *(i)* the client himself employs the expert. *(ii)* the expert in any manner related to the client.

3) Terms of expert's engagement: While collecting evidence from the expert, the auditor should see the terms of expert's engagement like:

- Objectives of the expert's work.
- Scope
- Confidentiality of expert's work, i.e whether it is to be communicated to third party.
- Confidentiality of the client's information used by the expert.
- Relation of the expert with the client.

4*) Appropriate Audit Evidence:* The auditor should seek reasonable assurance regarding the audit evidence collected. Seeking reasonable assurance in the sense that the assumptions made are reasonable and appropriate as to:

- Source data.
- Consistency with prior period items.
- Results of the expert's work are in light of auditor's knowledge of business.

The substance of the expert's findings is properly reflected in the financial information of the clients.

5*) Data used by Expert:* The auditor should consider whether the expert has used appropriate source data by inquiring from the expert himself whether he is satisfied from the source data. Also whether the source data is reliable.

Q. 5) Bring out the impact of experts work on the audit report?

Ans.

1) It the auditor is satisfied with the work of the auditor then he may issue a clean report. But while issuing a clean audit report the auditor should not make any reference as to the work of the expert.

2) A Qualified or adverse report is to be issued by the auditor if the followings conditions are satisfied:

- The audit evidence is inconsistent with the financial information.
- The auditor does not get sufficient audit evidence on hand.

Qualified report is submitted because such insufficient evidence leads to restriction on the scope of the audit being made.

AAS 10: USING THE WORK OF ANOTHER AUDITOR

Q. 1) Outline the Scope of AAS 10.

Ans. A Company may be having several branches hence it is not possible for a single auditor to cover the audit of all such branches. So a need for another auditor arises. Such auditor reports regarding its branch / division / unit to the principal (main) auditor. The Principal auditor in turn compiles such branch auditors report with its auditor report and presents total financial accounts (of H.O. + Branch) to the owners or shareholders of the entity.

Scope: The Statement within its scope covers:

- Relationship of Principal Auditor with that of Branch / Unit Auditor.
- The procedures to be applied by the Principal Auditor in such situations.
- Financial statements of one or more branches /units / divisions with Head Office.
- Responsibility of Principal Auditor regarding work done by another auditor.

Exclusions: The Statement does not cover the following:

- Two or more auditors appointed as joint auditors.
- The auditor's relationship with a predecessor auditor.
- When the Principal Auditor concludes that the financial statements of the branch / unit is immaterial.

Q. 2) Bring out the principal auditors audit procedures while using the work of another auditor?

Ans.

1) First of all the principal auditor should determine how the work of another auditor will affect the total financial accounts.
2) One of the statutory rights given by the Companies Act to the Principal auditor is to rely upon the work of another audit. In addition to it the companies act further provides that the auditor may even visit the branch office if the circumstances needed. The Principal auditor may examine the books and records of the said branch / component.
3) While planning for the audit the principal auditor should also consider the professional competence of another audit. He has to see whether the branch auditor is a member of Institute of Chartered Accountant.
4) The principal auditor may advise regarding significant accounting and auditing requirements and obtain representations for such compliance.
5) The principal auditor might discuss with the other auditor the procedures applied and even get a written summary from the other auditor. The audit findings of the other auditor may be in the form of a complete questionnaire form or a checklist.
6) The principal auditor should consider the significant findings of the other auditor.
7) The principal auditor may discuss the audit findings with the other auditor or the management. The principal auditor may even advise supplementary tests on the financial accounts if required.
8) In some cases the other auditor might be other than a professionally qualified person. This possibility arises in the case of foreign company in such case all the above points needed more importance.

Q. 3) Bring out the aspects to be documented by the Principal Auditor under AAS 10?

Ans.

- Name of the component / branch / division / unit audited by the other auditor.
- Significance of the component on the total financial accounts.
- Names of other auditors.
- How does the principal auditor deal qualified or adverse remarks by the other auditor?
- Any conclusions reached that individual components are not material.

Q. 4) Explain the co-ordination between the Principal Auditor and the other Auditor?

Ans. Yes coordination can be very well arranged between the principal and other auditor:

- There should be sufficient liaison between the between the principal and other auditor.
- The other auditor should inform regarding any significant matter, which may come to his notice to the principal auditor.
- Similarly the principal response in the positive manner. He has to advice and guide the other auditor regarding any important requirement in the audit.
- The correspondence can be more improved by way of meetings held or the principal auditor may send a detailed questionnaire form or a checklist to the other auditor.
- The questionnaire form or the checklist is to be filled by the other auditor accordingly on timely basis.

Q. 5) Bring out the impact of other auditors work on the audit report of the principal auditor?

Ans.

- It the auditor is satisfied with the work of the auditor then he may issue a clean report.
- A Qualified or adverse report is to be issued by the auditor if the followings conditions are satisfied: *(i)* Principal auditor cannot use the work of the other auditor. *(ii)* Audit procedures performed by the auditor was unable to satisfy as to the requirement of correct audit of financial accounts.

Qualified report is submitted because such insufficient evidence leads to restriction on the scope of the audit being made.

* If the other auditor modifies or intent to modify his report the principal auditor should consider such modification and should accordingly see how it will affect the total financial statements. Whether there is need to modify his own audit report.

Q. 6) Explain the sharing of responsibility between the principal Auditor and the other Auditor?

Ans. *(i) Responsibility of Principal Auditor:* The principal auditor is not at all responsible for the work done by the other auditor.

Exception: But the principal auditor will be responsible only where there arises a suspicion in the mind of principal auditor regarding the reliability of work done by the other auditor.

(ii) Reporting considerations by the Principal Auditor: While forming an opinion on the total financial accounts by the principal auditor his report should clearly state:

- Share of responsibility for the financial statements.
- Number of branches / units / components audited by the other auditor.

AAS 11: REPRESENTATIONS BY THE MANAGEMENT

Q. 1) Why there is a need for management representation?

Ans. The primary responsibility of preparation and presentation of final accounts is that of the management and not of the auditor. Management representation is letter whereby the management acknowledges his responsibility of preparation, presentation and acknowledgement of accounts. Even the management has to specify clearly in the MR letter that the accounting policies have also been properly followed.

MR's is not a substitute for obtaining other audit evidence through other means but should be treated as complementing other audit procedures. Hence MR's works out to be a good crosscheck. But there are few areas where MR's are only the audit evidence available to the auditor. This is possible only in case where knowledge is confined to the management only or where the matter is principally one of the intentions.

Areas where MR's are only the audit evidence:
(a) Representations under section 274 (1) *(g)* of the Companies Act, by the directors of the company.
(b) Representations on suits filed by or against the company.
(c) Representations on discontinuance of business for the purposes of making appropriate disclosures required under AS 24.
(d) Representations regarding status of negotiations with labour unions on bonus and salary increments.
(e) Representations on sale and purchase commitments.

Areas where MR's provide corroborative audit evidence:
(a) Representation on various MAOCARO Clauses.
(b) Representation on segments of the enterprises for disclosure in AS 17.
(c) Representation on frauds.
(d) Representation on amortization policy in the case of intangibles.
(e) Representation on subsequent events.
(f) Representation on going concern.
(g) Representation on valuation of construction contracts.
(h) Representations on satisfactory title of assets.
(i) Representations on useful life of the assets.

Q. 2) Management representation should be documented………..Explain?
Ans. MR's is supposed to an important source of audit evidence hence it is to be safely preserved with the working papers. MR's can be obtained in 3 ways:

- Written MR's letter.
- Oral representations noted by the auditor and duly acknowledged by the management.
- Authenticated copy of relevant minutes of meeting of the board of the directors or similar body.

Q. 3 What should an auditor do when management refuses to issue MR letter?

Ans. First of all management should on their own issue MR letter. If at all management do not give MR then the auditor himself should prepare a letter in writing setting out his understanding of management representations that have been experienced through out the audit course. Then the auditor has to send the same for acknowledgement by the management regarding his understanding of representation is correct or not. The management should accordingly acknowledge it. Any change may be mutually settled.

Again if the management refuses to acknowledge the letter written by the auditor then it would constitute the limitation on the scope of audit. In such a case the auditor should consider the effect of such refusal on his report.

Q. 4 How a Management representation helps as an audit evidence?

or

Q. 4 How much an auditor can rely on Management representation?

Ans.

(1) MR whose responsibility: The primary responsibility of preparation and presentation of final accounts is that of the management and not of the auditor. Management representation is letter whereby the management acknowledges his responsibility of preparation, presentation and acknowledgement of accounts. Even the management has to specify clearly in the MR letter that the accounting policies have also been properly followed.

MR's is not a substitute for obtaining other audit evidence through other means but should be treated as complementing other audit procedures. Hence MR's works out to be a good crosscheck. But there are few areas where MR's are only the audit evidence available to the auditor. This is possible only in case where knowledge is confined to the management only or where the matter is principally one of the intentions.

(2) If the matter is material: If the matter is material to the financial statement, the auditor should:

- Seek corroborative evidence from sources inside or outside the entity.
- Evaluate whether representations obtained is reasonable and consistent with over all knowledge of the business.
- Persons making representations are well informed on the matters.

(3) Situations where MR is too strong:

- The matter is beyond the auditors reach to audit i.e. it may be very technical.
- The management keeps proper records
- Strong internal audit department.

Q. 5 Explain the form and content of management representation?

Ans.

(1) MR should also be in writing.
(2) If MR is not in writing then the auditor has to note it down and acknowledges the same from the management.
(3) A MR should be addressed to the auditor.
(4) It should be dated and signed.
(5) A MR is generally signed by the members having the responsibility of preparing MR, example: MD, Finance Director.

AAS 12: RESPONSIBILITY OF JOINT AUDITORS

Q. 1) What is Joint Audit? What are its advantages and disadvantages?

Ans. In case of large entity due to its volume of transactions are very high, so it becomes impossible for a single auditor to complete the audit within the prescribed time. So two or more than two auditors are appointed. Such a group of auditors auditing a single entity are called joint auditors. For example: Joint Audits are very common in case of nationalized banks.

Advantages:

- Pooling and sharing of work as well as expertise because two heads are better than one.
- Lower work loads.
- Better quality performance.
- Better risk sharing.
- Advantage of mutual consultation.
- A sense of healthy competition between the auditors towards a better performance.

Disadvantages:

- Co-ordination problems in conduct of work.
- Ego minds, lack of harmony and understanding become a hurdle in conduct of audit.
- Responsibility may not be properly defined.
- Areas of common concerns may be neglected or buck passing is adopted.
- Superiority or seniority complex may make the audit work more complex. For example in case of a big audit firm and small audit firm may not see eye to eye to each other.
- Responsibility overlapping.
- Sharing of fees.

Q. 2) Outline the scope of Joint Audit?

Ans.

Applicability:

- AAS 12 lays down the professional responsibility of joint auditors.

Exclusions:

- Branch Audit under section 228 of the Companies Act 1956.

Q. 3) How is the work divided among the Joint Auditors?

Ans.

Manner of division: First of all division of work is always discussed mutually among the auditors who also shares the work. The division of work may be divided in the following manner:

- Branch wise.
- Geographically or location wise.
- Assets wise / liabilities wise.
- Period wise.
- Income / expenses wise.

Common areas: Certain common areas may not be shared but performed jointly. Such areas are of much significance.

Documentation: Division of work always has to be documented. Sharing of work has to be properly recorded in writing which helps to settle disputes in future. By documentation an auditor can get correct volume of work on hand. Documentation may be even communicated to the clients.

Q. 4) Responsibility of Joint Auditors is joint and several……….Comment?

Ans.
Several or Specific Responsibility:
Each auditor is totally responsible for the work allotted to him. He cannot share even 1% responsibility with any one. An auditor cannot omit any areas discussed below:

i) Internal Controls: He has to see whether proper internal checks have been implemented in the company. He has to evaluate the internal control structure. He should even satisfy himself as to the sufficiency of internal audit system.

ii) Sampling: Even in this area there is no escape or one cannot share the responsibility. Hence Sampling or tests checks have to be properly applied.

iii) Allocation of Branches: Even each auditor may be allocated a separate branch. Even in this case branch report has to be properly evaluated (which is allotted to him). Also he has to see whether the Branch Accounts are properly incorporated in the Total Accounts.

iv) Management Representations: Every auditor has to receive MR letter of his concerned branch / unit / component etc. He has to seek explanations from the Management regarding any information in the MR letter.

Joint Responsibility:
Some amount of work may not be carried out individually but jointly. Such work is called common areas of work. Following are the areas of joint audit:

i) Common Decisions: All the auditors may decide concerning the nature, timing or extent of audit procedures. Here in this case though the audit may be performed by any of the single auditor but as far as audit procedures are concerned all the auditors are equally responsible. To illustrate: X, Y, and Z are joint auditors of Insurance Company. Suppose Z carries out reinsurance aspect. The nature, timing and extent of audit procedure have been decided. Now as far as audit procedure is concerned all are jointly responsible. But within the area of work Z is alone responsible.

ii) Disclosure Matters: In respect of financial statements as to their statutory disclosure.

iii) Audit Report: The compliance of audit report with the requirements of the relevant statute.

iv) Communicating matters to each other: Any matter may be brought to the notice of each other and may be mutually agreed upon. Then for such matter each and every auditor is jointly liable.
If suppose any particular auditor comes across any matter which is relevant to the audit its his own duty to disclose it to other auditors. If he discloses it before submission of the final audit report then other auditors are also responsible. But if he discloses it after submission of the final audit report then he alone is responsible and not the other auditors.

Q. 5) Can an auditor be held responsible for the other auditors work?

Ans.
1) Each and every auditor has to assume that the other auditor has carried out his work:
- Following generally accepted accounting policies.
- Following generally accepted accounting procedures.

2) There is no need for a review for any auditor for other auditors work.
3) An auditor can fully rely on the work done by the other auditor. But if he finds any error then it is his duty to inform and consult the other auditor regarding rectification of such error.

Conclusion: In short it can be said that an auditor is not responsible for other auditors work.

Q. 6) What should an auditor do when there is difference of opinion?

Ans.

Mostly the auditors should work out any matter related jointly. But sometimes difference of opinion is possible. In such a case auditors should report separately. Hence any auditor having different view is not bound by the views of other auditors.

AAS 13: AUDIT MATERIALITY

Q. 1) What is Materiality?

Ans. Information is material if its omission or erroneous statement could influence the economic decision of users of the financial information. Materiality depends upon:

- From its size / amount
- From its nature of items
- From its legality
- From its contractual violation.

For example: Overvaluation of stock by Rs. 1,000 for a company earning a profit of Rs. 50,00,000 is not material. But if a company is earning Rs. 500, then if you consider the impact of the overstatement then the profit can turn into loss, hence it becomes very material. Thus materiality provides a threshold or cut off point rather than being a primary qualitative characteristic, which the information must have if it is to be useful. What is material is based on the professional judgment of the auditor.

The concept of materiality recognizes that some matters either individually or in the aggregate, are relatively important for true and fair presentation of the financial information. Auditor has to consider the materiality levels at both overall financial statements level and at the level of individual account balances and class of transactions.

Materiality also depends upon the legality, non – compliance of which may have a significant bearing on the financial information. For example: Non- provision in respect of NPA in the case of NBFC, even if the amounts are quite small, say Rs.100 needs to be reported to the RBI.

Auditor should also consider the sum total of the small misstatements which may cumulatively be material. Individually some items in isolation might not affect financial statements but collectively considered they are material. For example: Profit and loss A/c. may be overstated by Rs. 10,000 which is collectively material. The derivation of Rs. 10,000 say may be because of Overvaluation of stock Rs. 500, Investments are over valued by Rs. 700 & so on. Individually these items in isolation might not affect financial statements but collectively considered they are material.

Q. 2) Explain the relationship of Materiality and Audit risks?

Ans. Audit Risk means the risk that the auditor gives a clean audit opinion when financial statements were materially misstated. Since 100% auditing is not possible, there is always an audit risk. Auditing is all about managing this risk and to keep it at low level. Materiality is a matter of professional judgment, which depends upon the needs, and perception of the persons who relies on the financial statements. The auditors preliminary assessment of materiality helps him to decide on (a) what items to examine; and (b) whether to use sampling or analytical procedures etc. This means Materiality helps the auditor to determine the nature, timing and extent of audit procedures and techniques so as to reduce the audit risk to an acceptable level.
Relationship of Materiality and Audit risks: There is an inverse relationship between Materiality and Audit risks. This means higher the materiality level, lower will be the audit risks and vice – versa.
For example: Sundry Debtors showing a misstatement by a higher amount (high materiality) will have very less chances (low audit risks). But Sundry Debtors showing a misstatement of a small amount (less materiality) will have more chances (high audit risks).

Q. 3) Bring out the relevance of materiality in forming audit opinion?

Or

Explain how materiality helps us to gather audit evidence?
Or
What are the duties of the auditor vis-à-vis materiality?

Ans.
(a) Audit Planning: The auditor's preliminary assessment of materiality helps him to decide on:

- What items to examine?
- What procedures are to be used? Procedures means Analytical review, Sampling etc.

(b) Uncorrected Misstatements: In forming an opinion on the financial statements the auditor should consider the effect of uncorrected material misstatements. The aggregate of uncorrected material misstatements comprises of:

- The net effect of material misstatements identified during some previous years (past errors).
- The auditors best estimates of other misstatements i.e. projected errors.

(c) Prior Period Misstatements: An auditor might have ignored some of the misstatements during last year. But such misstatement will affect this year's account as well. For example: Closing stock will become opening stock of current year. So the effect of uncorrected material misstatements in the last year for the closing stock will be c/f. in the current year also. So the auditor has to consider prior periods misstatements in the current years misstatements if he believes that the current years accounts will be distorted.

(d) Analytical Review: Performance of Analytical Review may not detect the misstatement but may just estimate that there is misstatement. For exact determination of misstatements the auditor has to perform some other audit procedures to supplement such determination of misstatement.

(e) Sample Scrutiny: When an auditor uses sampling to test an account balance or class of transactions, he should project the amount of misstatement determined with the help of sample techniques. Such projected misstatements along with substantive procedures would help much the auditor in assessing aggregate misstatements.

(f) Audit Report: If the aggregate of uncorrected misstatements affects the financial statements materially or if the aggregate of uncorrected misstatements reaches the materially level then auditor had to report such aggregate of uncorrected misstatements to the management. The auditor may require the management to make adjustment of such uncorrected misstatements or extend his audit procedures. The disposition of aggregate of uncorrected misstatements may in the following ways:

- Adoption of Accounting Policies.
- Change of Accounting Policies.
- Passing adjusting entries.
- Relevant disclosures etc.

If the management refuses to adjust the uncorrected misstatements in the financial statements then the auditor has to issue a qualified or adverse audit report as the case may be.

AAS 14: ANALYTICAL REVIEW PROCEDURES

Q. 1) What are "Analytical Review Procedures"?

Ans. Analytical procedures means the analysis of significant ratios and trends including the resulting investigation of fluctuations and relationship that are inconsistent with other relevant information or which deviated from predicted amounts. The application of Analytical procedures is based on the expectation that relationship among data exists and continues in the absence of known information 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. Analytical procedures are a type of substantive audit procedures.

Types of Analytical procedures: Includes the following:
(a) Trend Analysis: Comparison entity's financial information with prior periods.
(b) Comparative Data Analysis: Comparison entity's financial information with budgets.
(c) Inter – firm comparison: Comparison entity's financial information with similar other company's and industry.
(d) Financial Ratio Analysis: Relationships among elements of financial information e.g. GP ratio, Turnover ratio.
(e) Capacity Utilization: Warehousing capacity, Physical capacity.
(f) Legal restrictions: Legal life of product, Labour law.
(g) Financial and non – financial relationship: Salary expense to number of employees, Sales to quantity sold, Sales figure to capacity utilization.

Various methods may be used in performing the APs. These range from simple comparisons to complex advanced statistical techniques. AP's may be applied to CFS, Divisions, and Segments and even to individual components of the Financial Statements. The auditor's choice of procedures, methods and level of application is a matter of professional judgment.

Q. 2) What are the purposes of "Analytical Review Procedures"?

Ans. Analytical procedures are used in auditing for the following purposes:

a) Analytical procedures in substantive procedures: In some cases APs can be more effective than tests of details in reducing detection risk. The detention risk should reduce. This is particularly true in case of volume of information is homogeneous and quite large. For example: In case of Salaries and Wages, the volume of information is quite large and only internal evidence is available. In such a case APs would provide substantive audit evidence and reduce the extent of vouching to a large extent. When APs are used as substantive procedures, a stable relationship between the base data and the figure to be audited is established. Differences between estimated and actual results are investigated into.
When performing APs as substantive procedures following factors are to be considered:
i) Nature of the entity and the degree to which information can be disaggregated, for example APs will be more effective when applied to individual components of financial statements than to the total enterprise as a whole.
ii) Whether the data was subjected to audit testing in the current year or prior year.
iii) Whether data are obtained from independent sources or from sources within the entity.
iv) Availability of information, viz: financial such as budgets or forecasts, and non – financial, such as the number of units produced or sold.
v) Reliability of the information obtained. For example: Budgets are prepared with due care.
vi) Knowledge gained during previous audits, together with auditors understanding of the accounting and internal control systems and the types of problems in the prior periods have given rise to accounting adjustments.

b) Analytical procedures in planning the audit: Applying APs in the planning stage will assist him in understanding the business and in identifying areas of potential risk. The audit risk can exists in two areas: (i) In general terms: at the enterprise level ex.: Doubt regarding going concern. (ii) In specific areas: Increase of costs in Marketing Department. An auditor may be unaware of many things in the business so applying APs in the planning stage will help him in determining the nature, timing and extent of other audit procedures. Taking steps at the initial stage in itself indicates right direction of the audit right from the beginning. At the initial stage the auditor might not have financial statements on hand. But he may very well use updated MIS information made available from the enterprises. For example: seeing wide variations in the GP ratio the auditor may go for detail checking of sales and closing stock.

c) Analytical procedures in overall review of the audit: While forming an opinion on the overall financial accounts of the company the auditor has to apply APs at this stage also. The auditor in this case may apply APs on the individual components of the financial statements. APs serves as the cross check or corroborative evidence for other audit procedures as well. For example:
Debtors Confirmation Letter: Other Audit Procedure
Bad – Debts List: Other Audit Procedure
Corroborative Audit Evidence→ Debtors T.O. ratio / Age of the Debtors: APs.

Q. 3) What are the duties of auditors regarding investigation of unusual items?

Ans. When the auditor finds significant fluctuations between relationships. If the estimated or predicted and the actuals differ widely then the auditor has to investigate such unusual items.

Extent of investigation: The auditor has to follow the following steps:
i) The auditor has to call information from the management. The information can be in the form of oral inquiries or in black and white.
ii) Corroboration of management's responses with auditors knowledge of business or any other audit evidence.
iii) If the management is unable to provide information or management may have provided incomplete information, auditor may go for other audit procedures.

Q. 4) Explain the extent of reliance put by the auditors on Analytical Review Procedures?

Ans. APs are based on the assumption that relationship between data exists and continue in the absence of known information to the contrary. The extent of reliance put by the auditors on Analytical Review Procedures depends on the following factors:
i) Extent of materiality: If the item is material Example: Inventory if the material. Then in such case the auditor should not rely on APs alone. Yes if the item is not material example: certain items of income and expenditure.

ii) Other audit procedures: If other audit procedures directed toward same objective then APs provide corroborative evidence. For example:
Debtors Confirmation Letter: Other Audit Procedure
Bad – Debts List: Other Audit Procedure
Corroborative Audit Evidence→ Debtors T.O. ratio / Age of the Debtors: APs.

iii) Accuracy of prediction: If the expected results of APs can be can be predicted with accuracy, such procedures are more reliable. For example: GP ratio is more consistent than some discretionary expenses like R & D expenditure.

iv) Assessment of inherent and control risks: Reliance on APs depends on the type of risks involved. For example: If internal control over sales orders processing is weak and, therefore, control risk is high, more reliance on tests of details of transactions and balances rather than on APs.

AAS 15: AUDIT SAMPLING

Q. 1) What is Audit Sampling ?

Ans. *Meaning of Audit Sampling:* In case of large companies audit work is voluminous. It is not possible to check each and every item within a class of transactions or account balance, so the auditor resorts to Audit Sampling. So Audit Sampling is a tool in the hands of auditor to select some transactions from so many and form a conclusion about the entire population. For example: Checking all receipts from debtors is not possible. The auditor may select say 60% of the receipts from the entire population as Audit Sampling. Based on 60% of the receipts the auditor draws conclusion regarding the accounts receivables.

Why Sampling:
1) Checking 100% items is very time consuming + Costly.
2) Large number of monotonous, repetitive items creates boredom in audit.
3) Audit work becomes too mechanical.
4) To provide appropriate audit evidence.
5) To evaluate sample results.
6) More concentration on essentials.
7) To compute risk in class of transactions or account balance.

Situations where Sampling can be used: Sampling has got wide applications if used:
1) Items are large.
2) Items are homogenous.
3) Auditing 100% becomes tedious.

Specific Areas where Sampling can be used:
1) Debtors Balances.
2) Payroll Checking.
3) Petty Vouchers.
4) Sales Invoices.
5) Purchase Bills.

Q. 2) What is Sampling Risk ?

Ans. Sampling Risk is computed as follows:

Audit Conclusion based on Sample selected	**xxx**
***Less:* Audit Conclusion if 100% items were checked**	**xxx**
Sampling Risk →	**xxx**

For example: The auditor may select say 60% of the receipts from debtors from the entire population as Audit Sampling. Based on 60% of the receipts the auditor draws conclusion regarding the accounts receivables. Sampling risks lies in 40% of the debtors. Also some risks may be there in even 60% Sampling tested debtors which is nothing but non – sampling risk.
Sampling Risk arises both during compliance procedures (testing internal control) and also at the time of substantive procedures (inquiry, valuation etc).

1) Sampling Risk in Compliance Procedures: In case of Compliance Procedures again the risks are bifurgated into:
(i) Risks of Under – Reliance and (i) Risks of Over – Reliance
To explain the above two sub – risks lets take our same example of Debtors balance. Suppose 60% of Debtors receipts which is our Sampling Size complies / agrees with the normal internal controls (compliance procedures), but 40% actually do not agree with normal internal controls (compliance procedures) then the auditor reaches at a wrong conclusion that the total debtors receipts are correct based on 60% sampling results. Here even the auditor may reduce his substantive procedures. This is how the auditor places over – reliance on the Sample Results. Conversly, in case 60% of Debtors receipts which is our Sampling Size do not complies / agrees with the normal internal controls (compliance procedures), but 40% actually do match / agree with normal internal controls (compliance procedures) then the auditor reaches at a wrong conclusion that the total debtors receipts are not

correct based on 60% sampling results. Here even the auditor may extend his substantive procedures. This is how the auditor places under – reliance on the Sample Results.

2) *<u>Sampling Risk in Substantive Procedures:</u>* In case of Substantive Procedures again the Risks are divided into: (i) Risks of Incorrect Rejection, (ii) Risks of Incorrect Acceptance.
Suppose the auditor chooses 70% payment vouchers as Sample Size and he found all the 70% of payment vouchers are accurate but the balance vouchers are not properly computed as compared to substantive procedures *(vouching procedure)*. Thus the auditor comes to a conclusion that all payment vouchers are properly computed which is actually wrong. Here the auditor has having the risks of Incorrect Acceptance. Conversly, Suppose the auditor chooses 70% payment vouchers as Sample Size and he found all the 70% of payment vouchers are having arithmetical errors but the balance vouchers are actually properly computed as compared to substantive procedures *(vouching procedure)*. Thus the auditor comes to a conclusion that all payment vouchers are wrongly computed which is actually wrong. Here the auditor has having the risks of Incorrect Rejection.

Q. 3) What are the steps in Sampling Plan ?
Or
Enumerate the factors for the design of the Sample Plan ?
Ans. While designing a sample plan the auditor should consider the following:

1) *<u>Audit Objective</u>:* The very first step is to specify the audit objective to be achieved by testing the sample + Which audit procedure is to be used for achieving the audit objective. Audit objective would define what constitute error and what is the population to use for sampling. For example: Audit objective may be to check overstatement of debtors balances.

2) *<u>Defining Population and Population items:</u>* The auditor has to define population which very much depends on the audit objective to be achieved. For example: In case of over stated Debtors (Extra debtors are recorded) *Debtors Balances* will become the population. Also the individual customers balances is called *population items* or *sampling unit*. Thus one can say that sum of sampling units is equal to population. In other words sampling units make up population. But in case of under stated Debtors (Non recording of some debtors), Debtors Listings will serve no purpose. In this case population will be receipts from debtors, unpaid sales invoices, debtors confirmations, debit and credit notes which provides information regarding understated debtors.

4) *<u>Stratification:</u>* Stratification means dividing the whole population into different divisions (strata) such that within each strata items have similar characteristics.
<u>Features of Stratification</u>:
i) Each strata is mutually exclusive of other.
ii) Stratification leads to a smaller sample size.
iii) It helps to design a more effective Sample.
<u>Example of Stratification</u>: Out of the total debtors balances, suppose the auditor divides the debtors population into debtors less than 6 months (Strata 1) and debtors more than 6 months (Strata 2). Thus debtors having age of 4 months will not have any place in Strata 2 and so on.

5) *<u>Sampling Size:</u>* Determining an appropriate Sampling Size is of utmost important for an auditor. Sampling Size is the quantum of sample for audit. For example: 70% Debtors if chosen for checking then it becomes Sampling Size of Debtors Sample.

<u>Factors determining Sampling Size</u>:

i) *<u>Sampling Risk</u>:* (For definition refer Q.2). Sampling Size is inversely proportionate to Sampling Risk. Higher the Sampling risk attached to a population smaller will be the Sampling Size and vice – versa. For example: If the risk in Debtors balances are insignificant i.e. lower risk then the auditor may say increase his Sampling Size to say 75%. In other words by spreading Sampling net he covers maximum debtors so that other methods may not be used. If much risk is attached then the auditor will not take a chance and will reduce the Sampling Size and may rely on other procedures as well.

ii) Tolerable Error: It is the maximum error acceptable by the auditor in the sample and still the auditor concludes that the sample has achieved its objective. It is the excusable error and even concludes that the sample is error free. For example: If out of 600 purchase invoices if 20 invoices are not authorized still the audit objective is achieved then tolerable error is 20 x 100 / 600 = 3.33%. If the sampling size is larger, tolerable error will be small. *Lets prove*: If the sampling size is larger, this means risk is less plus you might depend more on sampling in such case. Hence low tolerable error is to be set by the auditor.
Factors determining Tolerable Error: Sample Size, Auditors judgement, Control Procedures, Substantive Procedures, Materiality involved in the account balance and class of transactions.

iii) Expected Error: It is the pre – estimated errors on hand known by the auditor in the sample. Such errors are well known by the auditor. If the auditor expects errors in the population then the sampling size is to be larger. And if , the population is error free then the sampling size may be reduced. Of course the auditor should have a lot of past audit experience regarding the errors that are present in the population. But if the auditor takes the audit assignment for the first time then in such case some items may be chosen for testing before going for sample size.
Factors determining Expected Error: Auditors past audit experience, Auditors judgement, Control Procedures, Substantive Procedures, Materiality involved in the account balance and class of transactions.

6) Selecting a Sample item: The next stage is selecting a Sampling item which should represent the whole population under consideration. This means each element in the population have an equal opportunity of being selected. The auditor should be very careful while selecting a Sample. Some common methods of selection are:
1. Random Selection: It ensures that each item in the population has an equal chance of being selected. For this Random number tables are to be used. Random samples can be selected in a number of ways. Nowadays Computer packages are available in the market for random numbers, in which case both time and cost will reduce.

2. Systematic Selection: This is yet another method of selecting a sample. A sampling interval is created. *What is sampling interval?* It means every item selected has a constant interval between two selections. The first interval has a random start.
Lets illustrate:
Sample Checking: Accounts Receivable.
Total Population: 2,000 Debtors.
Sample Size: say 60% Debtors.
Sample Interval: say interval of 9. It means every 9th item will be selected for checking.
Random Start: say 4. It means from 4th item 9 will be counted. Thus, our sample items chosen will 4th, 13th, 22nd, 31st and so on.

3. Hapazard Selection: Sometimes bias may vitiate a sample chosen. Following a constant interval pattern may not give adequate results. For suppose every 9th item in the above example are of debtors less than Rs. 10,000. Thus Debtors having a balance of > than Rs. 10,000 may either be totally excluded or totally included. Thus pattern have to be haphazard in such case.

4. Cluster Sampling: Here the total population is divided into clusters. Clusters means a group of items. A number of clusters are then randomly selected. Either the whole cluster is completely checked or proportion items within a cluster may be checked.

7) Evaluation of Sample Results: Following are the duties of the Auditor for evaluating Sampling results:
1. Analysis of Errors detected in the Sample: First of all the auditor should know on hand that what is error exactly. He should compare the sample error with the audit objective set. For example: Suppose audit objective laid down was to check the totals of Vouchers. If a particular Voucher is not authorised then such error is not Sampling Error because such error do not match with the audit objective set. Hence an auditor should be very clear about the definition of Sampling error.

2. Projecting of Errors detected in the Sample: To reach a conclusion regarding the sample population the auditor will project the errors found in the sample. Projecting the error means projecting actual errors. When projecting the errors, qualitative aspects of the error have to be kept in mind. In case of Strata , the projection of errors has to be done for each strata separately and then the results have to be combined.

3. *Reassessing Sampling Risk*: After projecting the error the auditor should compare the projecting errors with tolerable errors. Following are the effects of comparison.

Comparison	***Effect***
If Projecting Errors < Tolerable Errors	Then the audit objective is achieved through Sampling.
If Projecting Errors > Tolerable Errors	Then the auditor has to reassess the sampling risk and even after that the risk found to be unacceptable, then the auditor has to extend his other audit procedures.

Remember that the above Projecting Errors are Net Projecting Errors.
Net Projecting Errors = Gross Projecting Errors – Errors rectified by the management during the Sampling Test.

Q. 4) What are the methods of Sampling ?
Or
Distinguish between Statistical Sampling and Non – Statistical Sampling ?

Ans. There are two methods of Sampling : (1) Statistical Method, (2) Non - Statistical Method or Judgement Sampling. AAS 15 recognises both the methods of Sampling.

Statistical Method	**Non - Statistical Method**
1. In Statistical Sampling the auditor applies statistical and mathematical formulaes for determining sampling size and sampling risk.	1. In Judgemental Sampling the auditor applies professional judgement and based on his past experience for determining sampling size and sampling risk.
2. Techniques used in Statistical Sampling are Random Numbers, Probability Theory and other Statistical Models.	2. Tools used by the auditor in case of Judgemental Sampling is his past experience, professional judgement, inquiry etc. For example: If the items in a sample are material the auditor may choose such items for his Sample Population.
3. Sampling Risk can be easily computed and hence exactly determined.	3. Sampling Risk can be just assessed but cannot be numerically computed. In other Quantification is not possible.
4. Sampling items selected have an equal chance of being selected. In other words the sample selection is only probabilistic.	4. The sample selection may either be probabilistic or non – probabilistic.
5. It goes by form.	5. It recognizes substance.
6. The results and decisions are objective in nature.	6. The results and decisions are more subjective in nature.

Q. 5) What are the Advantages of Statistical Method of Sampling ?

Ans. Following are the advantages of statistical method of sampling :

1) As the statistical use mathematical models hence the solutions are more exact, conclusive, objective and defensive.
2) Sampling Results and Sampling Risks is Quantifiable.
3) Overall time and cost of audit can be substantially reduced.
4) By adopting judgemental sampling method the size of sampling may be inappropriate. Hence Statistical Method of Sampling gives a proper shape to the Sampling Size.
5) Proper conclusions can be drawn from the mass and mess amount of data.
6) It reduces personal bias.

Q. 6) Enumerate the circumstances where Sampling is not appropriate ?

Ans. Following are the circumstances where sampling is not appropriate:

1) *Weak Internal Controls:* Where Internal Controls itself are very weak the weak internal controls give rise too much of risk. Even adopting sampling may give rise to samling risk. Thus audit will prove to be very doubtful under such risky conditions.
2) *Small Population Size:* In case of population size is very small sampling size has to be increased. If sampling size is increased then it may nearly covers the whole population also. Thus it is of no use to adopt sampling. And one should also know that sampling is meant for large mass of data.
3) *Heterogeneous Population:* Sampling is applicable to homogeneous popuation and not to heterogeneous population. Because heterogeneous population cannot be divided into stratas. The stratas items should have similar features to be eligible for homogeneous population.
4) *No Proper Arrangement of Population:* For a proper sampling the population should be properly arranged. For example: A Company might have arranged the creditors bills area wise in different files. What is needed is Creidtors less than 5,000 and greater than 5,000 and so on.

Q. 7) Explain Test Checking ? What are the advantages and Disadvantages of Test Checking ? Also list out some of the precautions to be adopted for test checking ?

Ans. *Meaning of Test Checking:* In case of large companies audit work is volumnious. It is not possible to check each and every item within a class of transactions or account balance, so the auditor resorts to Audit Sampling. So Audit Sampling is a tool in the hands of auditor to select some transactions from so many and form a conclusion about the entire population. Checking of such few transactions is called test – checking.

Examples of Test – Checking: 1) Checking 100% of Debtors for three months. 2) Checking 30% of Debtors for all the months.

Advantages of Test – Checking:

1) Checking 100% items is very time consuming + Costly. By adopting test checking much of the time and cost can be reduced.
2) Large number of monotenous, repetitive items creates boredom in audit.
3) Audit work becomes too mechanical.
4) To provide appropriate audit evidence.
5) More concentration on essentials.

Disadvantages of Test – Checking:

1) If the client staff comes to know that the auditor is adopting test – checking then they may become careless in their work.
2) The part of work not checked may contain some errors in case of test – checking it goes undetected.
3) Risk and doubt always remains even after a satisfied test – checking.
4) The auditor cannot take shelter behind test checking for any errors / fraud detected. In other words the auditor is fully responsible for the total work irrespective whether he goes for test checking or not.

Precautions to be adopted for Test – Checking:

(1) Initial step towards test checking for an auditor is to see whether the internal audit and internal controls has to be studied and to see whether they are properly working or not.
(2) Secondly transactions should be startified under proper heads.
(3) A proper sample size has to be selected for test checking.
(4) Test checking is to be devised in such a manner that maximum coverage of all the aspects of is to be made.
(5) Test checking for material items have to be increased. More coverage for material items is required.
(6) Teck check should be kept secret.
(7) The period and quantum of test checking should be changed every year.
(8) Bais should not be allowed to enter in test check plan.

AAS 17: QUALITY CONTROL FOR AUDIT WORK

Q. 1) List the Objectives of AAS 17.

Ans. AAS 17 seeks to establish standards of Quality Controls on:
i) Audit Firm: Implementation of policies and procedures at the audit firm level.
ii) On Individual Audit: Implementation of policies and procedures to the work delegated at the audit level.

Q. 2) Definitions:

Ans.
i) Auditor: means a person who has final responsibility of the audit.
ii) Audit Firm: In case of sole proprietorship practice the sole proprietor is Audit Firm. In case of partnership firms having partners all the practicing partners form a Audit Firm.
iii) Personnel: Means all the partners in the firm + all the staff members in the firm.
iv) Assistants: Means personnel other than the auditor.

Q. 3) What are the duties at the Firm level regarding Quality Control? Enumerate the objectives of quality control procedures at Firm Level?

Ans.
i) Duties at the Firm level: While implementing policies and procedures at the audit firm level the audit firm should see that the work is carried out as per required AS, SAAPs, and Guidance Notes. Also the control policies and procedures are properly implemented and communicated to the personnel. While implementing the auditors should be assured that the personnel properly understand the policies and procedures.

ii) Objectives of the policies and procedures at the Firm Level:

a) Basic Professional Requirements: Personnel in the audit firm are to adhere to the basic professional requirements or principles of audit viz: Independence, Integrity, Objectivity and Confidentiality.

b) Skill and Competence: The audit firm is to be staffed by personnel having required professional qualifications and maintained technical standards to enable them to fulfill their responsibilities with due care.

c) Assignment: While assigning the work to the audit firm the technical competence of the personnel is to be judged in relation to the audit work assigned.

d)Delegation: There should be sufficient direction, supervision and review of work at all levels to provide reasonable assurance that the work performed meets appropriate standards of quality.

e) Consultation: Wherever necessary, consultation within or outside the firm, with experts, should be made.

f) Acceptance and rejection of Clients: An evaluation of prospective clients and a review, on an ongoing basis, of existing clients is to be conducted. In making a decision to accept or retain a client, the firm's independence and ability to serve the client properly are to be considered.

g) Monitoring: The audit firm must continuously monitor the policies and procedures followed by it for the performance of audit.

h) Communication: Also the control policies and procedures are properly implemented and communicated to the personnel. While implementing the auditors should be assured that the personnel properly understand the policies and procedures.

Q. 4) Enumerate the objectives of quality control procedures at the individual audit level?

Ans.
a) Professional Competence of assistants: The auditor firm should assess the professional competence of the assistants performing the work delegated to them. Such assessment is necessary for determining the extent of direction, supervision and review by the audit firm.

At the overall audit firm level professional competence is assessed at general level. But at the individual audit level professional competence is assessed in relation to specific engagement. Though audit staff may be professionally competent to do general audit work, but in absence of information the audit staff may not have expertise to do bank audits.

b) Direction: Assistants to whom work is delegated need appropriate direction. Direction involves informing the assistants of (i) their responsibilities, (ii) objectives of audit procedures, (iii) nature of entity's business, (iv) possible auditing and accounting problems that may be faced by the assistants. Directions can be communicated through Audit Programme, Time Budgets and Overall Audit Plan.

c) Supervision: Supervision is closely related to direction and review and may involve elements of both. Persons having supervisory responsibilities have to perform the following functions:

(a) Monitoring function: Monitoring the progress of the audit to consider whether:
- assistants have the necessary skills and competence to carry out their assigned task.
- assistants understand and act according to the audit directions; and
- the work is being carried out as per the overall audit plan and audit programme.

(b) Reply function: Replying the significant questions raised during the audit; by assessing their significance and modifying the overall audit plan or audit programme.

(c) Resolving function: Resolving the differences of professional judgement that arises between personnel and consider the level of consultation that is appropriate.

d) Review: The work performed by each assistant should be reviewed by personnel of atleast equal competence.

Aspects of Review:
- The work is being carried out as per the overall audit plan and audit programme.
- Results obtained are properly documented.
- Significant audit and accounting problems raised have been resolved.
- The objectives of audit procedures have been achieved.
- Significant audit matters are properly reflected in the audit conclusions.

What to Review?
Following is to be reviewed on timely basis:
- Overall audit plan and programme.
- Inherent and control risks.
- Documentation of audit evidence.
- Adjusted Financial statements.

AAS 20: KNOWLEDGE OF THE BUSINESS

Q. 1) What is the need for Knowledge of the Business ?

Ans. An Auditor is supposed to have only general knowledge of the economy and the business concerned. He is only expert in his auditing, accounting, attestation and reporting activities. But while undertaking auditing assignments he should have atleast minimum level of knowledge of the industry for which he is doing the audit.

There is variety of companies for audit, like Hotels, Banking, Investment companies, Insurance companies etc. As far as financial transactions, events, business operations are concerned all these companies differ a lot. Knowledge of such business entities is very necessary for the auditor to process his audit assignment. Lets say expert knowledge is not required, but at least such knowledge which helps the auditor to understand the operations of the business and financial transactions and events. Hence it is must for an auditor to familiarize himself with the cleint's business and organisation.

How knowledge of business helps an Auditor:

- Assess the inherent and control risk of the entity. After all inherent and control riska are the major risk while the detection risk is under the control of auditor.
- For identifying problem areas.
- Prepare the audit plan and audit programme.
- Planning and performing the audit efficiently and effectively.
- Sources avenues for audit evidence.
- After all providing better service to the client.

However knowledge business means and includes the following as per AAS 20:

(i) Knowledge of the economy (ii) Knowledge of the concerned industry, (iii) Knowledge of the company

Q. 2) What Knowledge of the Business should the auditor possess regarding the Economy ? Also list out the sources to gain such information ?

Ans. *Knowledge of the economy*:

- Interest rates + availability of finance.
- Market conditions in terms oof business ups and downs.
- Foreign Currency rates and RBI prohibitions.
- RBI Regulations.
- Inflation, recession, growth in the economy.
- Monetary and fiscal policies of the government like: Duties, taxes, custom rates, subsidies, tariffs etc.

Sources to gain the information regarding the economy:

- Journals from the institutes like ICAI, ICSI.
- Financial Newspapers like Business Wizard, Economic Times.
- Books on Income Tax, Company Law, Excise etc.
- Budget News.
- Trade Journals.
- Newsletters and Journals from Chamber of Commerce, Chambers of Tax Consultant.
- Banks Reports, RBI regulations Act.
- Media sources like: Business News, Internet etc.

Q. 3) What Knowledge of the Business should the auditor possess regarding the Industry ? Also list out the sources to gain such information ?

Ans. *Knowledge of the industry*:

- The market environment and conditions.
- The level and degree of Competition.
- Latest technology and trend in the market regarding the product.
- Business and Financial Risk.
- Declining and expanding operations.
- Accounting policies and practices.
- Key Ratio of the industry.
- Direct Taxes, Indirect Taxes and Other Law applicable to the industry.
- Legislation and Regulatory Framework.
- Cyclical or seasonal activity.
- Environment requirements and problems.

Sources to gain the information regarding the industry :

- Journals specifically for the industry.
- Financial Newspapers like Business Wizard, Economic Times.
- Books on Income Tax, Company Law, Excise etc.
- Budget News.
- Trade Journals.
- Media sources like: Business News, Internet etc.
- Survey reports.
- Government statistics.

Q. 4) What Knowledge of the Business should the auditor possess regarding the Entity under audit ? Also list out the sources to gain such information ?

Ans. *Knowledge of the Entity under Audit*:

(a) Knowledge regarding the Company in brief and its Management :

- Structure of company whether partnership, private co. or public co.
- Organizational Structure – The Hierarchy.
- Managements objectives, philosophy, strategic plans.
- Board of Directors : Composition, their meetings, brief background of Directors.
- Existing of Audit Committees.
- Companies thinking on Corporate Governance.
- Internal Auditors and maintenance of Internal Controls in the company.
- Key Management Personal.
- Appointment and Retirements policy and procedure of the company.
- Related Parties.

(b) Knowledge regarding the Companies expansion:

- Business Restructuring – including merger schemes, discontinued operations.
- Franchises and agreements entered into with multinational companies etc.
- Information regarding Branches and depots.
- Investments made in Subsidiary, Joint Venture etc.

(c) Knowledge regarding the Companies products, facilities and operations:

- Nature of Product.
- Locations of plant, production facilities, warehouses etc.
- The companies services towards their customers like after sales services, complaints cells etc.
- Stock management and other current assets management policy.

- Important elements of expenses.
- Market Share, Discount structure, Selling price of the product.
- Research and Development.
- Taxes rate on products. (Rate of Excise Duty and CST)

(d) Knowledge regarding the Companies performance:

- Operating statistics.
- Profit trend.
- Market Prices of Shares.
- Quantum of Turnover.

(e) Knowledge regarding the Companies Capital Structure:

- Sources of Finance.
- Risk to Equity Shareholders.
- Recent Changes and future plans regarding the Capital Structure.
- Returns paid to capital providers.

(f) Knowledge regarding the Legislation and Reporting:

- Environmental and social responsibilities.
- Types of taxes and rates of taxes applicable.
- Subsidies, Rebates, Grants and Exemption eligible to the company.
- Disclosures, accounting policies and practices followed.
- Auditing and Accounting reporting requirements.
- Users of Financial Statements.

Sources to gain the information regarding the Entity :

- Previous experience with the client.
- Previous years Financial Statements.
- Memorandum and Articles of Association.
- Minutes Books and Other registers like Fixed Asset register.
- Budgets, Costing Standards Manual.
- Interim Financial Reports.
- Paying Visit to production facilities, branches, service facilities.
- Discussions with Internal Auditors, Managements, Legal Adviser etc.
- Organisation Flowcharts.

Contracts and Agreements entered by the company.

AAS 21: CONSIDERATIONS OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS

Q. 1) Its whose responsibility for preventing the non-compliance of laws and regulations.

Ans.
i) Objective of the standard: While carrying out the business the entity has to comply with various rules, regulation laws in force. The auditor may not have the expert knowledge of those laws, regulation or rule. However it is possible that not following those laws, regulation in the financial statement makes the financial statement materially misstated. Therefore it is necessary that the auditor should be aware and calculates the effect of non-compliance of these rules, regulations and laws on financial statements.

ii) What is non- compliance: Non-compliance refers to act of omission or commission by the entity being audited, either intentionally or un-intentionally, which are contrary to the prevailing laws or regulations.
Non-compliance does not include personal misconduct of the employees or management of the entity.

iii) Whose Responsibility? Considering the training and experience of the auditors interpretation of the laws is ordinarily beyond the auditors professional competence in such situation the auditor can take help of legal expert. But the primary responsibility for compliance of laws and regulations and detection and prevention of non-compliance of laws and regulations *is that of the Management.*

Q. 2) Enumerate the indicators of non-compliance of laws and regulations?

Ans.
i) Investigations by the Government Department, payments fines / penalties etc.
ii) Excessive payments for goods and services.
iii) Media comment – newspapers, T.V. news.
iv) Unusual sales commission.
v) Payments without proper exchange control documentation.
vi) Companies registered in tax – havens.
vii) Payments for unspecified goods and services or loans to related parties, employees, government employees.
viii) Suspense Ledger Accounts.
ix) Unusual payments in cash.
x) Unauthorized payments.

Q. 3) Explain the role of management for preventing and detection of non -compliance of laws and regulations?

Ans. As already discussed it is the primary responsibility for compliance of laws and regulations and detection and prevention of non-compliance of laws and regulations *is that of the Management.*
Following are some of the steps the management should take to detect and prevent non-compliance of laws and regulations:

- Proper training and understanding of laws and regulations to employees by opening training cells and arrangement of audio video lectures.
- Maintaining records of relating to compliance and non-compliance.
- Establishment of Legal department.
- Establishing Code of Conduct and of its compliance.
- Incorporating of rules and regulations in internal control procedures.
- Taking timely action against defaulter employees.
- Reporting of non-compliance to internal auditor.
- Reporting of non-compliance to the audit committee.

Q. 4) Explain the preliminary duties of the auditor for preventing and detection of non -compliance of laws and regulations?

Ans. It is rightly said that a stitch in time saves nine. Though the auditor is not responsible for the non –compliance of laws and regulations but to avoid any mess in normal auditing process the auditor is also required to play some role in preventing of non –compliance of rules and regulations.

(i) Audit Planning Stage: In the audit plan itself the auditor should understand and incorporate the conditions or events which leads to non –compliance of rules and regulations.

(ii) Auditors understanding of laws and regulations:

- Utilizing the knowledge of clients business for the understanding of laws and regulations.
- Inquire management concerning the policies and procedures adopted.
- Discuss with the managements regarding the rules / regulations / policies etc.
- Inquire from the management whether they have complied with the laws and regulations.
- Inspecting correspondence with relevant licensing or regulatory authority.
- Take advises from legal experts or Actuaries or technicians as the case may be. For example: Taking advises form lawyers regarding the cases pending in the court by understanding the development in the case.

(iii) Other Audit Procedures: The Auditor can use the results obtained by other audit procedures as well. The auditor should adopt vigilance during the audit because any procedure may bring instances of possible non – compliance with laws and regulations.

(iv) Management Representations: The auditor should obtain written representations from the management regarding possible compliances and non –compliances with laws and regulations.

Q. 5) Explain the duties of the auditor after non -compliance of laws and regulations is discovered?

Ans. Auditors responsibilities when non –compliances is discovered is explained in parts as follows:
I) ON DISCOVERY OF NON – COMPLIANCE:
In the first instance the auditor should evaluate the impact of the non –compliance on the financial statements in terms of:

1) Fines, Penalties levied.
2) Damages, litigations, threat of parting with assets.
3) Possible effect on going concern as an entity.
4) Whether potential effect require disclosure.
5) Whether potential effect has bearing on true and fair view of the financial statement.

II) DOCUMENTATION OF NON – COMPLIANCE:
When the auditor believes that there is non –compliance, the auditor has to record the following in his working papers:

- Copies of related records and documents.
- Minutes of meeting with the management.
- Consultation with the lawyer of the entity or any other lawyer if not satisfied with the entities lawyer.
- Review of management representation letter and its reliability.

III) COMMUNCATION WITH THE MANAGEMENT
The auditor should, as soon as practicable, either communicate with the

- Audit Committee
- Board of Directors
- Senior Management.

If the auditor suspects that there is an involvement of even the senior management, then he may communicate such non – compliance to its next higher authority like audit – committee. Even if such higher authority is the party to non – compliance then the auditor should take legal advice.

III) COMMUNCATION TO THE USERS OF FINANCIAL STATEMENT

If the auditor concludes that the non – compliance has a material effect on the financial statements, and such materiality is not properly reflected in the financial statements, the auditor should express a qualified or an adverse report.

If the auditor is prevented from obtaining audit evidence (limitation on the scope of audit) then the auditor may issue a disclaimer report.

IV) COMMUNCATION TO THE REGULATORY AUTHORITIES

Due to the confidentiality clause in professional ethics the auditor may not reveal regarding the non – compliance to the outside party. But in some circumstances such non – compliances has to be reported to the third party like RBI, SEBI etc because the duty of confidentiality is overridden by statute, law or by courts of law.

V) WITHDRAWAL FROM THE AUDIT ENGAGEMENT

The auditor may even disassociate himself from the engagement if:

- The top-management is also involved in the non –compliance.
- Limitation is placed on the scope of audit by the management.
- When the management even after reporting non –compliance, takes no remedial action.
- When duty of confidentiality comes across between the clients and third party.

AAS 22: INITIAL ENGAGEMENTS – OPENING BALANCES

Q. 1) Enumerate the objectives of AAS - 22?

Ans. 1) Objective of AAS – 22 is to check the Opening Balances -
Opening Balances means the balance, which is b/d. from the previous years. In other words closing balances of previous is opening balance.
2) The financial statements are audited for the first time.
3) Another auditor is auditing the accounts for the first time.

Q. 2) List out the auditors duties in an initial engagement – Opening Balances.

Ans. Following are the duties of an auditor in an initial engagement – Opening Balances:
1) Correct Closing Balances are brought down during the current year.
2) Opening Balances b/d. does not contain misstatements that materially affect the financial statements.
3) Appropriate accounting policies are consistently followed. It means accounting policies followed in the last year is followed in the current year to.
4) If same accounting policies are not followed in the current year the same has to be disclosed.
5) If after performing various audit procedures, the auditor is unable to obtain sufficient audit evidence concerning opening balances the auditor may in such case issue either Qualified Report or Disclaimer Report as the case may.
6) If Opening Balances b/d. contains misstatements that materially affect the financial statements and the same has not been given adjusted in the accounts or not properly disclosed then even in such case the auditor can issue Qualified Report or Disclaimer Report as the case may.

Q. 3) Outline the mode of obtaining audit evidence in respect of – Opening Balances.

Ans.
If Accounts are already audited in the previous year:
If some other auditor audits previous years accounts, then simply copies of audited financial statements have to be pursued by the current auditor regarding the appropriateness of opening balances.
If during the audit of current year any misstatements in the opening balances are found then such reliance on previous years audited accounts not to be placed.

If Accounts are not audited in the previous year:
If accounts of previous years are not audited or the current auditor is not satisfied with the work of previous auditor then the auditor has resort to other audit procedures to get the correct opening balance figure.
Some additional audit procedures are listed below:
In case of Current Assets and Current liabilities: As far as current assets and current liabilities are concerned audit evidence can be collected by performing normal auditing procedures during the year. For example: Collections form Debtors and Payments to the Creditors itself will prove as to the existence, rights and obligations, completeness and valuation of opening balances.

In case of any other assets and liabilities: Any other assets and liabilities includes Fixed Assets, Investments, long – term debts etc. Here the auditor should examine the records maintained by the company. The auditor can even obtain the confirmations regarding the opening balances from the third party as to the existence, completeness and valuation of such assets and liabilities.

AAS 24: AUDIT OF COMPANIES USING SERVICE ORGANISATIONS

Q. 1) Please outline the auditors duties in AAS – 24 in respect of Entities using Service Organisations.

Ans. *What is Service Organisations:* These are independent professional organizations who renders services to other entities in the form of: (i) data processing, (ii) Book Keeping procedures, (iii) Safe custody of investments for example: Custodial of assets, (iv) Affecting transactions on behalf of companies.
Service Organisations have strong infrastructure facilities for rendering the above services.

Auditor of the company who receives services of Service Organisations has the following duties:
1) Nature of Service: The auditor has to consider what type of services does our company receive from the Service Organisations i.e. financial (accounts) or operational (management, HRA etc)

2) Audit Planning: The auditor should consider how a service organization affects the clients accounting and internal control systems so as to plan the audit and develop an effective audit approach. Certain policies, procedures and records maintained by the service organization might be relevant to the audit of the financial statements of our client.

3) Extent of Authority: The auditor of the client has also to see the extent of authority given by his client to its service organization. The service organization may develop policies and procedures that affect accounting and internal control systems of our client. These policies and procedures are physically and operationally separate from our clients organization. The extent of authority given by client to its service organization is also relevant for audit. It is explained as follows:

Extent of authority given to service organisation	Duty left to the clients in such case	Policies and Procedures
Services are restricted to only processing and recording of transactions.	Client retains the authority of authorizing and maintaining the records.	Client has to implement effective policies and procedures within the organization
Services are extended to authorizing and maintaining the records also. In other words full services are rendered.	Just relax and rely on service organization.	Again relax and rely on the policies and procedures implemented by the service organizations.

3) Extent of Authority: The auditor of the client has also to see the extent of authority given by his client to its service organization. The service organization may develop policies and procedures that affect accounting and internal control systems of our client. These policies and procedures are physically and operationally separate from our clients organization. The extent of authority given by client to its service organization is also relevant for audit. It is explained as follows:

Extent of authority given to service organisation	Duty left to the clients in such case	Policies and Procedures
Services are restricted to only processing and recording of transactions.	Client retains the authority of authorizing and maintaining the records.	Client has to implement effective policies and procedures within the organization
Services are extended to authorizing and maintaining the records also. In other words full services are rendered.	Just relax and rely on service organization.	Again relax and rely on the policies and procedures implemented by the service organizations.

4) Assessment of Accounting and Internal Control Systems of SO: The auditor of the client has also assess the Accounting and Internal Control Systems of service organization. The Auditor has to perform the following procedures:

a) For clear understanding of the Accounting and Internal Control Systems of SO the auditor may collect information from service organisations internal auditors, management, regulatory bodies.
b) If the auditor concludes that the activities of the SO s are significant to the entity (client is much dependent on SO) and relevant to the audit, the auditor should obtain sufficient information to understand the accounting and internal control systems of the service organisation and to assess control risk at either the maximum, or to access control risk at minimum if tests of control are performed.
c) Even third party reports available with the auditor of Service Organisation can be obtained for clear understanding of the Accounting and Internal Control Systems of SO.

5) Regarding Service Organisations Auditor: The auditor of the client would also consider the need to request the SO to perform such procedures as to supply necessary information requested by the auditor of the client. If such reports are not made available within a certain time limit, the clients auditor may visit personally the Service Organisation. The client in such case should request the SO to allow access to necessary information to the auditor.

Auditor of the client should also consider the professional competence of the service organisation in the context of specific assignment if the other auditor is not a member of ICAI.

Q. 2) You are an auditor of X Limited. In the year 2003 – 2004 for the first time X Limited has appointed Y Limited for the complete services of book keeping + accounting + Authorization and maintenance of Accounts. How as an auditor would you plan your Audit for the Service Organisation Y Limited?

Ans. Following are the considerations for audit of SO (Audit Planning):

1) The auditor has to consider what type of services our company receives from the Service Organisations i.e. financial (accounts) or operational (management, HRA etc).
2) Relationship of the client with the SO. For example: SO may be an associate of the clients company.
3) Terms of Contract.
4) The material financial statement assertions that are affected by the use of the service organisation.
5) Inherent risks associated with such assertions.
6) Extent to which the clients Accounting and Internal Control Systems interact with the systems at the service organization.
7) Clients internal controls that are applied to the transactions processed by the service organization.
8) Service organization’s financial strength and organisational capability, including the possible failure of the service organization on the client.
9) Information about the service organization as reflected in the user and technical manual.
10) Information available on general and systems controls relevant to the clients applications.

Q. 3) How are the reports of Service Organisation's Auditors classified?

Ans. The report of the Service Organisation's Auditor may be classified as under:

Type A – Report on Suitability of Design	**Type B – Report on Suitability of Design and Operating Effectiveness**
● A description of the service organization's accounting and internal control systems, ordinarily prepared by the management of the service organisation; and ● An opinion by the service organisation's auditor that : 1. the above description is accurate; 2. the systems' controls have been placed in operation; and 3. the accounting and internal control systems are suitably designed to achieve their stated objectives. ● Such reports would be useful to the auditor of the client in gaining the required understanding of the accounting and internal control systems.	● A description of the service organisation's accounting and internal control systems, ordinarily prepared by the management of the service organization; and ● An opinion by the service orgnisation's auditor that; 1. the above description is accurate; 2. the system's controls have been placed in operation; 3. the accounting & internal control systems are suitably designed to achieve their stated objectives; & 4. the accounting and internal control systems are operating effectively based on the results from the tests of control. In addition to the opinion on operating effectiveness, the service organisation's auditor would identify the tests of control performed and related results. ● Such reports may be useful to the auditor of the client as a basis for reducing the assessment of control risk. The auditor of the client should also consider (a) length of the period covered by the service organization auditor's tests and (b) time since the performance of those tests.

While issuing a clients audit report the auditor should not make any reference as to the service auditors report.

AAS – 25 COMPARATIVES

Q1) Distinguish between Corresponding Figures and Comparative Figures?

Ans.: Before distinguishing Corresponding Figures and Comparative Figures one should know the elements of Amounts and other disclosures. It comprises of (Balance Sheet + Results of operations i.e. P/L Account + Cash Flows + Notes to Accounts + Other Disclosures).

Corresponding Figures	Comparative Figures
1) Amounts and other disclosures for the preceding period are included as a part of current period financial statements.	1) Amounts and other disclosures for the preceding period do not form part of current period financial statements. They are separately presented.
2) It adopts Integral View.	2) It adopts Discrete View.
3) Corresponding Figures are not stand-alone financial statements. The Amounts and other disclosures are read in relation to or in conjunction with the current period figures only.	3) Comparative Figures are stand-alone financial statements. The Amounts and other disclosures are read separately for current period and for previous period.
4) Auditors report refers to financial statements of the current period only.	4) Auditors report refers to each period that financial statements are presented for.
5) Reporting under Corresponding Figures is well accepted and adopted in India.	5) The framework of presentation under Comparative financial statements is not widely prevalent in India.

Q2) Write Short notes on Auditor's responsibilities regarding Comparative?

Ans.:

1) The auditor should obtain sufficient audit evidence that the corresponding figures meet the requirements of the financial reporting framework.
2) The auditor should assess following two conditions for corresponding figures:
   * Whether accounting policies has been consistently followed. It means current years figure and corresponding figure has subject to similar accounting policies. If there is any change adjustment has been done and disclosed.
   * Whether corresponding figures agrees with the amounts and other disclosures of previous years.
3) When another auditor has audited the financial statement for the previous period then the present auditor should comply with the requirements of SAP – 22: Initial Engagements – Opening Balances.
4) When the prior periods accounts are not audited the auditor should assess the conditions as laid down in point no.: 2 above. Also the auditor should comply with the requirements of SAP – 22: Initial Engagements – Opening Balances.
5) When the auditors report on the prior period, as previously issued as qualified / adverse / disclaimer report:

If the matters are resolved and adjusted	If the matters are not resolved and adjusted
↓	↓
The current report does not ordinarily refer to previous modifications.	The auditors report should be modified for the corresponding figures.

6) If prior period's financial statements are not audited, the incoming auditor should state in the auditor's report that the corresponding figures are unaudited

AAS – 26 TERMS OF AUDIT ENGAGEMENT

Q1) What is audit engagement letter?
Ans.: Before commencement of Audit every auditor and its client should agree upon the terms and conditions of audit and these terms and conditions are finally included in the engagement letter. The audit engagement letter is prepared by the auditor himself, to avoid any misunderstandings with respect to the audit. Though the objective and scope of the audit and the auditor's obligations are, normally, laid down in the applicable statute or regulations and the pronouncements of the ICAI. The auditor engagement letter confirms the auditor's acceptance of the appointment. Sometimes the audit engagement letter may be in the form of a contract.

Q2) What are the principal contents of an audit engagement letter?

Ans.: The form and content of audit engagement letter may vary from client to client, but it would generally include the following:

- The objective of the audit of financial statements.
- The scope of the audit: The Scope of an audit is determined by the Terms of engagements, Requirements of Law, Pronouncements of ICAI, Accounting Standards, Guidance Notes, and Assurance Standards.
- Managements responsibility for the following:
  - Preparation of Financial Statements.
  - Selection and consistent application of accounting policies and standards, along with proper explanations relating to the material departure from the accounting standards if any.
  - Preparation of Financial Statements on going concern basis.
  - Making judgments and estimates based on the reasonableness and prudential requirement so as to make the financial statements and profit and loss account more true and fair.
  - Maintenance of adequate accounting records and strict internal controls.
  - Test nature of audit, frauds and errors that may remain undetected.
  - Unrestricted access to records / documents / vouchers required for conducting an audit.
  - The fact that the audit process may be subjected to peer review under The Chartered Accountants Act, 1949.

Other inclusions in the audit engagement letter:

- Management Responsibility letters evidences.
- Request for the acknowledgment of audit engagement letter.
- Billing arrangements.
- Arrangements made by the management regarding the internal auditor, experts as per AAS – 9, other auditors etc.

Q3) Is the auditor required to issue a separate audit engagement letter for the components of a company?

Ans.: When the auditor of a parent entity is also the auditor of its subsidiary, branch or division, following factors are to be considered:

- Who appoints the auditor of the subsidiary, branch or division (component).
- Whether a separate audit report is to be issued for the component.
- Legal restrictions and requirements.
- Extent of work performed by another auditor.
- Degree of Internal Control.
- Degree of ownership by the parent.

Q4) What are out the provisions of recurring audit and issue of audit engagement letter as per AAS-26?

Ans.: It is always advisable to the auditor to issue an audit engagement letter for clearing all the misunderstandings. But is it required to issue audit engagement letter every year if the same auditor audits the accounts? The answer is no. But in the following circumstances, auditor can access the need to send a fresh engagement letter.

- If the client has misunderstood the audit objective and scope of the audit. For example: A new pronouncement might not have been understood by the client.
- Any new or special terms of the audit engagement.
- A significant change in the clients business. Example: Opening a overseas branch.
- Changes in ICAI pronouncements and legislations.

Q4) What are the responsibilities of an auditor when there is a change from a full audit engagement to one that provides a lower level of assurance?

Ans.: A client may request the auditor in between the audit process to change the terms of engagement to provide a lower level of assurance. Such restriction on the scope of audit may be either requested by the management or may be caused by the circumstances. Following are the auditor's responsibilities in this respect:

1) An auditor who, before the completion of the audit, is requested to change the engagement to one which provides a lower level of assurance, *should consider the appropriateness of doing so*.
2) The auditor should carefully see the reason for such a change. He should ask the explanation towards the change from the management.
3) If the change in the engagement is due to change in circumstances then it is considered reasonable. But in contrast, a change would not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory.
4) An auditor is also required to consider the legal or contractual implications of such change.
5) If the auditor concludes that there is reasonable justification to change the engagement and if the audit work performed complies with the AASs applicable to the changed engagement, the report issued would be that appropriate for the revised engagement. Reference should not be given to the original engagement.
6) Both auditor as well as the clients should agree on the new terms.
7) If the auditor concludes that there is no reasonable justification to change the engagement and still the client insists on changing the engagement and thereby not to issue a qualified or adverse report, then the auditor should not agree for the changed engagement. For example: If the auditor has not received sufficient appropriate audit evidence regarding the valuation reports of Plant then or confirmations regarding the debtor's balances and the clients asks for the change.
8) If the auditor is unable to for the changed engagement and is not permitted to continue the original engagement, the auditor should withdraw and consider whether there is any obligation, either contractual or otherwise, to report the circumstances necessitating the withdrawal to other parties, such as board of directors or shareholders.

AAS – 27 COMMUNICATION OF AUDIT MATTERS WITH THOSE CHARGED WITH GOVERNANCE

Q1) Define audit matters of governance interest? What are the liabilities of an auditor regarding audit matters of governance interest?

Ans.: 'Audit matters of governance interest' are those matters that arise from the audit of financial statements. Such audit matters comes to the attention of the auditor during the performance of audit. Such audit matters are relevant and important which affects financial statements and has to be reported to the persons who are charged with governance.

Auditor's responsibilities in respect of audit matters of governance interest:

1. Auditor should communicate the audit matters of governance interest arising out of the audit of financial statements to the persons who are charged with governance.
2. Auditor should determine the relevant persons who are charged with governance and with whom audit matters of governance interest can be communicated and discussed.
3. Auditor should determine the relevant and important audit matters of governance interest arising from the financial statements which need to be communicated and discussed.
4. It is not necessary that auditor should identify all the audit matters to the persons charged with governance. To avoid misunderstanding an audit engagement letter may explain the audit matters of governance interest that need to be communicated to the persons charged with the governance.
5. The effectiveness of the communication will be enhanced by developing a constructive working relationship between the auditor and those charged with governance.
6. The auditor should communicate audit matters of governance interest on a timely basis. Communication should be done on timely basis to avoid in delays in taking action. This means a timely action can be taken by the management on such audit matters of governance interest. In certain cases the auditor may communicate the matters sooner than previously agreed.
7. If the Audit Report on Financial Statements as per AAS – 28 requires certain modifications, then communications between the auditor and the persons charged with governance cannot be regarded as substitute.
8. The requirements of professional pronouncements legislation or regulation may impose obligations of confidentiality that restricts the auditor's communication of audit matters of governance interest. The auditor refers to such requirements before communicating with those charged with governance. In some cases the reporting requirements of governance interest and professional ethics clashes in which case the reporting becomes complex. In such case the auditor has to seek a legal advice.
9. Sometimes additional reporting requirements are imposed by the pronouncements / legislation regarding audit matters of governance interest. These additional communications requirements are not covered AAS – 27; however the additional reporting requirements may affect the content, from and timing of communications with those charged with governance. Example: Reporting requirements regulated by Long form audit report in case of Public Sector Banks, reporting under section 619(3) of the Companies Act 1956, in case of Government Companies.

Q2) Who are the persons "those charged with governance interest"? To whom the auditor should communicate audit matters of governance interest?

Ans.: *Meaning of persons charged with governance interest:* Persons charged with governance interest are those persons who direct, supervise and control the entity. They manage the affairs of the company. Those charged with governance are ordinarily, accountable for ensuring that the entity achieves its objectives of financial reporting and reporting to interested parties. Those charged with governance are Directors, Managing Directors and Managers of the entity.

To whom the auditor should communicate the audit matters of governance interest?

- The auditor should determine the persons who are charged with governance because communications regarding the audit matters of governance interest is to be made only those persons.
- The structure of governance interest may vary from entity to entity depending on the size and legal constitution.

- Auditor has to study properly the structure of the organization to exactly know the persons who are charged with governance.
- Auditor has to use judgment wherever required and consider the legal responsibilities of the persons charged with governance.
- Auditor has also to consider the importance and sensitivity of the audit matter of governance interest.
-

Entity	*Persons who are charged with governance*
1. Limited Company	Board of directors / audit committee / ethics committee
2. Partnership Firms	Partners only
3. Trusts	Trustees
4. Cooperative Societies	Managing Committee

- When the entity's governance interest structure is not well defined due to the circumstances of the engagement or due to some of the legal constraints, then auditor has to come to an agreement with the entity who are the persons to whom the audit matters of governance interest is to be discussed. This happens in case of government companies, owner – managed companies, sole proprietorship and not – for profit organization.

Q3) What are the various audit matters of governance interest?
Ans.: FIRST DEFINE AUDIT MATTERS OF GOVERNANCE INTEREST (REFER Q.1)

Various audit matters of governance interest:
- The objective and overall scope of the auditor. (Here auditor is guided by AAS 2).
- Selection and changes in accounting policies. Example: Change in the method of Depreciation form WDV to SLM (Here auditor is guided by AS 1).
- Potential effect on the financial statements of any significant risks and exposures. Example: Effect of pending litigation, Changes in the forex rates which may affect the Foreign exchange assets / liabilities / subsidiary / joint ventures.
- Any provisions / estimates / subsequent events which requires adjustments and which will have a significant change on the financial statements. (Here auditor is guided by AS 4, AS 29, AAS 18, AAS 19).
- Material uncertainties casting doubt on the entity's ability to continue as a going concern. (Here auditor is guided by AS 1, AAS 16).
- Disagreements with management about matters that, individually or in aggregate, could be significant to the financial statements or to the auditor's report. For example: Provision stated by the management may be Rs. 40,000, but as assessed by the auditor it worked out to be Rs. 70,000. Auditor is also required to communicate how the conflicts were resolved or the conflicts are yet to be resolved.
- Expected modification of the auditors report (Here auditor is guided by AAS 28).
- Other matters which require the attention of the management (persons charged with governance) like weakness in the internal control, deeply laid down frauds, questions regarding the integrity of the management. (Here auditor is guided by AAS 4 and AAS 6).
- Expected changes in the audit engagement letter (Here auditor is guided by AAS 26).

The auditor considers whether the audit matters of governance interest previously communicated is still not resolved continued to become the current years audit matter of governance interest. What effect last years audit matter of governance interest has on the current year's financial statements. Is it required to communicate again the same audit matter in the current year also?

Q4) How should the auditor communicate various audit matters of governance interest?

or

What are the methods of communicating audit matters of governance interest?

Ans.: The communication may be either orally or in writing. Whether it should be orally or in writing depends on the following:
- The structure of governance interest, the size and operating structure and legal constitution.
- Various communication methods / process available.
- The importance and sensitivity of the audit matter of governance interest.

- The hierarchy in the communication process.
- The number of meetings held between the management and auditor.
- The amount of on-going contact and dialogue the auditor has with those charged with governance.

If the communication is made orally, the auditor should make documentation in his working papers. Such documentation may take the form of minutes of the auditor's discussion with those charged with governance.

Initially the auditor can discuss the audit matter of governance interest with the management. But if the matter relates to the question of the management's competence and integrity, then the matter can be discussed with the persons charged with governance. If management agrees to communicate a matter of governance interest with those charged with governance, the auditor may not need to repeat the communications, provided that the auditor is satisfied that such communications have effectively and appropriately been made.

AAS – 28 THE AUDITORS REPORT ON FINANCIAL STATEMENTS

Q1) What is Audit Report?
Ans.: It is an instrument through which the auditor expresses his opinion about the accounts. Every auditor has to issue Audit Report after finalizing the financial statements. He has to give the opinion regarding the truth and fairness of the accounts.

Q2) What are the basic elements of an Audit Report?
Ans.: The basic elements of an Audit Report describe the form and content of an Audit Report.

1. Title of Auditor Report: Every report contains a title. Similarly An Audit Report should have an appropriate title. A title distinguishes an Audit Report with other Reports.

2. Addressee: An Audit Report should be address to either the shareholders or to the authority who has appointed the auditor.

3. Opening and introductory paragraph: The auditor's report should identify the financial statements of the entity that have been audited including the date of and audited period covered. The audit Report should also be able to identify the name of the company.
The auditor has to make it very clear that the maintenance of accounting system, compliance of accounting standards, installation of internal control and checks is the responsibility of the management. Auditor has the responsibility to check whether the management has complied with the accounting standards, proper functioning of internal control and full proof accounting system.

4. Scope paragraph: Scope of audit is generally decided by the following:
- Terms of audit engagement
- Companies Act For example: As per section 227 (3) auditor is require to report to the shareholders whether the company has complied with the mandatory AS or not.
- Pronouncements of ICAI
- Auditing Standards issued by ICAI
- Legal requirements
- Banking Act in case of Banks.

Audit engagement letter cannot reduce the legal and statutory requirements of audit but can increase and enhance it. Auditor's Report should describe the scope of the audit by stating that the audit was conducted in accordance with the auditing standards generally accepted in India,. Readers of the financial statement needs that the accounts are subjected to audit are in accordance with applicable accounting and auditing standards.
The report should include a statement the audit was planned and performed to obtain reasonable assurance whether the financial statements are free from material misstatement.

The auditor's report should describe the audit as including:
- Evidence on a test basis evidence to support the amounts and disclosures in financial statements.
- Assessing the accounting principles used in the financial statement.
- Assessing the accounting estimates by the management and used in the preparation of financial statements.
- Evaluating the overall financial statement presentation.
- A statement that the audit provides a reasonable basis for his opinion.

5. Opinion paragraph: The opinion paragraph reflects the opinion of the auditor regarding the financial statements audited during the year. The opinion paragraph includes the following:
- The financial statements reflect the true and fair position.
- The financial statements have been prepared in accordance with the applicable Accounting Standards and complying with the Companies Act 1956.
- The financial statements have been prepared by considering the Guidance Notes issued by the Institute of Chartered Accountants of India.

Thus the auditor provides an opinion within the Financial Reporting Framework.

6. Date of report: Date of Auditor's report is the date on which date auditor signs the report expressing his opinion regarding the financial statements audited during the year. The Auditor's report date cannot be earlier than the date of approval of financial statements prepared by the management.

7. Place of Signature: The auditor's report should specify where the financial statements are attested (signed).

8. Auditor's Signature: The auditor should sign the audit report.
In case of proprietorship → By the auditor in his personal capacity.
In case of partnership → By the auditor as a partner.
In any case the auditor is required to mention his Membership No. assigned by ICAI.

Q3) What are the types of an Audit Reports issued by the Auditor?
Ans.:
1. Unqualified / Clean Auditor Report: After finalizing the accounts for the year if the books of accounts / documents / records reflects true and fair view of the business then Auditor in such case issues an Unqualified Report. It means the auditor issues the report without any qualification / reservation. In most of the cases the auditor issues a clean report only. Management tries to secure a clean report from the auditor. If the auditor requires any changes to be made in the accounts / requires any disclosure then the management agrees with it to secure a clean report.

Unqualified Report indicates the following:
- The financial statement of the entity is showing a "true and fair view" without any reservations.
- It indicates that the management has provided complete information as required during the audit session in which case it was possible for the auditor to give a clean report.
- The financial statement of the entity is prepared as per the mandatory accounting and auditing standards.
- The financial statement of the entity complies with the Companies Act 1956, applicable statute, SEBI guidelines, RBI norms etc.
- Proper accounting polices has been followed.
- Adequate disclosures regarding material misstatement is made.

Example on Unqualified Report: "In our opinion and to the best of our information the balance sheet and profit and loss account give a true and fair view of the state of affairs and working results".

2. Qualified Report: An auditor is required to report to the shareholders through audit report for the "true and fair view" of the statement of affairs of the company. The auditor reports on matters without any doubt. But if there is any doubt regarding any particular matter then the auditor requests the management to make adjustment. But if the management denies making adjustment then the auditor has to qualify the report. But if the subject matter are highly material then the auditor has to issue an adverse report.
Effects of Qualifications in Audit Reports:
- As per the companies act the management is answerable to the auditors for the qualifications raised.
- The shareholders become suspicious about the integrity of the management.
- The market value of the share gets affected.

Manner of Qualifying the Report:
1) All qualifications should form part of the audit report.
2) The auditor should give full details regarding the qualifications and should provide the reasons regarding the qualifications.
3) If the auditor is not satisfied on one / two points he gives a qualified report on these points and then gives his usual report stating "subject to these qualifications, the accounts disclose true and fair view.
4) Effect of the qualifications on the profit / loss account should always be quantified.
5) The report should be brief and comprehensive.
6) There should be brevity in the report as far as possible.

7) If there is a disagreement between the auditor and the management / law than in addition to the opinion of the auditor the opinion of opinion of the management should also be indicated.
8) It is recommended that as far as possible the auditor should not issue any separate report to the shareholder. Shareholders do not appreciate a mass amount of data.
9) Vague statements, the effect of which upon the accounts is not ascertainable, should be avoided, e.g. debit balances are subjected to confirmations.
10) The auditor should not normally include the director's explanation in his report in respect of qualifications made by him.
11) The auditor is required to exercise proper judgment before forming an opinion.
12) It is better for the auditor to discuss the qualifications with the management before issuing the report with the company's management and make their view clear.

Examples of Qualifications: "In our opinion books of account has not been maintained as the cash book do not show the complete record of cash transactions. Subject to the above, we report that ………"

3. Disclaimer of opinion: Disclaimer Report is issued whenever auditor does not have sufficient information on hand to form an opinion on the "true and fair view" of the statement of affairs of the company. Here auditor abstains to report on a particular matter. For example: Some times books of accounts / any records are held by the I. Tax Department or Excise Department in such case the auditor is unable to verify those records which is held by Tax Departments. The auditor issues an opinion of disclaimer when:

- Absence of sufficient audit information / evidence.
- Limitations placed on the scope of audit.

Example on Disclaimer Report: "We have been unable to verify the relevant books of accounts as they were in the police custody. Hence we are unable to form an opinion on the balance sheet and profit and loss account to give a true and fair view of the state of affairs and working results".

4. Adverse or Negative Report: When the qualifications in the report are so serious that the auditor forms an opinion that the financial statements do not exhibit "true and fair view" of the statement of affairs of the company, then the auditor issues a negative report. The financial statements are completely distorted which are not reliable. The auditor issues a negative opinion:

- Disagreement with the management (Ex.: Disagreement with management regarding accounting policies / disclosures)
- The auditor is not satisfied with the financial statements as they do not exhibit "true and fair view" of the statement of affairs.

Example on Disclaimer Report: (paragraph of disagreement………..

1) The company has deferred borrowing costs of Rs. 40,000 which is not as per AS – 16.
2) The company has adopted LIFO method of stock valuation which is not allowed by AS-2………………….

"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 do not give a true and fair view of the state of affairs and working results".

AAS – 30 EXTERNAL CONFIRMATIONS

Q1) What is External Confirmations?
Ans.: Evidence, which originates outside the clients organization is External Evidence. Thus External Confirmation is one of the audit procedure applied by the auditor. A written information / confirmation provided by the outside party directly to the auditor. External Confirmations are part of auditor's substantive procedures.

Areas of External Confirmation:
Bank Balances, Customers Balances, Closing stock with consignees and other parties, Loan balances, Creditors balances, Investments confirmation from Depositories.

Q2) How External Confirmations reduces audit risks?
Ans.: External Confirmations are part of auditor's substantive procedures. We have seen in AAS – 6 that the assessed level of control risk and inherent risk would determine the nature, timing and extent of substantive procedures followed by the auditor to reduce his detection risk, which reduces the overall audit risk. External Confirmations is one of such substantive procedures applied by the auditor which reduces the audit risks. Auditor has to see that the evidence collected by the External Confirmations should reduce the risk to an acceptable level.
Factors to consider while obtaining External Confirmations:
- To what extent do external confirmations satisfy the objective collecting sufficient audit evidence?
- Materiality of the account balance.
- The assessed level of control risk and inherent risk by the auditor.
- If the external confirmations do not satisfy the objective collecting sufficient audit evidence that appropriateness of applying other audit procedures.

Q3) What are the assertions addressed by External Confirmations?
Ans.: External Confirmations provides external evidence which reduces the overall audit risks. Also an auditor should be very clear about the objective to be achieved by collecting the evidence through the external confirmations. For example: Objective may to have correct value of investments, which an auditor can get from the depository.
The auditor is concerned with the following assertions:
- *Existence* –That an asset or liability exists at a given date.
- *Rights and obligations*- that an asset is an asset of an entity and liability is an obligation at a given date.
- *Occurrence*- that a transaction took place which pertains to the entity.
- *Completeness*-that there are no unrecorded assets or liabilities or transactions.
- *Valuation*- that an asset or liability is recorded at an appropriate carrying value.
- *Measurement*- that a transaction is recorded at a proper amount and bifurcating between revenue or capital expense.
- *Presentation*- that an item is properly disclosed / classified using acceptable accounting policies.

Q4) What are the types of External Confirmations request?
Ans.: There are two types of external confirmations: (i) Positive Confirmations, (ii) Negative Confirmations.

Positive Confirmations	*Negative Confirmations*
1) Here the respondent replies the auditor either by an agreement with the confirmation requested or by providing additional / other information.	1) Here the respondent is required to reply only when there is disagreement with the confirmation requested.
2) A response towards positive confirmation provides reliable audit evidence.	2) A response towards negative confirmation provides less reliable audit evidence as compared to positive confirmation.
3) Other substantive procedures are not required to confirm positive confirmation.	3) Other substantive procedures are required to supplement negative confirmation.
4) Positive confirmation requests may be used to reduce audit risk when: - Account balances are large - Internal controls are weak	4) Negative confirmation requests may be used to reduce audit risk when: - Account balances are small but there are large number of accounts

- The auditor has reasons to believe that there may be a substantial number of accounts in dispute or inaccurate or irregular.	- Internal controls and risk is low - The auditor has reasons to believe that respondents will disregard these requests. - Number of errors is not expected.

A combination of positive and negative confirmations may be used depending on the judgement of the auditor.

If there is no response to positive confirmation:
If there is no response to positive confirmation then the auditor can try another request. If there is no response to the second or third request positive confirmation then the auditor is required to provide alternative audit procedures. The alternative audit procedures should be such that the information gained should be same as the auditor would get in positive confirmation.

Q5) What are the characteristics of Respondents?
Ans.: The evidence collected by the auditor as Confirmation should be highly reliable. The evidence provided by the respondent is affected by the respondent's competence, independence, authority, knowledge of the matter. The confirmation collected should provide appropriate audit evidence. For ex: If the confirmation is taken from a related party then there is a doubt about the reliability of the confirmation.

Q6) What is the process of Confirmation?
Ans.:

- *Before sending Confirmation:* Before performing confirmation proves the auditor has to choose the accounts for confirmation. He has to prepare the request for the confirmation. What an auditor has to do is to hand over the lists of confirmation accounts to the management. The management will prepare the requests for confirmation. The auditor should see that the requests for confirmation should be duly addressed and stamped. It is the auditor who has to send the request for the confirmation. It is requested that all replies and the undelivered confirmations are delivered directly to the auditor.
- *Timing of external confirmation:* It is generally called upon at the end of financial year. But in some cases the requests may even be called upon at a date other than the financial year ending. This happens in case the inherent and control risks are assessed at less than high. For a date of confirmation other than balance sheet date the auditor should take permission from the management. Where the auditor decides to request for confirmations as at the date other than the financial year end, the auditor would need to examine the movements in the concerned account (s) that occurred between the date of the confirmations and the date of the financial statements.
- *Designing the external confirmation request:* The auditor should design the request for confirmation so as to satisfy the audit objective. Following are the factors to be considered for designing the confirmation request:

- Form of the confirmation request.
- Prior experience on the audit or similar engagements.
- Nature of the information confirmed from the confirmation
- Effectiveness of the internal control system of the entity.
- Apparent disputes / inaccuracies / irregularities in the accounts.
- The amount of materiality involved.

- *Nature of the information confirmed from the confirmation:* Their can be various types of information an auditor can request from the third party. Therefore it is necessary to mention the nature of information being confirmed by the party. The confirmation will affect the audit evidence. The auditor is required to understand the transaction and the arrangements between client and the third party from whom confirmation is to be received. Understanding of the transactions and arrangements helps to determine the information to be confirmed.
- *Prior Experience:* The auditor gains the maximum information from his past experience. His past experience could have identified various mistakes, misstatements and irregularities regarding the information to be collected.
- *Reliability of responses received:* The auditor should consider only the reliable information collected. For ex: Confirmation received from a related party may not be reliable. As far as possible get the confirmations in writing and not orally. If the information is highly material then it should only in writing.

- *Evaluation of External Confirmation:* Auditor has to evaluate the results of external confirmation. He has to evaluate the results of external confirmation with the additional results obtained. The evidences provided by the external confirmation and additional procedures should be correlated to assess the bearing of such evidences on the assertions obtained. The evidences provided by the external confirmation and additional procedures should provide sufficient audit evidence regarding the financial statements being audited.
- *Management Request:* Where the management requests the auditor not to seek confirmation of certain account balances, the auditor should consider whether there are valid grounds for such a request. The auditor should ask the management to give the request in writing. For ex: A confirmation to a disputed creditor. If the auditor accepts the request of not seeking the confirmation then the auditor can apply alternative procedures to check the validity and accuracy of the account balance.

  Where the auditor does not accept the management's request and is prevented from carrying out the confirmations, this has to be viewed as a limitation on the scope. The auditor has to consider this in his audit report. An attitude of professional skepticism can guide the auditor in this matter. The auditor should also see that the request of the management does not indicate the existence of error or fraud.

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