COMMERCE HARBOUR'S

AUDIT PLANNING, STRATEGY AND EXECUTION

APPLICABLE FOR NOV 2022 EXAMS & ONWARDS

SELF STUDY NOTES FOR CA FINAL AUDIT

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PREFACE TO THIS EDITION

Author is glad and happy to present this comprehensive book to CA final students. This book will cater the needs of CA finalists registered under new course for Nov 2022 examinations & onwards.

We know that during CA preparation days, we used to probe over various author's books and extracted the best material and compile the same with main study material in order to have a single book for study. This not only saved my time to study from different book but also help us in revision during examinations.

With this thought in my mind, author started writing this book that will help the students in getting "best & exam-oriented material" at one place. The author has tried to compile entire syllabus and sure that after referring this book and with correct study strategies, student will students can pass examinations with flying colours.

PaS^{+} 1.0 book is an attempt to help students in making "audit" an easy going subject by providing the right study material and in better manner. Will soon be coming with 2 more books which will be complementary to this notes/book. Summary & MCQs….

Wishing you all the very best for your career ahead.

Develop a passion for learning. If you do, you will never cease to grow." – Anthony J. D'Angelo

सीखते रहो, बढ़ते रहो

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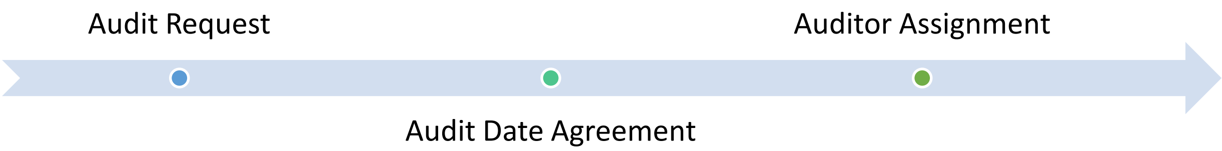
CHAPTER 1
AUDIT PLANNING, STRATEGY AND EXECUTION

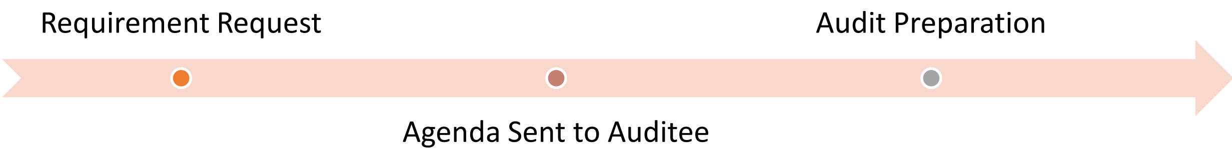
1.1 Meaning:

SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing" state that in order to achieve the overall objectives of the auditor, the auditor shall use the objectives stated in relevant SAs in planning & performing audit.

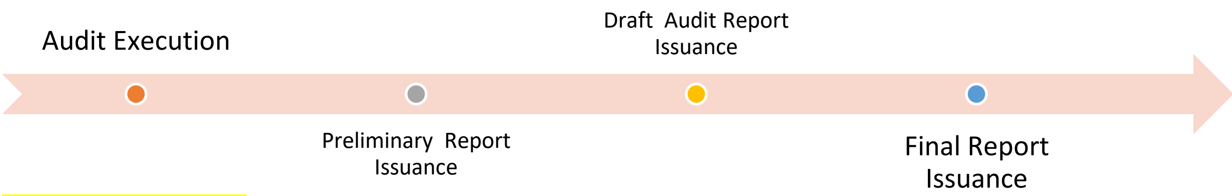
AUDIT PLANNING



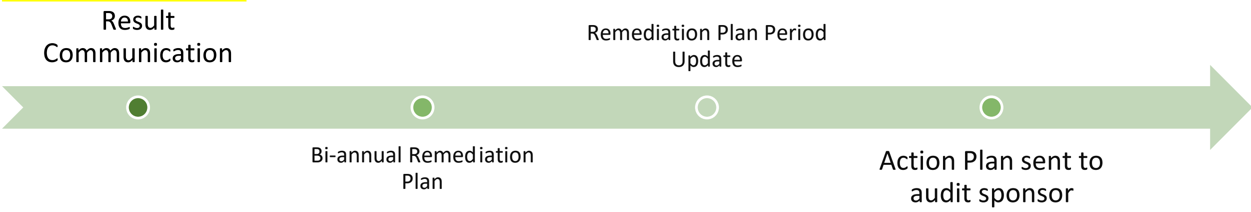
AUDIT PREPARATION



AUDIT EXECUTION



AUDIT FOLLOW UP



1.2 Benefit/advantages of planning and audit of financial statements:

Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways:

Code to remember: D.C. – P.A.S.T.

(i) Direction and Supervision of Engagement Team
(ii) Easy Coordination in work done by auditors of components and experts.
(iii) Proper Organisation and Management of Audit Engagement.
(iv) Attention to Important
(v) Proper Selection of Engagement Team
(vi) Timely resolution of Potential Problems

1.3 Nature and extent of Planning:

This aspect of planning depends on the following points:

- **Size and Complexity of the Auditee**: If the size and complexity of organization of which audit is to be conducted is large, then much more planning activities would be required as compared to an entity whose size and complexity is small
- **Past Experience & Expertise**: The key engagement team members' previous experience & expertise also contributes towards variation in planning activities.
- **Change in Circumstances**: Another factor contributing towards variation in planning activities is change in circumstances.

1.4 Planning – A continuous process:

Planning includes consideration of the timing of certain activities and audit procedures. It also involves Audit Programming. It often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Following matters required to be considered while planning:

- The analytical procedures to be applied as risk assessment procedures.
- Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
- The determination of materiality.
- The involvement of experts.
- The performance of other risk assessment procedures

1.5 Overall Audit Strategy and Audit Plan - Responsibility of the Auditor:

Overall audit strategy and the audit plan remain the auditor's responsibility. When discussing matters about the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit to be taken.

For Example - discussing the nature and timing of detailed audit procedures with management may result in ineffectiveness of the audit by making the same predictable. The engagement partner and other key members of the engagement team shall be involved in planning the audit. The involvement of the engagement partner and other key members of the engagement team in planning will enhance the effectiveness and efficiency of the planning process

1.6 Acceptance and continuance of client relationships and audit engagements:

Acceptance and Continuance of Client Relationships and Audit Engagements are very important preliminary engagement activities. The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed. **Below are the activities that need to be undertaken by auditors at beginning of current audit**.

1. Performing procedures required by SA 220, "Quality Control for an Audit of Financial Statements" regarding the continuance of the client relationship and the specific audit engagement.
2. Evaluating compliance with ethical requirements, including independence, as required by SA 220.
3. Establishing an understanding of the terms of the engagement as required by SA 210.

1.7 Content of Audit Plan:

The auditor shall develop an audit plan that shall include a description of-

- Nature, timing and extent of planned risk assessment.
  (SA315→Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment
- The nature, timing and extent of planned further audit procedures at the assertion level (SA330→The Auditor's Responses to Assessed Risks)
- Other planned audit procedures that are required to be carried out so that the engagement complies with SAs

1.8 Changes to planning decision:

The auditor shall update and change the overall strategy and audit plan as deem necessary by the auditors. Below are the reasons of changes made by auditor:

Overall Audit Strategy

2.1 Introduction:

The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

2.2 Factors while establishing overall strategy:

Code to Remember: C – O.P.E.N.

1. Characteristics determination of audit:
   - Identify the characteristics of the engagement that define its scope.

2. Objective Reporting:
   - Ascertain the reporting objectives of the engagement to plan timing of audit and nature of communication.

3. Preliminary Work:
   - Consider the results of preliminary engagement activities.
   - Whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant.

4. Efforts of team:
   - Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts.

5. Nature, timing and Extent of Resources:
   - Ascertain the nature, timing and extent of resources necessary to perform engagement.

2.3 Benefits of overall strategy:

Process of establishing the strategy helps auditors in following matters:

CODE TO REMEMBER : T.E.A.M.

{Being in a team is greatest benefit, hence benefit of audit strategy}

1. **Timing of deployment of resources:**
   - If business has proper audit strategy, then they will be well versed with the timing of deploying the resources.

2. **Employment of qualitative resources:**
   - This includes deployment of resources for specific audit areas.
   - For instance, use of appropriately experienced team members for high-risk areas or the involvement of experts on complex matters.

3. **Allocation of quantity of resources:**
   - This includes allocating the resources for specific audit areas.
   - For instance, number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high-risk areas.

4. **Management of resources:**
   - This includes how such resources are managed, directed and supervised.
   - For instance, when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place

2.4 Consideration in establishing the overall audit strategy:

There are various matters/factors that need to be considered while establishing overall audit strategy. These matters may also influence the auditor's detailed audit plan.

Characteristics of the Engagement
1. The financial reporting framework
2. Industry-specific reporting requirements.
3. The expected audit coverage
4. The nature of the control relationships between a parent and its components
5. The extent to which components are audited by other auditors
6. The entity's use of service organizations and how the auditor may obtain evidence.
7. The effect of information technology on the audit procedures.
8. The availability of client personnel and data.

Reporting Objectives, Timing of the Audit, and Nature of Communications:
1. Entity's timetable for reporting
2. Discussion with management regarding type & timing of reports to be issued.
3. Communication with auditors of components regarding types and timing of reports to be issued.
4. The nature and timing of communications among engagement team members.
5. The discussion with management regarding communications on the status of audit work.

Significant Factors, Preliminary Engagement Activities, and Knowledge Gained on Other Engagements
1. Determination of materiality in accordance with SA 320.
2. The impact of the assessed risk of material misstatement at the financial statement.
3. Results of previous audits including the identified deficiencies and action taken to address them
4. Volume of transactions which may determine reliance on internal control.
5. Significant business developments affecting the entity.
6. Significant industry developments.

Nature, Timing & extent of resources:
1. Selection of the engagement team and the assignment of audit work to the team members.
2. Engagement budgeting.

2.5 Documenting the audit plan:

The auditor should document the following→

(a) Overall audit strategy.

(b) The audit plans.

(c) Significant changes made to overall audit strategy or the audit plan and reason thereon such as:

- **Record of Key Decisions:**
  - Documentation of the overall audit strategy;
  - To properly plan the audit and to communicate significant matters to the engagement team.
- **Record of Nature, Timing and Extent of Risk Assessment Procedure:**
  - The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures.
  - It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance.
- **Record of reasons for Change in Audit Plans**
  - A record of the significant changes explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit.
  - It also reflects the appropriate response to the significant changes occurring during the audit.

2.6 Relationship between overall audit strategy and audit plan:

An audit strategy sets the direction, timing, and scope of an audit. The strategy is then used as a guideline when developing an audit plan. Hence audit strategy comes first and then audit plan. The audit strategy provides the guidelines for developing the audit plan. It establishes the scope and conducts of the audit procedures and thereby works as basis for developing a detailed audit plan.

CA. Sandeep has already developed an audit strategy for Ram Ltd. While a detailed audit plan is being developed, she decided that materiality levels set earlier need to be increased as weaknesses in the internal controls were highlighted in the internal audit report. Subsequently, a deviation from the audit strategy is felt necessary. Therefore, Sandeep would firstly modify the overall strategy and thereafter prepare the audit plan according to the strategy. This shows that the audit strategy and audit plan are closely inter-related as change in one is resulting into change in the other.

Audit Programme

3.1 Introduction:

An audit programme is commonly prepared to allocate work to team members that include the list of audit procedures and instructions to be followed by the member

3.2 Formulating an audit program:

The programme may contain audit objectives for each area and should have sufficient detail to serve as a set of instructions to the assistants involved in the audit and as a means to control the proper execution of work. **The important matters which need to be considered in this regard are:**

CODE TO REMEMBER : O – S.O.N.I.A.

1. **Overall Plan:**
   - Overall plan for the audit programme should be drawn up to ensure a systematic approach to the work.
   - In case of any divergence from overall audit plan, then first the overall plan should be modified after due consideration and thereafter only the matter may be taken in the audit programme.

2. **System of internal control and accounting procedures:**
   - The existence of a system of internal control ensures that both financial and statistical records are checked continuously.
   - The auditor, in framing his opinion on financial statements needs reasonable assurance that transactions are properly authorized and recorded in the accounting records.
   - The study and evaluation of internal control helps the auditor to establish the reliance he can place on the internal control.

3. **Organisation size and structure of its management:**
   - An increase in the size of the organization enhances the complexity of the examination of its accounting records.
   - It means bigger the size of an organisation, more planning required for conducting audit.

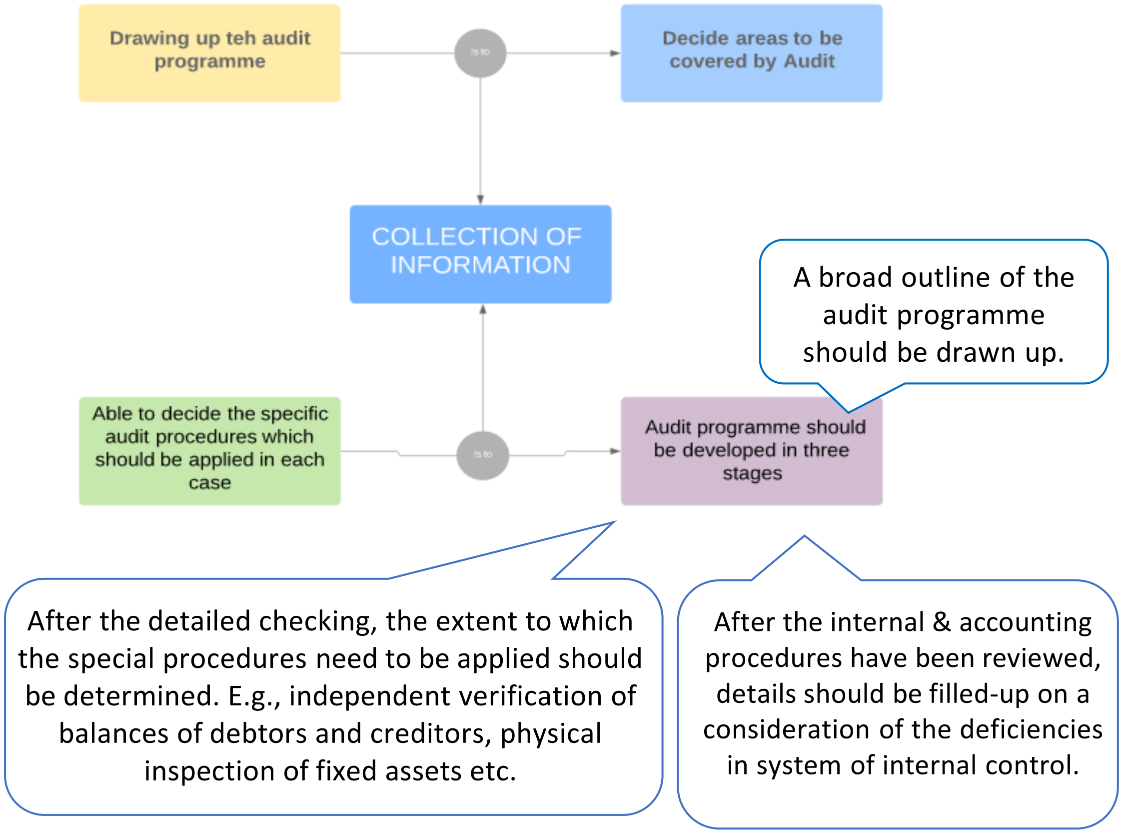
4. **Nature of business in which the organisation is engaged:**
   - On his first appointment, the auditor should examine in detail the financial and accounting organisation of the business.
   - This can be done by visiting the client's office; by observing different stages through which papers pass before each transaction is authorized and recorded.
   - In the case of an industrial concern, he must also visit the factory to acquaint himself with the different processes of manufacture.
   - Auditor, therefore, should draw up the programme of audit on a consideration of the technical, financial and accounting set-up of the company.

5. **Information as regards organisation of the business:**
   - To plan audit programme, it is necessary that the auditor should obtain from his client information i.e. history of client, business.
   - Purpose and nature of engagement and time schedule for the completion of audit.

6. **Accounting and management policies:**
   - The auditor should review the financial statements of the past several years, audited by his predecessors.
   - This would reveal a great deal of information regarding accounting and management policies which have been followed in the past and whether these have been employed consistently or not.

3.3 Formulating an audit program:

Below diagram depicts the way an auditor draws up an audit program:



At each subsequent engagement the programme should be reviewed and, if necessary, modified on account of:

(i) Experience gained during the previous audits;
(ii) Important changes that have taken place in the business specially in the system of internal control, accounting procedures /structure of management /scope of business; and
(iii) Evaluation of internal control made for the current year.

Audit Execution

4.1 Introduction:

<u>Execution Planning</u>:

- It is important to lay down the roadmap for audit execution to ensure timely and quality audit results.
- The auditors need to plan their work in order to carry out the audit in an effective, efficient and timely manner.
- A detailed audit program is prepared laying down the audit objectives, scope and audit approach.
- Manpower requirement, audit team qualifications, and the time element, etc. are some of the important considerations.

Risk and Control Evaluation

- Auditors should conduct a detailed risk and control assessment of each segment of business.
- Controls that exist for each risk associated with the segment; the work steps required to test the effectiveness of the controls etc.
- It is necessary to borne in mind materiality levels as the same is linked with Audit Risks.

Testing

- After gaining the required understanding of risks and related controls, the auditors should test the operating effectiveness of the controls to determine whether controls are operating as designed.
- There are multiple test methods which can be used to arrive at the conclusions on the effectiveness of the controls.

Reporting

- SA 700, "Forming an Opinion and Reporting on Financial Statements" establishes standards on the form and content of the auditor's report issued.
- The auditor should review and assess the conclusions drawn from the audit evidence obtained for the expression of an opinion on the financial statements.
- The review includes→Whether financial statements have been prepared in accordance with an acceptable financial reporting framework applicable to the entity under audit.
- The auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole.

4.2 Other Consideration:

There are certain other considerations which auditor is required to take care while executing the audit, which are given as under:

SA 600 - USING THE WORK OF ANOTHER AUDITOR

1. When auditor delegates work to assistants or uses work performed by other auditors & experts, he will continue to be responsible for forming and expressing his opinion on the financial information.
2. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill & care & is not aware of any reason to believe that he should not have so relied. In case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, such as in the case of the work of branch auditors appointed under the Companies Act the auditor's report should expressly state the fact of such reliance.
3. SA 600 does not deal with those instances where two or more auditors are appointed as joint auditors nor does it deal with the auditor's relationship with a predecessor auditor.

Principal Auditor	Other Auditor
• Auditor with responsibility for reporting on the financial information of an entity. • When that financial information includes the financial information of one or more components audited by another auditor.	• An Auditor, other than the principal auditor; • with responsibility for reporting on financial information of component which is included in the financial information audited by the principal auditor

Acceptance as principal auditor (M.A.R.D.)

- Materiality of the portion of the financial information which the principal auditor audits.
- Performance of Additional procedures as set out in this SA regarding the components audited by other auditor(s) resulting in principal auditor having significant participation in such audit.
- Risk of material misstatements in the financial information of the components audited by the other auditor(s); &
- Principal auditor's Degree of knowledge regarding the business of the components.

Principal Auditor's Procedure

- Right of Principal auditor to visit and examine books of accounts of a component.
- Principal auditor to consider the professional competence of other auditors.
  - 👉 Principal auditor shall consider the professional competency of other auditor in context of specific assignment if the other auditor is not a member of the ICAI.
- Procedures to be performed by principal auditor when using the work of other auditors.
  - 👉 Principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of other auditor is adequate for the principal auditor's purposes.
  - 👉 Procedures to be performed by Principal Auditor while using the work of other auditors-
    - Advise the other auditor regarding use of his (other auditor) work and report and make sufficient arrangements for co-ordination at the planning stage of the audit.
    - Advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.
- The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a questionnaire or check-list.
- Principal Auditor to document in his working papers – the components whose financial information audited by other auditors. The principal auditor should also document the procedures performed and the conclusions reached.

Co-ordination between auditors

- Principal auditor may find it necessary to issue written communication(s) to the other auditor.
- principal auditor should advise the other auditor of any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.
- The principal auditor may require the other auditor to answer a detailed questionnaire and the other auditor should respond to such questionnaire on a timely basis.

Reporting Considerations

- When the principal auditor concludes, based on his procedures that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion.
- In all circumstances, if the other auditor issues, or intends to issue, a modified auditor's report, the principal auditor should consider whether the subject of the modification is of such nature and significance, in relation to the financial information of the entity on which the principal auditor is reporting.

Division of Responsibility (Between principal & other auditor)

- The principal auditor would not be responsible in respect of the work entrusted to the other auditors, except in circumstances which should have aroused his suspicion about the reliability of the work performed by the other auditors.
- Principal auditor's report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity.

SPACE FOR IMPORTANT POINTS

SA 610 - USING THE WORK OF INTERNAL AUDITOR

Responsibility of external auditor	External auditor is responsible for forming the opinion on the financial statements of the company and it cannot be delegate for the reason that he uses the "work of internal auditor" to provide direct assistance on the engagement.
Definition of SA 610	defines the conditions that are necessary for the external auditor to be able to use the work of internal auditors. It also defines the necessary work effort to obtain sufficient appropriate evidence that is adequate for the purposes of the audit.
The objectives of the external auditor, where the entity has an internal audit function	(a) To determine whether the work of the internal audit function or direct assistance from internal auditors can be used. (b) f using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit. (c) If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.
Using work of internal auditor	**Whether the work of the internal audit function can be used for purposes of the audit** **YES** ▪ Extent to which IA function's organizational policies support objectivity of internal auditor. ▪ Competency level of internal audit function. ▪ Whether internal audit function applies a systematic & disciplined approach. **NO** ▪ Function's organizational status & policies don't support objectivity of internal auditor. ▪ Function lacks sufficient Competence. ▪ The function doesn't apply a systematic & disciplined approach.
Nature & extent of work of IA function	(a) The external auditor shall consider the nature and scope of the work performed by internal audit function. (b) The external auditor shall make all significant judgments in the audit engagement. (c) External auditor shall also evaluate whether using the work of internal audit function would still result in the external auditor being sufficiently involved in the audit. (d) External auditor shall discuss the planned use of its work with the function as a basis for coordinating their respective activities. (e) External auditor shall read the reports of the internal audit function relating to the work of the function
Direct Assistance	▪ **If Prohibited** - It is relevant for the principal auditors to consider whether the prohibition also extends to component auditors. ▪ **If not prohibited-** a. There are no significant threats to objectivity of internal auditor. b. Shall include inquiry of the internal auditors.

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<td>Determining the Nature and Extent of Work that Can Be Assigned to Internal Auditors Providing Direct Assistance (Internal auditor को क्या दिया जा सकता है?)

* Those Charged with Governance</td>
<td>Nature and Extent of Work that Can Be Assigned to Internal Auditors Providing Direct Assistance

Consideration to be kept in mind by the external auditor
1. Judgment magnitude.
2. Assessed risk of material misstatement.
3. Evaluation of existence & significance of threats.

The external auditor shall shall not use internal auditors to provide direct assistance to perform procedures that
1. Involves making significant judgements.
2. Relate to higher assessed risks of material misstatement where the judgement required is more than limited.
3. Relate to work which is reported to management or TCW* by Internal audit function
4. Relate to decisions the E.A. makes in accordance with SA.</td>
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<td>Factors to be considered while establishing the objectivity of Internal auditor's Code: S.A.F.E</td>
<td>1. Solidarity relationship (Family or personal) with individual working, to which work relates.
2. Association with the department or any person, to which work relates.
3. Financial interest in the entity other than renumeration.
4. Extent to which organization's policy is in line with the IA objectivity.</td>
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<td>Review of the work performed by internal auditor</td>
<td>The external auditor shall direct, supervise and review the work performed by internal auditors on the engagement in accordance with SA 220-
1. The nature, timing and extent of direction, supervision, and review shall recognize that the internal auditors are not independent of the entity; and

2. The review procedures shall include the external auditor checking back to the underlying audit evidence for some of the work performed by the internal auditors.</td>
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SPACE FOR IMPORTANT POINTS

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SA 620 - USING THE WORK OF AN AUDITOR'S EXPERT	
Scope	SA 620 deals with the auditor's responsibilities regarding the use of work in a field of expertise other than accounting or auditing when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence.
SA-620 does not deal with	• Situations where the engagement team includes a member with expertise in specialised area of accounting or auditing. (Auditor's Expert) • The auditor's use of the work of an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements (a management's expert), which is dealt with in SA 500. (Management Expert)
	Auditor's Expert – An individual/organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert. **Management's Expert** – An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.
Auditor's responsibility	• The auditor has sole responsibility for audit opinion expressed, and that responsibility is not reduced by auditor's use of the work of an auditor's expert. • Auditor may accept that expert's findings or conclusions in the expert's field as appropriate audit evidence, in case expert followed all applicable SAs.
Expertise in a field other than accounting or auditing!!! - The actuarial calculation of liabilities - The estimation of oil and gas reserves. - Interpretation of contracts, laws and regulations - Complex or unusual tax compliance issues. - The valuation of complex financial instruments, land and buildings, P&M etc.	
Need for an auditor's Expert Reduce P.A.I.N.S.	• Performing and designing audit procedures to respond to assessed risks at the assertion level, comprising tests of controls or substantive procedures. • Assessing and identifying the risks of material misstatement. • Implementing and determining overall responses to assessed risks at the financial statement level. • Nature and understanding of the entity and its environment, including its internal control. • Sufficiency and appropriateness evaluation of audit evidence obtained in forming an opinion on the financial statements.
Factors to be considered while using auditor's Expert Code: M.O.R.E.	• Is Management used a management's expert in preparing the financial statements • Obtaining the nature and significance of the matter, including its complexity • Risks of material misstatement in the matter. • Expected nature of procedures to respond to identified risks, including the auditor's knowledge of and experience with the work of experts

Management's expert	**Auditor need to consider the following while using management expert's work-** • Nature, scope and Objective of management's expert's work. • Extent to which management exercise control over management's expert's work. • Management's expert's competence and capabilities. • Management's expert is subject to technical performance standards or any other professional or industry requirements.
Nature, timing and extent of audit procedure Code: S. – N.E.A.R.	• The Significance of that expert's work in the context of the audit; • The Nature of the matter to which that expert's work relates; • The auditor's knowledge of & Experience with previous work performed by that expert; and • Whether that expert is subject to Auditor's firm's quality control policies. • Risks of material misstatement in the matter to which that expert's work relates;
Competence, capabilities & objectivity of auditor's Report	Auditor shall evaluate whether auditor's expert has- • **Necessary competence, capabilities and objectivity for auditor's purposes.** • **If there is auditor's external expert, inquiry regarding interests and relationships.** (Auditor के बाहरी विशेषज्ञ)
Evaluating the objectivity of an auditor's external expert	**Auditor shall evaluate auditor's external expert -** • If there is relation between external expert and entity that may affect objectivity. • If proper safeguard measures applied by the external expert to reduce the threats at an acceptable level.
Other matters	**Competency of the auditor's experts in respect of-** • **Its relevancy to the matter for which expert's work will be used.** • **Requirement of relevant accounting and auditing standards.** • **Reconsideration of initial assessment by expert due to change in condition or some unexpected events.**
Obtaining an understanding of field of expertise of auditor's expert	**Auditor shall obtain a sufficient understanding of the field of expertise of the auditor's expert to enable the auditor to-** • Determine scope, objectivity and nature of work (S.O.N) of expert's work for auditor's purposes. • Evaluate the adequacy of that work for the auditor's purposes. 
Agreement with auditor's expert	**Auditor shall agree, in writing when appropriate, on following matters with the auditor's expert -** • Scope, objectives and nature (S.O.N.) of expert's work. • Roles and responsibilities the of auditor and that expert. • Nature, extent and timing (N.E.T.) of communication between auditor and that expert, including the form of any report to be provided by that expert.
Evaluating the adequacy of the auditor's expert work	**The auditor shall evaluate the adequacy of the auditor's expert's work for auditor's work-** • Relevance & reasonableness of expert's findings or conclusions, and their consistency with other audit evidence. • If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances. • If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data.

When work of auditor's expert is not adequate for auditor's purpose	**When work of auditor's expert is not adequate, the auditor shall-** • Agree with that expert on nature and extent of further work to be performed; • Perform further audit procedures appropriate to the circumstances and it may be necessary to express a modified opinion in the auditor's report in accordance SA because the auditor has not obtained sufficient appropriate audit evidence.
Reference to auditor's expert in the auditor report	• Auditor shall not refer to work of an auditor's expert in an auditor's report containing an unmodified opinion unless required by law or regulation to do so. • If auditor makes reference to work of an auditor's expert in auditor's report because such reference is relevant to an understanding of a modification to the auditor's opinion, the auditor shall indicate in the auditor's report that such reference does not reduce the auditor's responsibility for that opinion.

Example 1

While doing audit, Ram, the auditor requires reports from experts for the purpose of Audit evidence. What types of reports/opinions he can obtain and to what extent he can rely upon the same?

Answer 1

Using the Work of an Auditor's Expert: As per SA 620, "Using the Work of an Auditor's Expert", during the audit, the auditor may seek to obtain, in conjunction with the client or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert. While doing audit, Ram, the auditor can obtain the following types of reports, or options or statements of an expert for the purpose of audit evidence-

1. The valuation of complex financial instruments, land and buildings, plant and machinery, jewellery, works of art, antiques, intangible assets, assets acquired and liabilities assumed in business combinations and assets that may have been impaired.
2. The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans.
3. The estimation of oil and gas reserves.
4. The valuation of environmental liabilities, and site clean-up costs.
5. The interpretation of contracts, laws and regulations.
6. The analysis of complex or unusual tax compliance issues

When the auditor intends to use the work of an expert:

- He shall evaluate the adequacy of the auditor's expert's work, including the relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence;
- If that expert's work involves use of significant assumptions & methods, relevance and reasonableness of those assumptions and methods in the circumstances; and
- If that expert's work involves the use of source data that is significant to his work, the relevance, completeness, and accuracy of that source data.
- If auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, he shall agree with that expert on the nature and extent of further work to be performed by that expert; or perform further audit procedures appropriate to the circumstances.

SA 540 – AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE ACCOUNTING ESTIMATES & RELATED DISCLOSURES

Scope

- SA 540 deals with auditor's responsibilities regarding accounting estimates, including fair value accounting estimates, **and**
- Related disclosures in an audit of financial statements.

Nature of Accounting estimates

Some financial statement items cannot be measured precisely, and can only be estimated. For purposes of this SA, such financial statement items are referred to as accounting estimates.

The information available to management for making of an accounting estimate varies widely → which affects the degree of estimation uncertainty → The degree of estimation uncertainty affects, in turn, the risks of material misstatement of accounting estimates.

Degree of estimate uncertainty

Below are the considerations to be kept in mind-

- Nature of accounting estimates.
- Extent to which generally accepted method used to make estimates, **and**
- Subjectivity of assumption uses to make estimates.

Below are situations where an entity is required to do the

Estimates

1. Allowance for doubtful accounts
2. Inventory obsolescence
3. Warranty obligations
4. Depreciation method or asset useful life.
5. Carrying amount of an investment where there is uncertainty regarding its recoverability.
6. Outcome of long-term contracts.

Fair value accounting estimates

1. Complex financial instruments
2. Share-based payments
3. Property or equipment held for disposal
4. Assets & liabilities acquired.
5. Transactions involving the exchange of assets or liabilities between parties without Monetary consideration.

Estimate involves judgement-

- Estimation involves judgments based on Information available when the financial statements are prepared.
- The auditor is not responsible for predicting future conditions, transactions or events that, if known at the time of the audit, might have significantly affected management's actions or the assumptions used by management.

Management Bias

Accounting estimates are imprecise and can be influenced by management judgment. Such judgment may involve unintentional/intentional management bias.

A difference between the outcome of an accounting estimate and the amount originally recognised or disclosed in the financial statements does not necessarily represent a misstatement of financial statements. This is particularly the case for fair value accounting estimates, as any observed outcome is affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of financial statements.

Definitions

Accounting Estimate-

This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation.

Management bias-

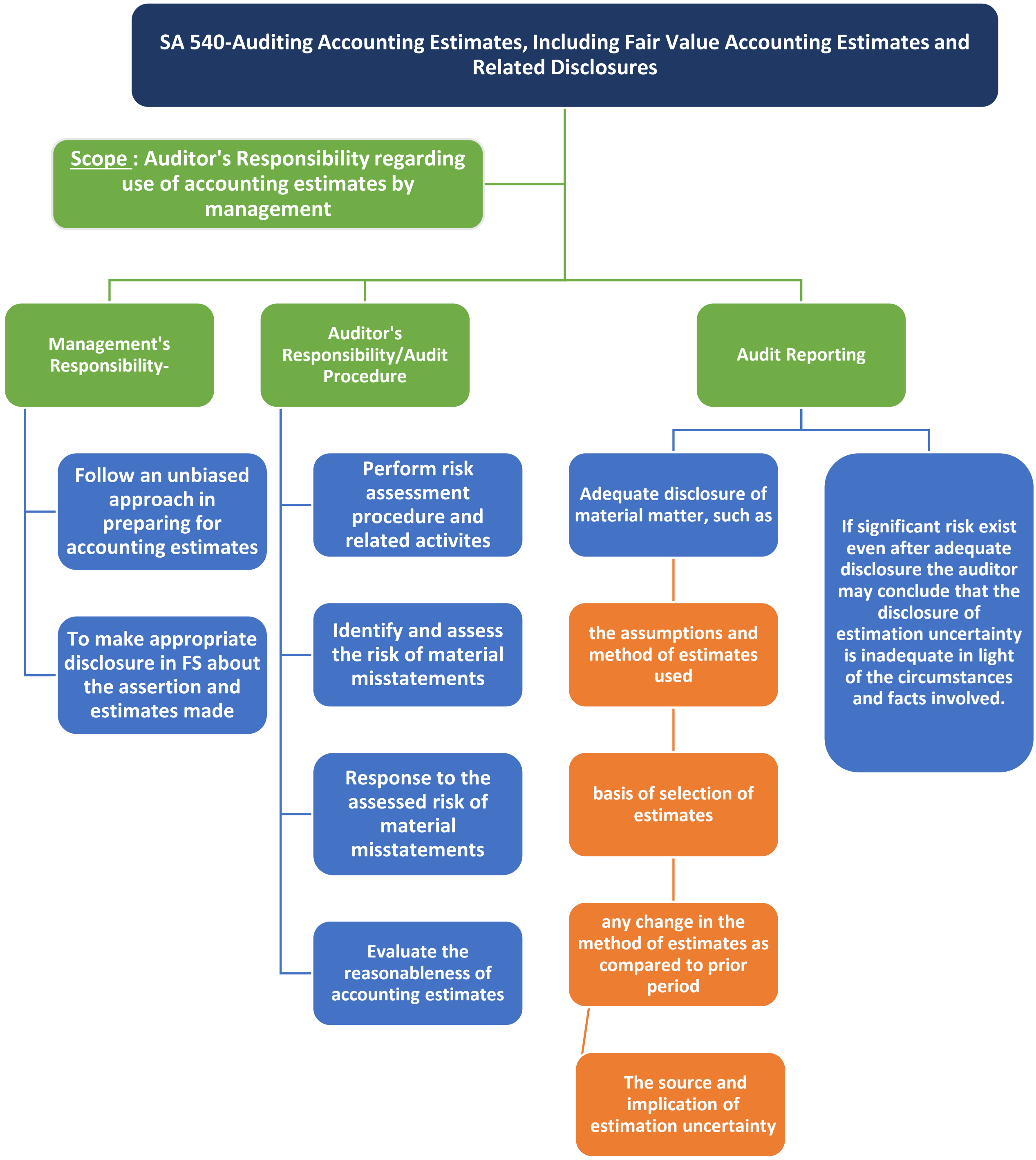
A lack of neutrality by management in the preparation and presentation of information.

	Management's point estimate- The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate. **Estimation uncertainty-** The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement. **Outcome of an accounting estimate -** The actual monetary amount which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by the accounting estimate.

Now we will study what is the role of auditor in accounting estimates done by an entity. Below is the broad outline of auditor's responsibilities and procedures-

Auditor's responsibilities & Audit procedures	**Risk Assessment Procedures and Related Activities for Accounting Estimates-** Auditor shall obtain an understanding of following in order to provide a basis for identification and assessment of the risks of material misstatement for accounting estimates- • Requirements of the applicable financial reporting framework relevant to estimates. • How management identifies those transactions, events that requires accounting estimates. • How management makes the accounting estimates – **the method, relevant controls, whether expert used, the assumptions, changes in the method etc.**
How management makes the accounting estimates + Auditor's role	Management's estimates include – method used in making estimates, relevant controls, expert involvement, assumptions used etc. The auditor shall review the outcome of- • Estimates used in financial statement of prior period. • It's subsequent re-estimation for the purpose of the current period. Auditor shall access that whether information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements.
Estimation Uncertainty + Auditor evaluation	**For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of SA 330, the auditor shall evaluate-** • Existence of alternative assumption, it's rejection reason and how management has otherwise addressed estimation uncertainty in making the accounting estimate. • Whether the significant assumptions used by management are reasonable. • Management's intent to carry out other courses of action and is it relevant to reasonableness of the significant assumptions used by management.
Responses to the Assessed Risks of Material Misstatement	**Based on assessed risk of material misstatement the auditor, shall determine-** • Whether management has appropriately applied applicable financial reporting framework. • Whether methods for making the accounting estimates are appropriate and have been applied consistently. • If there are changes in accounting estimates or in the method used for making those from prior period, are those appropriate in the present circumstances.

	In response to the assessed risk of material misstatement, the auditor shall undertake one or more of the following- • Whether events occurring up to the date of the auditor's report provide sufficient audit evidence regarding the accounting estimate. • Test checks implemented by management for making estimates. • Whether the assumptions are in line with the objective of applicable financial reporting. • Considering the source, relevance and reliability of external data. • Recalculating accounting estimate and reviewing information about an accounting estimate for internal consistency.
Evaluating the Reasonableness of accounting Estimates, & Determining Misstatements	The auditor shall evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework, or are misstated.
Audit Reporting and disclosure	The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework. **Preparation of Financial statement** 1. Assumption used. 2. Method of estimation. 3. Basis of selection of estimates. 4. Change in method of estimates. 5. Source & implication of estimate uncertainty. **Accounting Estimates** 1. Risk with accounting estimate. 2. Associated risk with estimate Uncertainty to be disclosed even if It is in line with applicable financial Reporting framework.


SA 540-Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures
Scope : Auditor's Responsibility regarding use of accounting estimates by management
Management's Responsibility-
Auditor's Responsibility/Audit Procedure
Audit Reporting
Follow an unbiased approach in preparing for accounting estimates
To make appropriate disclosure in FS about the assertion and estimates made
Perform risk assessment procedure and related activites
Identify and assess the risk of material misstatements
Response to the assessed risk of material misstatements
Evaluate the reasonableness of accounting estimates
Adequate disclosure of material matter, such as
the assumptions and method of estimates used
basis of selection of estimates
any change in the method of estimates as compared to prior period
The source and implication of estimation uncertainty
If significant risk exist even after adequate disclosure the auditor may conclude that the disclosure of estimation uncertainty is inadequate in light of the circumstances and facts involved.

IGNITE AND TEST YOUR BRAIN NERVES

Example 1

While auditing Z Ltd., you observe certain material financial statement assertions have been based on estimates made by the management. As the auditor how do you minimize the risk of material misstatements?

Solution 1

As per SA 540, the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatements for accounting estimates-

- Requirements of the applicable financial reporting framework relevant to estimates.
- How management identifies those transactions, events that requires accounting estimates.
- How management makes the accounting estimates – the method, relevant controls, whether expert used, the assumptions, changes in the method etc.
- Whether and, if so, how the management has assessed the effect of estimation uncertainty.

Example 2

KRP Ltd., at its annual general meeting, appointed Mr. X, Mr. Y and Mr. Z as joint auditors to conduct audit for the financial year 2020-21. For the valuation of gratuity scheme of the company, Mr. X, Mr. Y and Mr. Z wanted to refer their own known Actuaries. Due to difference of opinion, all the joint auditors consulted their respective Actuaries. Subsequently, major difference was found in the actuarial reports. However, Mr. X agreed to Mr. Y's actuary report, though, Mr. Z did not. Mr. X contends that Mr. Y's actuary report shall be considered in audit report due to majority of votes. Now, Mr. Z is in dilemma. Explain the responsibility of auditors, in case, report made by Mr. Y's actuary, later on, was found faulty?

Solution 2

SA 620 "Using the Work of an Auditor's Expert", the expertise of an expert may be required in actuarial calculation of liabilities, however, auditor has the sole responsibility for audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert. if the expert's work involves use of significant assumptions and methods, then the relevance and reasonableness of those assumptions and methods must be ensured by the auditor and if the expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data in the circumstances must be verified by the auditor.

In this case, Mr. X, Mr. Y and Mr. Z, jointly appointed as auditors of KRP Ltd., referred their own known Actuaries for valuation of gratuity scheme. **Actuaries are an auditor's expert as per SA 620.** Mr. Y's referred actuary has provided the gratuity valuation report, which later on was found faulty. Further, Mr. Z is not in agreement with this report, therefore, he submitted a separate audit report specifically for such gratuity valuation

In this case Mr. X and Mr, Y will be held responsible gross negligence and using such faulty report without examining the adequacy of expert actuary's work. Since, Mr. Z expressed a different opinion, he will not be liable. (Mr X and Mr Y not verified the source data).

Example 3

A & Co. was appointed as auditor of Great Airways Ltd. As the audit partner what factors shall be considered in the development of overall audit plan

Solution 3

Overall plan is basically intended to provide direction to audit work programming and includes the determination of timing, manpower development and co-ordination of work with the client, other auditors and other experts. The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit:

a) Terms of his engagement and any statutory responsibilities
b) Nature and timing of reports or other communications.
c) Applicable Legal or Statutory requirements.
d) Accounting policies adopted by the clients and changes, if any, in those policies.
e) The effects of new accounting and auditing pronouncement on the audit.
f) Identification of significant audit areas.
g) Setting of materiality levels for the audit purpose.
h) Conditions requiring special attention such as the possibility of material error or fraud or involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
i) Degree of reliance to be placed on the accounting system and internal control.
j) Possible rotation of emphasis on specific audit areas.
k) Nature and extent of audit evidence to be obtained.
l) Work of the internal auditors and the extent of reliance on their work, if any in the audit.
m) Involvement of other auditors in audit of subsidiaries or branches of client &
n) Allocation of works to be undertaken between joint auditors and the procedures for its control and review.
o) Establishing and coordinating staffing requirements

Example 4

AKJ Ltd is a small-sized 30 years old company having business of manufacturing of pipes. Company has a plant based out of Dehradun and have their corporate office in Delhi. Recently the company appointed new firm of Chartered Accountants as their statutory auditors.

The statutory auditors want to enter into an engagement letter with the company in respect of their services but the management has contended that since statutory audit is mandated by law, engagement letter may not be required. Auditors did not agree to this and shared a format of engagement letter with management for their reference before getting that signed. In this respect management would like to understand that as per SA 210 (auditing standard referred to by the auditors), if the agreed terms of the engagement shall be recorded in an engagement letter or other suitable form of written agreement, what should be included in audit engagement letter.

Solution 4

As per SA 210 'Agreeing the Terms of Audit Engagements', auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. The agreed terms of the audit engagement shall be recorded in an audit engagement letter and shall include-

a) Objective and scope of the audit of the financial statements.
b) Responsibilities of the auditor and the management.
c) Identification of applicable financial reporting framework for preparation of financial statements.

d) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

Example 5

A Pvt Ltd is engaged in the business of real estate. The auditor of the company requested the information from the management to review the outcome of accounting estimates (like estimated costs considered for percentage completion etc) included in the prior period financial statements and their subsequent re-estimation for the purpose of the current period. The management has refused the information to the auditor saying that the review of prior period information should not be done by the auditor. Please advise

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Solution 5

Auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re- estimation for the purpose of the current period. Auditor should also ensure that review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements.

The outcome of an accounting estimate will often differ from the accounting estimate recognised in the prior period financial statements. By performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may obtain:

- Information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process.
- Audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates.
- Audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.

Example 6

X Ltd had a net worth of INR 1300 crores because of which Ind AS became applicable to them. The company had various derivative contracts – options, forward contracts, interest rate swaps etc. which were required to be fair valued for which company got the fair valuation done through an external third party. The statutory auditors of the company involved an auditor's expert to audit valuation of derivatives. Auditor and auditor's expert were new to each other i.e., they were working for the first time together but developed a good bonding during the course of the audit. The auditor did not enter into any formal agreement with the auditor's expert. Please advise.

Answer 6

As per SA 620, Using the work of an Auditor's Expert, scope, objectives and nature of auditor's expert's work may vary considerably with circumstances, it is therefore required that these matters are agreed between the auditor & the auditor's expert. In certain situations, need for a detailed agreement in writing is required - Access to confidential information by auditor, matter to which the auditor's expert's work relates is highly complex, auditor has not previously used work performed by that expert, greater the extent of auditor's expert's work, & its significance in the context of the audit.

In the given case, considering the complexity involved in valuation & volume of derivatives & also due to the fact that the auditor and auditor's expert were new to each other, auditor should have signed a formal agreement/ engagement letter with the auditor's expert in respect of the work assigned to him.

Example 7

Cineplex, a movie theatre complex, is the foremost theatre located in Delhi. Along with the sale of tickets over the counter and online booking, the major proportion of income is from the cafe, shops, pubs etc. located in the complex. Its other income includes advertisements exhibited within/outside the premises such as hoardings, banners, slides, short films etc. The facility for parking of vehicles is also provided in the basement of the premises. Cineplex appointed your firm as the auditor of the entity. Being the head of the audit team, you are, therefore, required to draw an audit programme initially in respect of its revenue and expenditure considering the above-mentioned facts along with other relevant points relating to a complex

Solution 7

Audit Programme of Movie Theatre Complex-

- Peruse the Memorandum of Association and Articles of Association of the entity.
- Ensure the object clause permits the entity to engage in this type of business.
- In respect of ticket sale-
  (a) Verification of collection process and to check if all are accounted for accurately.
  (b) Verification of system of online booking of various shows and its realization & accounting.
  (c) Reconciliation between amount collected and number of seats available.
  (d) Verification of process of cancellation and its subsequent accounting.
- Income from cafe, shops, pubs etc - Verify the internal control system and its effectiveness.
- Income from parking - Verify the system of collection from the parking areas.
- Other considerations.
  (a) Verify the system of control exercised relating to the income receivable from advertisements exhibited within the premises.
  (b) Verify the system of payment of salaries and other benefits to the employees.
  (c) Verify the insurance premium paid and ensure it covers the entire assets.
  (d) Verify the payments effected in respect of the maintenance of the building.