

CA Final Audit Summary Notes Index

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CHAPTER 04

STANDARDS OF AUDITING

Brief about the Engagement and Quality Control StandardsTypes of Engagement Standards

Standards of Auditing (SA's) 200 -799	To be applied in the Audit of historical FS
Specialized Areas (SA's) 800 series	To be applied in the Audit of historical FS prepared using a special purpose FR framework
Standards on Review Engagements (SRE's) 2400 series	To be applied in the review of historical FS
Standards on Assurance Engagements (SAE's) 3400 series	To be applied in assurance engagements dealing with subject matters other than historical FS
Standards on Related Services (SRS's) SRS 4400 series	To be applied to engagements to apply agreed upon procedures to information and other related services engagements such as compilation engagements

Meaning Of Assurance Engagements

Assurance Engagement means: An Engagement in which-

practitioner express a conclusion which will enhance the degree of confidence of a third party, known as intended user.

Meaning Of Related Services

Sometimes, **a practitioner is engaged to assist for accounting and other skills**. For Example, compilation of Financial Statements where no assurance is required. It can be said that "any services given by a practitioner other than assurance services are related services".

Meaning of Review

"Review" is a limited assurance engagement. Limited assurance is the level of assurance obtained where engagement risk is reduced to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for expressing a conclusion.

Framework of Standards**Maha Mantras for Standards- Reporting & Important instances of Interlinking in Standards**

Situation	Auditor's Response
SAAE available- Auditor concludes misstatement is material and pervasive	Adverse Opinion as per SA 705
SAAE available- Auditor concludes misstatement is material but not pervasive	Qualified Opinion as per SA 705
Unable to obtain evidence	Qualified or Disclaimer as the case may be
In exam, student is able to conclude that misstatement exist but unable to ascertain the pervasiveness	Just mention that "Modify the opinion as per SA 705"
In exam, student gets confused and not able to conclude w.r.t opinion to be given	Use the following phrase in exam " The auditor shall consider the implications in his report and report accordingly"
When the Auditor is unable to perform Audit Procedure given in a particular SA	Perform Alternative Audit Procedure. If Alternative Procedure cannot be performed, Modify the opinion as per SA 705.
Risk of Material Misstatement increases due to discovery of Material Misstatement	Apply Further Audit Procedures
Internal Controls are not reliable	Perform more Substantive Audit Procedures, Report as per Section 143(3), Communicate to TCWG as per SA 265
Auditor is in dilemma- For example- whether to report to regulatory authority or no	Seek legal advise
When Auditor finds anything significant	Communicate to TCWG Consider implication in his report
When auditor is unable to continue engagement	Determine whether withdrawal is legally permissible. If legally permissible, determine whether there is any requirement to communicate to the regulatory authorities and the authorities appointing him.

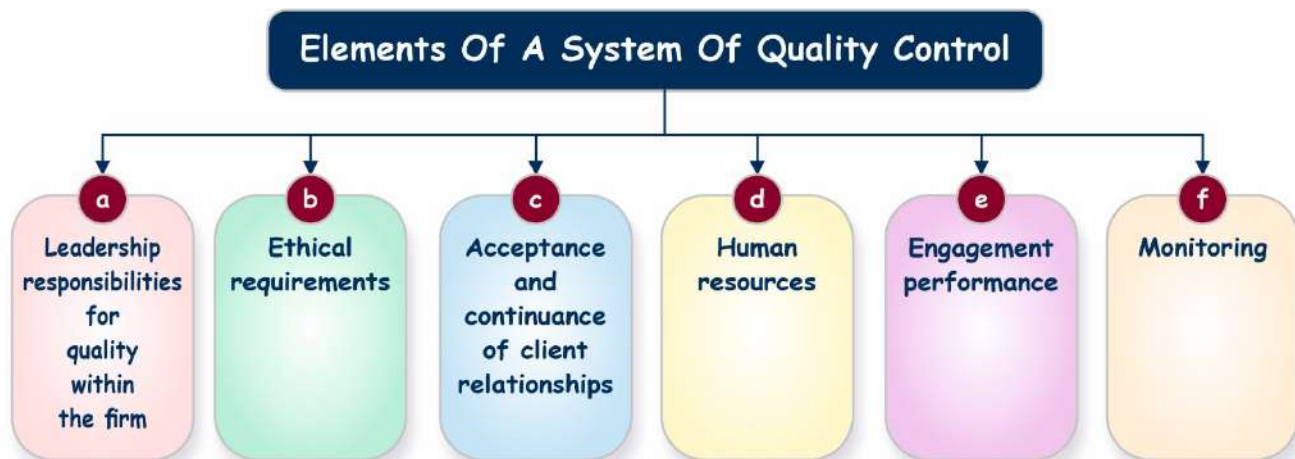
	As per Companies Act, practically he is required to report to ROC and Shareholders.
When Auditor discovers Fraud	Apply SA 240, 143(11), 143(12), SA 705 and Determine whether it is possible to continue.
When Auditor discovers misstatement	Apply SA 450, 260 and 705
When Auditor identifies ROMM	Apply SA 315, 330, 260, 450 and 705
When Auditor identifies undisclosed RPT	Apply SA 550, AS 18, SA 240, CARO 2020 and SA 705
When Auditor identifies subsequent events	Apply AS 4 and SA 560
When Auditor identify instances of noncompliance of laws and regulation	Apply SA 250 and SA 705
When Auditor identifies pending litigations	Apply 250, 560, 570, Section 143(3) and ensure whether provision for Contingent Liability is made as per AS 29/Ind AS 37.
When Auditor identifies a complex matter	Seek expert opinion
When Auditor identifies material uncertainties in going concern	Apply SA 570 and SA 701
Default in Statuary dues	SA 250 and CARO 2020

SQC – 1 “Quality Control for Firms That Perform Audits & Reviews Of Historical Financial Information, And Other Assurance & Related Services Engagements”

Objective - All firms to have system of quality control that provides reasonable assurance that:

- (a) Firm & personnel comply with professional standards, regulatory & legal requirements,
- (b) Reports issued by firm or partners are appropriate in the circumstances.

Elements Of A System Of Quality Control



The firm's system of quality control should include policies and procedures addressing each of the following elements:

(a) Leadership responsibilities for quality within the firm

Audit quality is paramount in all engagements. It is non-negotiable. Following considerations should be taken into account while upholding quality of the firm

- i. The firm assigns its **management responsibilities** so that commercial considerations do not override the quality of work performed.
- ii. The firm's policies and procedures **addressing performance evaluation, compensation, and promotion (including incentive systems)** with regard to its personnel are designed.
- iii. The firm devotes **sufficient resources** for the development, documentation and support of its quality control policies and procedures.
- iv. A firm before accepting an engagement should acquire vital information about the client like **integrity and competence**.

(b) Ethical requirements

Establish policies & procedures to reasonable assure that Firm & personnel comply with relevant ethical requirements of

1. Integrity. 2. Objectivity. 3. Professional competence & due care. 4. Confidentiality. 5. Professional behaviour.

Observance of "Independence" in all engagements is the founding requirement. The firm should establish policies and procedures designed to provide it with reasonable assurance that **the firm, its personnel and (including experts contracted by the firm and network firm personnel) maintain independence** where required by the Code. Such policies and procedures should enable the firm to-

- ❖ Communicate its independence requirements to personnel.
- ❖ Identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the engagement.

Note :

- ❖ At **least annually**, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent in terms of the requirements of the Code.
- ❖ SQC 1 lays special emphasis on familiarity threat. The familiarity threat is particularly relevant in the context of financial statement audits of listed entities. For these audits, the engagement partner should be rotated after a pre- defined period, **normally not more than seven years** (except in cases where audit of listed entities is conducted by a sole practitioner).

(c) Acceptance and continuance of client relationships

Auditor should also obtain necessary information before accepting the audit engagement. The information which assists the auditor in accepting and continuing of relationship with client are as follows:

- ❖ The integrity and competence of TCWG and management of the entity. { For example, if criminal cases etc are going on against the promoters, consider the same before acceptance}.
- ❖ Engagement team own's competence to perform the audit.
- ❖ Compliance with relevant ethical requirements by firm and the engagement team.
- ❖ Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

With regard to the integrity of a client, matters that the firm considers include, for example:

- ❖ The **identity and business reputation** of the client's principal owners, key management, related parties and those charged with its governance.
- ❖ The **nature of the client's operations**, including its business practices.

- ❖ Information concerning **the attitude** of the client's principal owners, key management and those charged with its governance towards such matters as **aggressive interpretation of accounting standards and the internal control environment**.
- ❖ Whether the client is aggressively concerned with maintaining **the firm's fees as low as possible**.
- ❖ Indications of an **inappropriate limitation in the scope of work**.
- ❖ Indications that the client might be involved in **money laundering or other criminal activities**.

In considering whether the firm has the capabilities, competence, time and resources to undertake an engagement, following matters have to be taken into consideration: -

- ❖ Firm personnel have **knowledge of relevant industries** or subject matters;
- ❖ Firm personnel have **experience with relevant regulatory or reporting requirements**, or the ability to gain the necessary skills and knowledge effectively;
- ❖ The firm has **sufficient personnel** with the necessary capabilities and competence;
- ❖ **Experts** are available, if needed;
- ❖ Individuals meeting the criteria and eligibility requirements to perform **engagement quality control review** are available, where applicable; and
- ❖ The firm would be able to complete the engagement within **the reporting deadline**.

(d) Human resources

The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles. Such policies and procedures should address relevant HR issues including **recruitment, compensation, training, career development, performance evaluation etc.**

(e) Engagement performance-

1. **Consultation-** The firm should establish policies and procedures designed to provide it with reasonable assurance that:
 - (i) Appropriate consultation takes place on difficult or contentious matters;
 - (ii) Sufficient resources are available to enable appropriate consultation to take place;
 - (iii) The nature and scope of such consultations are documented; and
 - (iv) Conclusions resulting from consultations are documented and implemented.
2. **Differences of opinion-** The firm should establish policies and procedures for dealing with and **resolving differences of opinion** within the engagement team, where applicable, between the engagement partner and the engagement quality control reviewer. The report should not be issued until the matter is resolved. **Conclusions reached should be documented and implemented.**
3. **Engagement Quality Control review-**
 1. The Engagement partner shall take responsibility for reviews being performed in accordance with the firm's review and procedures.
 2. **For audits of financial statements of listed entities, the Engagement partner shall**
 - Determine that an engagement quality control reviewer has been appointed.
 - Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer and
 - **Not date the auditor's report until the completion of the engagement quality control review.** {Further, SA 700 also requires Audit report to be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements}.

An engagement quality control review for audits of financial statements of listed entities includes considering the following:

- The engagement team's evaluation of the **firm's independence** in relation to the specific engagement.
- **Significant risks** identified during the engagement and the responses to those risks.
- Judgments made, particularly with respect to materiality and significant risks.
- Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations.
- The significance and disposition of corrected and uncorrected **misstatements** identified during the engagement.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.
- Whether **working papers selected for review** reflect the work performed in relation to the significant judgments and support the conclusions reached.
- The appropriateness of the report to be issued.

4. Engagement documentation -

- a) **Documentation wrt EQCR** - Policies and procedures on documentation of the engagement quality control review should require documentation that:
 - (i) The procedures required by the firm's policies on engagement quality control review have been performed;
 - (ii) **The engagement quality control review has been completed before the report is issued;** and
 - (iii) The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.
- b) **Completion of the Assembly of Final Engagement Files**- The firm should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been finalized. **In the case of an audit, for example, such a time limit is ordinarily not more than 60 days after the date of the auditor's report.**

Retention of Engagement Documentation

The firm should establish policies and procedures for the retention of engagement documentation for a period sufficient to meet the needs of the firm or as required by law or regulation. **In the specific case of audit engagements, the retention period ordinarily is no shorter than seven years from the date of the auditor's report, or if later, the date of group auditor's report.**

(f) Monitoring

Quality control of engagements has to be monitored taking into account following factors:

- ❖ Deciding whether quality control system of the firm has been **appropriately designed and effectively implemented.**
- ❖ Examining whether **new developments in the professional standards**, legal and regulatory requirements have been reflected in the quality control policies.
- ❖ Conducting **monitoring by entrusting responsibility** of monitoring process to a partner or other persons with sufficient and appropriate experience and authority in the firm.
- ❖ Dealing with **complaints and allegations against the firm or any employees** of it of non-compliance with professional standards or appropriate regulatory requirements by a person within or outside the firm.

- ❖ Taking **appropriate remedial actions** against the personnel who did not conform to quality control policies.
- ❖ **Taking action when deficiencies in the design or operation** of the firm's quality control policies and procedures, or non-compliance with the firm's system of quality control are identified

SA 200 "OVERALL OBJECTIVES OF THE INDEPENDENT AUDITOR & CONDUCT OF AN AUDIT IN ACCORDANCE WITH SAS"

Requirements of SA 200

- i. **Ethical Requirements Relating to an Audit of Financial Statements-** The auditor shall comply with relevant ethical requirements like Integrity, Objectivity, Professional competence & due care, Confidentiality, & Professional behaviour.
- ii. **Professional Skepticism- Professional skepticism means**
 1. Mental attitude of the auditor;
 2. Involving questioning mind;
 3. Alertness to possible misstatements due to fraud or error; { Alertness is requires w.r.t contradictory audit evidence, conditions indicating possible frauds etc}
 4. A critical assessment of audit evidence.

Professional Skepticism reduces risk of :

 - **Overlooking** unusual circumstances.
 - **Overgeneralizing** when drawing conclusions from audit observations.
 - **Using inappropriate assumptions** in determining N,T,E of audit procedure & evaluating the results thereof.
- iii. **Professional Judgment-** means the application of relevant **training, knowledge and experience** within the context of auditing, accounting and ethical standards in making informed decisions **about**
 - Nature, time and extent of audit procedures.
 - Materiality of Audit Risk.
 - Evaluation whether Sufficient and Appropriate Audit Evidence has been obtained.
 - Drawing conclusion based on audit evidence obtained.
 - The evaluation of management's judgments in applying the entity's applicable financial reporting framework.
- iv. **Sufficient Appropriate Audit Evidence -** To obtain reasonable assurance, the auditor shall obtain SAAE. If the auditor is unable to obtain SAAE to support his conclusions or unable to draw reasonable assurance, he should either give a **disclaimer of opinion or should withdraw from engagement if permitted by law.**
- v. **Complying with SAs Relevant to the Audit-** If he fails to comply with Standards of Auditing and fails to depart his attention to the departure, he will be guilty of professional misconduct.

Inherent Limitations for an audit {Because of inherent limitations auditor cannot give absolute assurance only give reasonable assurance and cannot reduce audit risk to zero}

The inherent limitations of an audit arise from:

1. **Nature of Financial Reporting**
 - Preparation of financial statements involves making many judgments by management involving subjective decisions or a degree of uncertainty.
 - Internal controls are designed by management and such controls may not have operated to produce reliable financial information due to their own limitations.

2. Nature of Audit Procedures

- There are **practical and legal limitations** on ability of auditor to obtain audit evidence. For example, an auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence
- Example of legal limitation may be - Auditor does not have powers of an investigating officer like search and seizure or Management may not provide complete information as requested by auditor.
- The nature of Audit Procedure is such that evidences that the Auditor obtains is **persuasive rather than conclusive**.
- Fraud may involve sophisticated and carefully organized schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting those misstatements.
- Audit is **not an official investigation** and auditor does not have powers like search and seizure.

3. Timeliness of Financial reporting and the Balance between Benefit and Cost

- The matter of difficulty, time or cost involved is not itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less persuasive.
- Relevance of information, and thereby its value, tends to diminish over time. So, it may happen that information being relied upon by auditor is not timely and may have lost its reliability.

Other Limitations {Certain assertions or subject matters where it is difficult to detect material misstatements due to potential effects of inherent limitations:} IMP

- **Frauds**, particularly fraud involving senior management or collusion.
- The existence and completeness of **related party relationships** and transactions.
- The occurrence of **non-compliance with laws and regulations**.
- Future events or conditions that may cause an entity to cease to continue as **going concern**.

Scope of Audit

- SA 200 also states that the management cannot restrict the scope of auditor's audit function.
- If scope is restricted or there is a threat to auditor's independence, communicate to TCWG as per SA. If scope is restricted, Auditor shall consider possibility of withdrawal if legally practicable. If withdrawal is not practicable, Give a **Qualified / Disclaimer of Opinion**.

In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- ❖ There are many laws and regulations, relating principally to the operating aspects of an entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.
- ❖ Non-compliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls or intentional misrepresentations being made to the auditor.
- ❖ Whether an act constitutes non-compliance is ultimately a matter for legal determination by a court of law.

SA 210 "AGREEING THE TERMS OF AUDIT ENGAGEMENT"

Initial Audit Engagement

Pre-conditions for Audit /Premise of Audit

1. Determine whether the **financial reporting framework***** is to be applied in the preparation of the financial statement is acceptable;
2. Obtain **Management Representation that it acknowledges its responsibility** regarding:-
 - (i) For the preparation of the financial statements in accordance with *the applicable* financial reporting framework.
 - (ii) For such **internal control** as management determines is necessary to enable the preparation of financial statements that are **free from material misstatement, whether due to fraud or error**; and
 - (iii) To provide the auditor with- access to BOA, additional information as needed , unrestricted access to persons within entity.

Contents of Engagement Letter (Important)

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

- (a) The objective and scope of the audit of the financial statements;
- (b) The responsibilities of the auditor;
- (c) The responsibilities of management;
- (d) Identification of the applicable **financial reporting framework** for the preparation of the financial statements; and
- (e) 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.

Recurring Audits

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

Procedure in case of Change in terms of audit engagement

1. When a client requests the auditor to change the terms of engagement, auditor should consider whether proposed changed terms of engagement will provide **lower level of assurance**.
2. If the proposed terms do convey a **lower level of assurance**, the auditor should not agree unless reasonable justification given by management.
3. **If reasonable justification not given by management**- Withdraw if legally permissible and also consider the need/ obligation to report the circumstances, which compelled him to withdraw, to board of directors or shareholders or related regulatory authority.

Circumstances that may warrant revision in terms of audit engagement

1. Change in **senior management**.
2. Change in Financial Reporting Framework (**FRF**).
3. Change in **reporting requirement**.
4. Significant change in **ownership**.
5. Significant change in **nature and size of entity**.
6. Revised **terms of audit engagement**.
7. **Misunderstanding** of scope and objective of the audit.
8. Change in **legal or regulatory requirements**.

Note :

FRF v/s Law-conflict-Discuss conflict with management. If additional requirement can't be met even by additional disclosure, modify audit report as per SA 705.

FRF prescribed by Law or Regulation - Other matters which affects acceptance

If auditor has determined that FRF prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation, auditor shall accept the audit engagement only if the following conditions are present-

- (a) Management agrees to provide **additional disclosures** in financial statements and
- (b) It is recognized in **terms of audit engagement** that:
 - (i) The auditor's report on F/S will incorporate **EOM para**, drawing user's attention to the additional disclosures, in accordance with **SA 706** and
 - (ii) The phrases "present fairly, in all material respects", or give a true and fair view" in accordance with applicable FRF, auditor's opinion on F/S will **not be used unless required by law**.

SA 220 "QUALITY CONTROL FOR AN AUDIT OF F.S."**Objective of this SA**

The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:

- (a) The audit complies with professional standards and regulatory and legal requirements; { Example, if reporting on CARO 2020 is not proper, SQC 1 and SA 220 is also violated}.
- (b) The auditor's report issued is appropriate in the circumstances.

Requirements of this SA / Factors that should be considered for incorporating quality control

1. **Leadership responsibility** - The **engagement partner (EP)** should be appointed, and he should take up the responsibility of overall quality control and to direct, review and supervise the work of his engagement team.
2. **Ethical Requirements** - same as SQC 1.
3. **Independence** - same as SQC 1.
4. **Acceptance and continuance of client relationship** - same as SQC 1
5. **Assignment of Engagement Team** - The engagement partner shall be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to:
 - Perform the audit engagement in accordance with professional standards and regulatory and legal requirements; and
 - Enable an auditor's report that is appropriate in the circumstances to be issued.
6. **Engagement Performance- (Refer SQC 1)**
7. **Monitoring** - Obtain reasonable assurance that firm's policies / procedures relating to QC are relevant, adequate, and operating effectively.

Note :

These quality control policies must be present at both the levels of audit: **FIRM LEVELS AUDIT & INDIVIDUAL LEVELS AUDIT**.

8. **Documentation -**

The engagement partner should document following matters pertaining to an audit engagement:

- Issues identified with respect to compliance** with relevant ethical requirements and how they were resolved.
- Conclusions on compliance with independence requirements** that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.
- Conclusions reached regarding the acceptance and continuance of client** relationships and audit engagements.
- The **nature and scope of, and conclusions resulting from**, consultations undertaken during the course of the audit engagement.

Besides, the engagement quality control reviewer shall document, for the audit engagement reviewed, that:

- The **procedures** required by the firm's policies on engagement quality control review have been performed.
- The EQCR has been completed on or before the date of the auditor's report.
- The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

SQC 1 VS. SA 220- KEY DIFFERENCES IN NATURE, SCOPE AND APPLICABILITY

S.N.	SQC 1	SA 220
1	It applies to entire firm and fixes the responsibility of firm to be assumed by CEO or managing partners.	It applies to a particular audit engagement and engagement partner takes responsibility of the same.
2	It is applicable to audits, reviews of historical financial information, and other assurance and related services engagements.	It is applicable to audit engagements only.
3	It relates to setting up of a quality control system consisting of policies and procedures for firm as a whole.	It deals with responsibilities of engagement teams to implement quality control procedures that are applicable to audit engagements.
4	It pertains to establishing a system of quality control designed to provide firm with a reasonable assurance that a firm and its personnel comply with professional standards and regulatory and legal requirements so that reports issued by firm or engagement partners are appropriate in circumstances.	It is premised on the basis that firm is subject to SQC 1 . Therefore, SQC 1 is a sine qua non for applicability of SA 220. It is within overall context of a firm's system of quality control, engagement teams implement quality control procedures applicable to audit engagements.

SA 230 "AUDIT DOCUMENTATION"

Important Note (Retention Period) and Assembly of working papers time given in SQC 1 read with SA 230

Which matters are to be documented?

- ❖ Nature, Time and Extent of Audit Procedures to comply with laws.
- ❖ Results of Audit Procedures performed and audit evidences collected.

- ❖ Significant matters arising during audit.
- ❖ Discussion of matters with TCWG.
- ❖ Reasons for discarding/modifying/deleting working papers after 7 years.
- ❖ Sometimes some SA's require mandatory documentation

Factors affecting form, contents and extent of audit documentation

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

Ownership of Documentation

1. The principal auditor of an enterprise does not have the right to access to the audit working papers of the branch auditors. {He can only refer report of branch auditor as per Section 143(8).}
2. Working papers may contain some vital information of the client. Hence, Auditor cannot share the working papers to any 3rd party, unless it is a requirement of law. { Reason-Confidentiality}.
3. Can the auditor provide the access of his working papers to client?

As per SA 230 read with SQC 1, **Audit documentation is the property of the auditor**. He may at his discretion, make portions or extracts of audit documentation available to the clients, provided such disclosure does not undermine validity of work performed, or in case of assurance engagements, the independence of auditor and his personnel.

DOCUMENTATION

The auditor shall document:

- ❖ The circumstances encountered;
- ❖ Additional procedures performed;
- ❖ Audit evidences obtained; and
- ❖ Conclusions reached thereon and their effect on audit report.

Examples of Documentation of Professional Judgements made, where significant and serves to explain the Auditor's conclusion and to reinforce the quality of the judgement.

- ❖ Matters that give rise to significant risks.
- ❖ Results of audit procedures indicating
 - That the financial statements could be materially misstated, or
 - A need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
- ❖ Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- ❖ Findings that could result in a modification to the auditor's opinion or the inclusion of an EOM in the auditor's report.

SA 240 "THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS"

1. Meaning of Fraud and its Characteristics

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

Although fraud is a broad legal concept, the auditor is concerned with fraud that causes a material misstatement in the financial statements.

❖ Two types of intentional misstatements are relevant to the auditor :

- Misstatements resulting from **fraudulent financial reporting**
- Misstatements resulting from **misappropriation of assets**

2. Fraudulent financial reporting

2.1 Fraudulent financial reporting may be accomplished by the following:

- (i) **Manipulation of Accounts:** Detection of manipulation of accounts with a view to presenting a false state of affairs is a task requiring great tact and intelligence because generally management personnel in higher management cadre are associated with this type of fraud and this is perpetrated in methodical way. This type of fraud is generally committed:
 - (a) to avoid **incidence of income-tax** or other taxes;
 - (b) for **declaring a dividend** when there are insufficient profits;
 - (c) to **withhold declaration of dividend** even when there is adequate profit (this is often done to manipulate the value of shares in stock market to make it possible for selected persons to acquire shares at a lower cost); and
 - (d) for **receiving higher remuneration** where managerial remuneration is payable by reference to profits.
- (ii) **Misrepresentation in or intentional omission** from, the financial statements of events, transactions or other significant information.
- (iii) **Intentional misapplication of accounting principles** relating to amounts, classification, manner of presentation, or disclosure.

2.2 Techniques of committing fraud by management overriding controls.

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

3. Misappropriation of assets can be accomplished in a variety of ways including:

- ❖ **Embezzling receipts.** (For example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).
- ❖ **Stealing physical assets or intellectual property.** (For example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).

- ❖ **Causing an entity to pay for goods and services not received.** (For example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).
- ❖ **Using an entity's assets for personal use.** (For example, using the entity's assets as collateral for a personal loan or loan to a related party).

3.1 Defalcation of Cash

- ❖ This can be done by
 - **Inflating** Cash Payments
 - **Suppressing** Cash Receipts
 - **Casting** wrong totals in Cash Book.
- ❖ By Inflating Cash Payments
 - Making payments against **fictitious vouchers**.
 - Making payments against vouchers, the amounts whereof have been inflated.
 - **Manipulating totals** of wage rolls either by including therein names of dummy workers or by inflating them in any other manner.
- ❖ Suppressing Cash Receipts
 - **Teeming and Lading** Fraud
 - **Writing off good debt** as bad debt and misappropriating the amount.
 - Not accounting for cash sales fully.
 - Not accounting for miscellaneous receipts, e.g., sale of scrap, quarters allotted to the employees, etc.
 - Writing down asset values in entirety, selling them subsequently and misappropriating the proceeds.
 - Adjusting unauthorised or fictitious rebates, allowances, discounts, etc. to customer's accounts and misappropriating amount paid by them.

4. Fraud Risk Factors

Fraud risk factors are events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud. Broadly, there are 3 Fraud Risk Factors arising from Fraudulent Financial Reporting or Misappropriation of Assets :

- ❖ **Incentive/Pressure**- management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome/individuals have an incentive to misappropriate assets.
- ❖ **Opportunity** - A perceived opportunity to commit fraud may exist when an individual believes **internal control can be overridden**, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.
- ❖ **Attitude/Rationalization**- Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act.

Examples of fraud risk factors: Following are examples of fraud risk factors relating to misstatements arising from fraudulent financial reporting and from misappropriation of assets respectively

(A) Risk factors relating to misstatements arising from fraudulent financial reporting

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

Incentives/Pressures

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

- (a) **High degree of competition** or market saturation, accompanied by declining margins
- (b) **High vulnerability to rapid changes**, such as changes in technology, production, obsolescence, or interest rates.
- (c) **Significant declines in customer demand** and increasing business failures in either industry or overall economy.
- (d) **Operating losses** making the threat of bankruptcy, foreclosure, hostile takeover imminent.
- (e) **Recurring negative cash flows** from operations or an inability to generate cash flow from operations while reporting earnings and earnings growth.
- (f) **Rapid growth or unusual profitability** especially compared to that of other companies the same industry.
- (g) **New accounting, statutory, or regulatory requirements.**

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

- (i) **Profitability or trend level expectations** of investment analysts, institutional investors, significant creditors, or other external parties.
- (ii) Need to **obtain additional debt or equity financing to stay competitive**— including financing of major research and development or capital expenditures.
- (iii) **Marginal ability to meet exchange listing requirements** or debt repayment or other debt covenant requirements.
- (iv) **Perceived or real adverse effects** of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.

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

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

Opportunities

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

- (i) **Significant related-party transactions** not in the ordinary course of business or with related entities not audited or audited by another firm.
- (ii) A **strong financial presence** or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions.
- (iii) Assets, liabilities, revenues, or expenses based on significant estimates that involve **subjective judgments or uncertainties** that are difficult to corroborate.
- (iv) **Significant, unusual, or highly complex transactions**, especially those close to period end that pose difficult "substance over form" questions.

Attitudes/Rationalizations

- ❖ Communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective.
- ❖ **Non-financial management's excessive participation** in or preoccupation with the selection of accounting policies or the determination of significant estimates.
- ❖ **Known history of violations of securities laws or other laws and regulations**, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations.
- ❖ Excessive interest by management in **maintaining or increasing the entity's stock price or earnings trend**.
- ❖ The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.
- ❖ Management failing to remedy known **significant deficiencies in internal control** on a timely basis.
- ❖ An interest by management in **employing inappropriate means to minimize reported earnings** for tax-motivated reasons.
- ❖ **Low morale** among senior management.
- ❖ The owner-manager makes no distinction between personal and business transactions.
- ❖ **Dispute between shareholders** in a closely held entity.
- ❖ Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
- ❖ **The relationship between management and the current or predecessor auditor is strained, as exhibited by the following: -**
 - **Frequent disputes with the current or predecessor auditor** on accounting, auditing, or reporting matters.
 - **Unreasonable demands on the auditor**, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report.
 - **Restrictions on the auditor** that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.
 - **Domineering management behaviour** in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

(B) Risk factors relating to misstatements arising from misappropriation of assets.**Incentives/Pressures**

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

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

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

Opportunities

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

- (a) Large amounts of cash on hand or processed.

- (b) Inventory items that are small in size, of high value, or in high demand.
- (c) Easily convertible assets, such as bearer bonds, diamonds, or computer chips.
- (d) Fixed assets which are small in size, marketable, or lacking observable identification of ownership.

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

- (a) **Inadequate segregation of duties or independent checks.**
- (b) **Inadequate oversight of senior management expenditures**, such as travel and other reimbursements.
- (c) **Inadequate management oversight** of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations.
- (d) **Inadequate job applicant** screening of employees with access to assets.
- (e) **Inadequate record keeping** with respect to assets.
- (f) **Inadequate system of authorization** and approval of transactions (for example, in purchasing).
- (g) **Inadequate physical safeguards** over cash, investments, inventory, or fixed assets.
- (h) Lack of complete and **timely reconciliations of assets.**

Attitudes/Rationalizations

- (a) Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
- (b) Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.
- (c) Behaviour indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
- (d) Changes in behaviour or lifestyle that may indicate assets have been misappropriated.
- (e) Tolerance of petty theft.

5. Circumstances Relating to Possibility of Fraud/ Conditions or events which increases risk of fraud or error

1. **Discrepancies in Accounting Records:** arises due to improper recording, unauthorised transactions, last minute adjustments.
2. **Conflicting or missing evidences:** missing documents, altered documents, non-availability of original documents, unexplained items, Missing inventory/physical assets. etc.
3. **Unusual relationship between auditor & management:** undue time pressure, unusual delay in providing info, unwillingness to address weaknesses in IC, Denial of access to key files/IT operation.
4. **Others:** Management not allowing auditor to meet with TCWG, varied accounting policies, frequent changes in accounting estimate.

6. Scope of this SA 240

This Standard on Auditing (SA) deals with the auditor's responsibilities relating to fraud in an audit of financial statements.

- a) In accordance with SA 315, auditor should identify and assess risks of material misstatement due to fraud at the financial statement level, and at assertion level for classes of transactions, account balances and disclosures.
- b) In accordance with SA 330, the auditor should determine overall responses to address the assessed risk of material misstatement due to fraud at financial statement level.
- c) Perform Risk Assessment Procedures, & General understanding of its entity, its environment and Internal Control System as per SA 315.

7. Objectives

The objectives of the auditor are:

- ❖ To identify and assess the risks of material misstatement in the financial statements due to fraud;
- ❖ To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
- ❖ To respond appropriately to identified or suspected fraud.

8. Auditor's Responsibilities relating to fraud in an audit of Financial Statement.

1. Obtaining Reasonable Assurance that financial statements taken as a whole are free from material misstatement, whether due to fraud or error.
2. Maintain Professional Skepticism throughout the audit.
3. Obtain Written Representation from the Management that Management is responsible for the design, implementation and maintenance of internal control to prevent and detect fraud.
4. As per SA 200, due to inherent limitations of an audit, there is **an unavoidable risk** that some material misstatement of financial statement will not be detected, even though the audit is properly planned and performed in accordance with SA's.
5. Risk of not detecting a material misstatement resulting Management fraud is greater than Employee fraud, because management can easily manipulate accounting records because management is in a unique position to penetrate fraud because of Management's ability to manipulate accounting records & prepare financial statements by overriding controls.
6. Perform Risk Assessment Procedures
 - a) Enquiry of Management regarding management's assessment of the risk of material misstatement due to fraud.
 - b) Enquiry of Those Charged with Governance whether they have knowledge of fraud affecting the entity.
 - c) Evaluation of fraud risk factor.
 - d) Evaluation of identified unusual & unexpected relationship.
7. Consider impact of fraud on financial statement.
8. Consider reliability of WR if management fraud found.
9. Communicate to chairman, Board of Directors.

Point to Remember :

The liability of the auditor for failure to detect fraud exists only when such failure is clearly due to not exercising reasonable care and skill. If after the completion of the statutory audit, if a fraud has been detected, the same by itself cannot mean that the auditor did not perform his duty properly. If the auditor can prove with the help of his papers (documentation) that he has followed adequate procedures necessary for the proper conduct of an audit, he cannot be held responsible for the same. If however, the same cannot be proved, he would be held responsible.

9. Why evaluation of fraud risk factors by auditor is necessary?

- i. The auditor shall evaluate whether one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and **therefore may indicate risks of material misstatement due to fraud.**
- ii. The fact that fraud is **usually concealed** can make it very **difficult to detect**. Nevertheless, the auditor may identify **fraud risk factors**.

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

10. Responses to the assessed risks of material misstatement due to fraud at the financial statement level

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

- (a) **Assign and supervise personnel** taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of **the risks of material misstatement** due to fraud for the engagement;
- (b) Evaluate **whether the selection and application of accounting policies** by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from **management's effort to manage earnings**; and
- (c) **Incorporate an element of unpredictability** in the selection of the **nature, timing and extent of audit procedures.**

11. Responses to the assessed risks of material misstatement due to fraud at the assertion level

- a) The auditor shall design and perform further audit procedures whose **nature, timing and extent** are responsive to the assessed risks of material misstatement due to fraud at the assertion level.
- b) In doing so, **the auditor may change nature, timing and extent of audit procedures** to obtain audit evidence that is **more reliable and relevant** or to obtain additional **corroborative information.**

For example, if the auditor identifies **that management is under pressure to meet earnings expectations**, there may be a related risk that management is inflating sales by entering into sales agreements that include terms that preclude revenue recognition or by invoicing sales before delivery. In these circumstances, the auditor may, for example, **design external confirmations not only to confirm outstanding amounts, but also to confirm the details of the sales agreements**, including date, any rights of return and delivery terms.

In addition, the auditor might find it effective to **supplement such external confirmations with inquiries of non-financial personnel** in the entity regarding any changes in sales agreements and delivery terms.

12. Audit Procedures Responsive to Risks Related to Management Override of Controls

- ❖ **Management is in a unique position to perpetrate fraud because of its ability to manipulate A/C records** and prepare fraudulent F.S. by overriding controls that otherwise appear to be operating effectively. Due to unpredictable way in which such override could occur, it is a ROMM due to fraud and thus a significant risk.
- ❖ Irrespective of auditor's assessment of risks of management override of controls, auditor shall design and perform audit procedures to:
 - a) **Test appropriateness of journal entries** recorded in general ledger and other adjustments in F.S.
 - b) **Review accounting estimates for biases** and evaluate whether circumstances producing bias represent ROMM due to fraud.
 - c) For significant transactions outside normal course of business or appear to be unusual evaluate whether **business rationale of transactions** suggests that they have been entered to engage in fraudulent financial reporting or conceal misappropriation of assets.

13. Communications to Management and with Those Charged with Governance

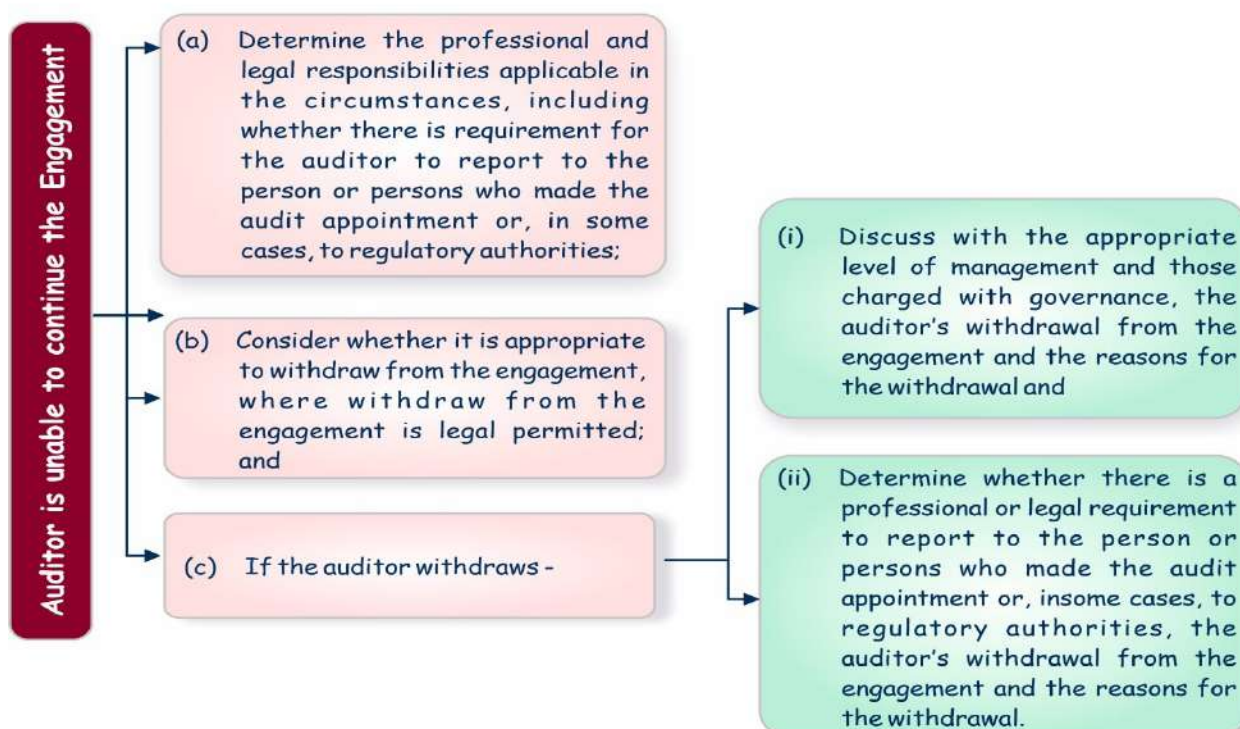
- i. If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters **on a timely basis** to the appropriate level of management in order to **inform those with primary responsibility** for the prevention and detection of fraud of matters relevant to their responsibilities.
- ii. Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving management, employees who have significant roles in internal control or others where the fraud results in a material misstatement in the financial statements, the auditor shall communicate these matters to those charged with governance on a timely basis.
- iii. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them **the nature, timing and extent of audit procedures** necessary to complete the audit.
- iv. The auditor shall communicate with those charged with governance any other matters related to fraud that are, in the auditor's judgment, relevant to their responsibilities.

14. Communications to Regulatory and Enforcement Authorities

- If the auditor has identified or suspects a fraud, the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances. Also, in some entities the auditor may have a duty to report misstatements to authorities in those cases where management and those charged with governance **fail to take corrective action**.

15. Circumstances in which auditor is unable to continue the engagement

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



SA 250 "CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS"

Objectives of auditor in accordance with SA 250

The objectives of the auditor in accordance with SA 250 are :

- (a) To **obtain sufficient appropriate audit evidence** regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements;
- (b) To perform specified audit procedures to help identify **instances of non-compliance** with other laws and regulations that may have a material effect on the financial statements; and
- (c) To **respond appropriately to non-compliance or suspected non-compliance** with laws and regulations identified during the audit.

Responsibility of the Management

Compliance of Laws & Regulations is duty of Mgt & TCWG. Examples of the types of policies and procedures Management may implement to assist in the prevention and detection of non-compliance with laws and regulations:

- i. **Monitoring legal requirements** and ensuring that operating procedures are designed to meet these requirements.
- ii. **Instituting and operating** appropriate systems of **internal control**.
- iii. Developing, publicizing and following a **code of conduct**.
- iv. Ensuring employees are properly trained and understand the code of conduct. **Monitoring compliance** with the code of conduct and acting appropriately to discipline employees who fail to comply with it.
- v. **Engaging legal advisors** to assist in monitoring legal requirements.
- vi. Maintaining a **register of significant laws** and regulations with which the entity has to comply within its particular industry and a record of complaints.

Responsibility of the Auditor

1. The auditor is responsible for obtaining **reasonable assurance that the financial statements, taken as a whole, are free from material misstatement**, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework.
2. This SA distinguishes the auditor's responsibility in relation to compliance with two different categories of laws and regulations:
 - Provision of those laws and regulations generally recognized **to have a direct effect on the determination of material amounts** and disclosures in the financial statements such as tax and labour laws. The auditor should obtain **Sufficient and appropriate audit evidence** w.r.t. laws directly effecting determination of amount and disclosure in financial statement.
 - **Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements**, but compliance of which may be fundamental to operating aspects of business or to avoid material penalties. (Eg- environmental laws and regulations). The auditor should obtain general understanding of regulatory framework and how entity complies with it. { Ensure whether provisions for fines and penalties are made and take expert opinion if needed.}
3. The auditor shall perform the following audit procedures to identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements: -
 - (a) Inquiring of management.

- (b) During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention.
- (c) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.
- (d) Obtain written representation that all known instances of non-compliance or suspected non-compliance with laws and regulations have been disclosed to the auditor.

Indications of Non-Compliance with Laws and Regulations (IMP)

When the auditor becomes aware of the existence of, or information about the following matters, **it may be an indication of non-compliance with laws and regulations:**

- (i) **Investigations by regulatory organisations** and government departments or payment of fines or penalties.
- (ii) **Payments for unspecified services** or loans to consultants, related parties, employees or government employees.
- (iii) **Sales commissions or agent's fees** that **appear excessive** in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
- (iv) Purchasing at **prices significantly above or below market price**.
- (v) **Unusual payments** in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.
- (vi) Unusual payments towards **legal and retainership fees**.
- (vii) Unusual transactions with companies registered in **tax havens**.
- (viii) Payments for goods or services made other than to the country from which the goods or services originated.
- (ix) Payments **without proper exchange control** documentation.
- (x) Existence of an **information system which fails**, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- (xi) **Unauthorised transactions** or improperly recorded transactions.
- (xii) **Adverse media comment**.

Reporting responsibility of an auditor in the context of non-compliance of Law and Regulation:

A. Reporting non-compliance to TCWG

- ❖ If, in the auditor's judgment, the non-compliance referred above is believed to be intentional and material, the auditor shall communicate the matter to those charged with governance as soon as practicable.
- ❖ If the auditor suspects that **management or those charged with governance are involved in non-compliance**, the auditor shall communicate the matter to the **next higher level of authority** at the entity, if it exists, such as an audit committee or supervisory board. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, **the auditor shall consider the need to obtain legal advice**.

B. Reporting non-compliance in Auditors Report

- ❖ Report as per SA 705. { Q/A if non-compliance is materially affecting F/S and Q/D if auditor is unable to conclude effect of non-compliance on F/S}.
- ❖ Whenever there is a default in the payment of statutory dues, also report as per clause vii of CARO 2020.

SA 260 "COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE"**Matters to be communicated**

1. **The Auditor's Responsibilities in Relation to the Financial Statement Audit**
2. **Planned Scope and Timing of the Audit**
3. **Significant Findings from the Audit-**
 - (a) Significant findings w.r.t accounting policy, accounting estimate and financial statement disclosures.
 - (b) **Significant difficulties, if any, encountered during the audit**
 - **Delay by the management** in providing information.
 - An **unnecessarily brief time** within which to complete to audit.
 - **Unavailability** of information.
 - **Extensive unexpected efforts** required to obtain SAAE.
 - **Restrictions imposed on auditor** by the management.
 - **Management's unwillingness** to make or extend its assessment of the entity's ability to continue as a going concern when requested
 - (c) Circumstances that affect the form and content of the auditor's report, if any and
 - (d) Any other significant matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process.

In some circumstances, such difficulties may constitute a scope limitation that leads to a modification of the auditor's opinion.

4. **Communication of Auditor's Independence in case of Listed Entities**

In the case of listed entities, the auditor shall communicate with those charged with governance: -

- (a) A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, **network firms have complied with relevant ethical requirements regarding independence;** and
- (b) (i) All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to effect on independence..
- (ii) The related safeguards that have been applied to **eliminate identified threats to independence or reduce them to an acceptable level.**

Requirement of additional information in the auditor's report

Circumstances in which the auditor is required or may otherwise consider it necessary to include **additional information in the auditor's report** in accordance with the SAs, and for which communication with those charged with governance is required, include when Auditor expects to modify his opinion as per SA 705/ include Going concern Para as per SA 570/KAM as per SA 701/EOM or OM as per SA 706.

Factors affecting Mode of Communication

The form of communication may be orally or in writing, detailed or summarized, structured or non-structured.

The various factors governing mode of communication are:

- ❖ Whether a discussion of the **matter will be included** in the auditor's report.
- ❖ Whether the matter has been **satisfactorily resolved**.
- ❖ Whether management has **previously communicated** the matter.
- ❖ The size, operating structure, control environment, and legal structure of the entity.
- ❖ Legal requirements, in some entities, a written communication with TCWG is required in a prescribed form by local law.

- ❖ The expectations of TCWG, including arrangements made for periodic meetings or communications with the auditor.
- ❖ The amount of ongoing contact and dialogue the auditor has with TCWG.
- ❖ Whether there have been **significant changes in the membership of a governing body**.

Importance of communication

1. Communication with those charged with governance enables them to be made aware of the key audit matters that the auditor intends to communicate in the auditor's report.
2. The auditor may consider it useful to provide TCWG with a draft of the auditor's report to facilitate this discussion.
3. Communication with those charged with governance recognizes their important role in overseeing the financial reporting process, and provides the opportunity for TCWG to understand the basis for the auditor's decisions.
4. It also enables TCWG to consider whether new or enhanced disclosures may be useful.

Other factors that may be relevant to the timing of communications include:

- ❖ The **size, operating structure, control environment, and legal structure** of the entity being audited.
- ❖ Any **legal obligation** to communicate certain matters within a specified timeframe.
- ❖ The **expectations of those charged with governance**, including arrangements made for periodic meetings or communications with the auditor.
- ❖ The time at which the auditor identifies certain matters, for example, the auditor may not identify a particular matter (e.g., non-compliance with a law) in time for preventive action to be taken, but communication of the matter may enable remedial action to be taken.

Reporting to Shareholders	Reporting to TCWG
1. SA 700, 701, 705 and 706 are the applicable standards.	1. SA 260 deals with provisions relating to reporting to those charged with governance.
2. Reporting to shareholders generally focus on true and fair view of shareholders.	2. Matters to be included to TCWG are auditor's independence, planned scope and timing of audit, significant findings from the audit and independence.
3. Reporting to shareholders is an external report and issued in public domain.	3. Reporting to TCWG is an internal report and not issued in public domain.

SA 265 "COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL TO TCWG & MANAGEMENT"

The auditor shall include in the written communication of significant deficiencies in internal control:

- (a) A **description of the deficiencies** and an explanation of their potential effects; and
- (b) **Sufficient information** to enable TCWG and management to understand the deficiencies.

What is deficiency in Internal Control?

- ❖ When control is designed, implemented or operated in such a way that it is **either unable to prevent, detect or correct material misstatements on timely basis or when internal control system does not exist.** { For example, internal control systems established by the insurance company may not be able to capture insurance premiums which may have become due and payable. }

Timing for Communication by the auditor

- a) **For listed entities**, communicate ideally **before approval date of financial statements** and

- b) For unlisted entities in any case **within 60 days from issue of audit report** (before assembly of audit files.)

How to decide if deficiency is significant or not?

Examples of matters that the auditor may consider in determining **whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency include:**

- ❖ The likelihood of the deficiencies leading to **material misstatements** in the financial statements in the future.
- ❖ The **susceptibility to loss or fraud** of the related asset or liability.
- ❖ The **subjectivity and complexity of determining estimated amounts**, such as fair value accounting estimates.
- ❖ The financial statement amounts exposed to the deficiencies.
- ❖ The **volume of activity** that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- ❖ **The importance of the controls to the financial reporting process;** for example:
 - General monitoring controls (such as oversight of management).
 - Controls over the prevention and detection of fraud.
 - Controls over the selection and application of significant accounting policies.
 - Controls over significant transactions with related parties.
 - Controls over significant transactions outside the entity's normal course of business.
 - Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).
- ❖ The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
- ❖ The interaction of the deficiency with other deficiencies in internal control.

Indicators of Significant Deficiencies

- ❖ **Evidence of ineffective aspects of the control environment, such as:**
 - Indications that significant transactions in which management is financially interested are not being appropriately scrutinised by those charged with governance.
 - Identification of **management fraud**, whether or not material, that was not prevented by the entity's internal control.
 - **Management's failure to implement appropriate remedial action** on significant deficiencies previously communicated.
- ❖ Absence of a **risk assessment process** within the entity
- ❖ Evidence of an **ineffective entity risk assessment process**,
- ❖ Evidence of an **ineffective response to identified significant risks** (e.g., absence of controls over such a risk).
- ❖ Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.
- ❖ **Disclosure of a material misstatement** due to error or fraud as prior period items in the current year's Statement of Profit and Loss.
- ❖ Evidence of **management's inability to oversee the preparation of the financial statements**.

Determining an appropriate level of detail for communication of significant deficiencies

The level of detail at which auditors communicate significant deficiencies is a **matter of professional judgement**.

Factors that auditor may consider in determining an appropriate level of detail for communication include-

- (i) The nature of entity.
- (ii) The size and complexity of the entity.
- (iii) The entity's governance composition.
- (iv) Legal or regulatory requirements

SA 299 "JOINT AUDIT OF FINANCIAL STATEMENTS"**Scope of this SA**

This Standard deals with the professional responsibilities which the auditors undertake in accepting such appointments as joint auditors. The Standard **does not deal with the relationship between the principal auditor and the branch auditor as the same is governed in SA 600**.

Requirements of SA 299

1. The engagement partner and other key members of the engagement team from each of the joint auditors shall be involved in planning the audit.
2. The joint auditors shall **jointly establish** an overall audit strategy that sets the scope, timing and direction of the audit.
3. Development of Audit Plan {Principles of SA 300 will be applicable}.
4. Identification of Risk of Material Misstatements.
5. Allocation of work.

Audit Planning and Allocation of Work**1. Development of Audit Plan**

In developing the joint audit plan, joint auditors shall:

- a. Identify **division of audit areas and common audit areas** amongst the joint auditors that define the scope of the work of each joint auditor;
- b. Ascertain the **reporting objectives of the engagement** to plan the timing of the audit and the nature of the communications required;
- c. Consider & communicate among all joint auditors the factors that, in their professional judgment, are significant in directing engagement team's efforts;
- d. Consider the results of **preliminary engagement activities**.
- e. Ascertain the **NTE of resources** necessary to perform the engagement.

2. Allocation of Work

- Joint auditors should, **by mutual discussion**, divide the audit work among themselves.
- The division of work would usually be in terms of audit of **identifiable units or specified areas**.
- In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with **reference to items of assets or liabilities or income or expenditure**.
- Certain areas of work, **owing to their importance** or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors.

3. Documentation of Work Allocated

- The joint auditors shall discuss and document the nature, timing, and the extent of the audit procedures for common and specific allotted areas of audit to be performed by each of the joint auditors and the same shall be **communicated to those charged with governance**.
- The joint auditors shall obtain **common engagement letter and common management representation letter**.
- The work allocation document shall be signed by all the joint auditors & same shall be communicated to TCWG.
- Documentation of allocation of work **helps in avoiding any dispute** or confusion which may arise among the joint auditors regarding the scope of work to be carried out by them.
- Communication of allocation of work to the entity helps in avoiding any dispute or confusion which may arise between the entity and the joint auditors.

Responsibility of Joint Auditors

Jointly and severally responsible for:

- (a) The audit work which is **not divided among the joint auditors** and to be carried out by all joint auditors.
- (b) **Presentation and disclosure** of the financial statements as required by the applicable FRF.
- (c) Ensuring that audit report complies with the requirements of applicable SA.
- (d) In respect of matters which are brought to notice of joint auditors by any one of them and on which there is an agreement among the joint auditors.
- (e) Decisions taken by all the auditor's in relation to nature, time and extent of Audit Procedures.
- (f) Responsibility of obtaining and evaluation information and explanation from the management is generally a joint responsibility of all the auditors.

Individual Responsibilities Of Each Joint Auditors:

- ❖ To determine **the nature, timing and extent of audit procedures** to be applied in relation to the areas of work allocated to the said joint auditor.
- ❖ It is the individual responsibility of each joint auditor to study and **evaluate the prevailing system of internal control**.
- ❖ Reviewing audit reports of work allocated to him.

Point to Remember :

In respect of common areas, the joint auditors are only responsible for appropriateness of nature, timing and extent of planned audit procedures agreed among them. The responsibility of individual execution lies with concerned joint auditor.

Rights Of Joint Auditors:

- ❖ To assume that other joint auditors have carried out work in accordance with generally accepted auditing procedures since another joint auditor is also a member of ICAI.
- ❖ To assume that the other joint auditors have brought to said auditor's notice any departure from applicable financial reporting framework or significant observations that are relevant to their responsibilities noticed in the course of the audit.
- ❖ Where financial statements of a division/branch are audited by one of the joint auditors, the other joint auditors are entitled to proceed on the basis that such financial statements comply with all the legal and regulatory requirements and present a true and fair view of the state of affairs and of the results of operations of the division/branch concerned.

Differences Of Opinion:

- ❖ **A joint auditor is not bound by the views of the majority of the joint auditors** regarding the opinion formed by the said joint auditors.

- ❖ **Separate audit report** can be issued in case of disagreement. Reference to such report shall also be made under the heading "Other Matters Paragraph" as per Revised 706, "Emphasis of Matter Paragraphs and other Matters in the Independent Auditors Report".

Communication with Those Charged with Governance

- ❖ When the joint auditors expect to modify the opinion in the auditor's report/ include EOM /OM Para, the joint auditors shall communicate with TCWG the circumstances regarding such expectation/proposed wordings.

SA 300 "PLANNING AN AUDIT OF FINANCIAL STATEMENTS"

Refer Chapter - Audit Strategy and Planning

SA 315 "IDENTIFYING AND ASSESSING THE RISK OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT"

Scope of this SA

This SA deals with the auditor's responsibility to identify and assess the ROMM in the financial statements, through understanding the entity and its environment, including the entity's internal control.

How will auditor understand entity and its environment?

The auditor shall obtain an understanding of the following:

- Relevant industry, regulatory, and other external factors including the applicable financial reporting framework.
- The nature of the entity, including:**
 - its operations;
 - its ownership and governance structures;
 - the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
 - nature of entity; to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.
- The entity's **selection and application of accounting policies**, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.
- The **entity's objectives and strategies**, and those related business risks that may result in risks of material misstatement.
- The **measurement and review of the entity's financial performance**.

UNDERSTANDING OF ENTITY'S INTERNAL CONTROL SYSTEM & its components

To be done in Risk Assessment and Internal Control Chapter.

AUDIT RISK. (INHERENT RISK VS. CONTROL RISK VS. DETECTION RISK).

- ❖ Audit Risk is the risk that an auditor may issue an inappropriate opinion when the financial statements are materially misstated. Audit risk is a function of the risk of material misstatement and detection risk. (Defined in SA 200)
- ❖ **Risk is of 3 types** - Inherent risk, control risk and detection risk.
 - **Inherent Risk** - There will always be risk of material misstatement existing in account balance or class of transaction or disclosure presuming that there is no internal Control. Therefore, such risk of material misstatement due to non-existence of internal controls is known as an inherent risk.

- **Control Risk** - The risk of material misstatement existing in account balance or class of transaction or disclosure will not be prevented, detected and timely corrected by system of internal control.
- **Detection Risk** - Detection Risk is the risk that even auditor's substantive procedure will fail to detect risk of material misstatement although risk existing in account balance or class of transaction could be material.

There are two components of Audit Risk

- (A) **Risk of Material Misstatement** - Risk that financial statement may contain material misstatement assessed by the auditor prior to audit.
- (B) Detection Risk.

Key Points

- ❖ As per SA 315 read with SA 330, auditor exercises his professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptable low level.
- ❖ Higher, the Inherent Risk and Control Risk, the more substantive procedures the auditor will perform, obtain more audit evidence, and reduce his detection risk so as to reduce audit risk to an acceptable low level.
- ❖ **Audit risk = Risk of Material Misstatement × Detection Risk**
- ❖ **Risk of Material Misstatement = Inherent Risk × Control Risk**
- ❖ **Therefore, Audit Risk = IR × CR × DR**

Identifying and assessing the Risk of Material Misstatement

For this purpose, the auditor shall:

- a) Identify risks throughout the process of obtaining an understanding of the entity and its environment by considering the classes of transactions, account balances, and disclosures in the financial statements;
- b) Assess the identified risks, and evaluate whether they relate **more pervasively** to the financial statements as a whole and potentially affect many transactions;
- c) Relate the identified risks to what can go wrong at the assertion level; and
- d) Consider the likelihood of misstatement, including the possibility of multiple misstatements;

Assessment of Risk: Auditor is required to assess the risk of material misstatement at 2 levels:

- (a) **Financial Statement Level:** Risk that relate pervasively to the financial statement and may affect many assertions.
- (b) **Assertion Level:** Risk that relate to individual transactions, account balance and disclosures wrt Occurrence, Existence, Completeness, Accuracy, cut-off classification, Disclosure.

Risk Assessment Procedure (RAP)

- ❖ **Risk Assessment Procedures included the following: -**
 1. Inquiries of management and others (TCWG) who can assist in identifying risk of material misstatement.
 2. Observation and Inspection.
 3. Inquiry of others.
 4. Analytical Procedures (SA-520).

IT SYSTEM ALSO POSE SPECIFIC RISKS TO AN ENTITY'S INTERNAL CONTROL? WHAT ARE THOSE RISKS?

- (i) Reliance on inaccurate input, processing and output.

- (ii) **Possibility of IT personnel gaining access** beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- (iii) In appropriate **manual intervention**.
- (iv) Unauthorized access to data that may result in destruction of data or improper changes to data. (U)
- (v) Unauthorized **changes to data** in Master files.
- (vi) Unauthorized **changes to systems or programs**.
- (vii) **Failure to** make necessary changes to systems or programs.

RISK THAT REQUIRES SPECIAL CONSIDERATION:

In exercising judgment as to which risks are significant risks the auditor shall consider at least the following:

- (a) whether the risk is a **risk of fraud**;
- (b) whether the risk is related to recent significant economic, accounting or other developments like changes in regulatory environment, etc. and, therefore, requires specific attention;
- (c) the **complexity** of transaction;
- (d) whether the risk involves significant **transactions with related parties**;
- (e) the **degree of subjectivity** in the measurement of financial information related to the risk;
- (f) whether the risk involves significant transactions that are **outside the normal course of business** for the entity.

CONDITIONS AND INDICATIONS THAT MAY INDICATE RISK OF MATERIAL MISSTATEMENT (GIVE FEW EXAMPLES)

- (i) **Significant transactions** with related parties.
- (ii) **Weakness** in internal control.
- (iii) Changes in **IT environment**.
- (iv) **Launch of new products** or services.
- (v) **Going concern** and liquidity issues.
- (vi) Significant amount of **unusual transactions**.
- (vii) **Pending litigation and contingent liabilities**.

Circumstances under which risk may arise / change: (Important)

As per **SA 315 "identifying and assessing the risks of material misstatement through understanding the entity and its environment"** the entity's risk assessment process forms the basis for how management determines the risks to be managed.

If that process is appropriate to the circumstances, including the nature size and complexity of the entity, it assists the auditor in identifying RMM. **Risk can arise or change due to below mentioned circumstances:**

1. **Changes in operating environment:** changes in the regular or operating environment can result in changes in competitive pressures and significantly different risks.
2. **New personnel:** new personnel may have a different focus on or understanding of internal control.
3. **New or revamped information systems:** significant and rapid changes in information systems can change the risk relating to internal control.
4. **Rapid growth:** significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
5. **New technology:** incorporating new technologies into production processes or information systems may change the risk associated with internal control.
6. **New business models, products or activities:** entering into business areas or transactions with which an entity has little experience may introduce new risk associated with internal control.

7. **Corporate restructurings:** restructurings may be accompanied by staff reduction and changes in supervision and segregation of duties that may change the risk associated with internal control.
8. **Expanded foreign operating:** the expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
9. **New accounting pronouncements:** adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statement.

SA 320 "MATERIALITY IN PLANNING AND PERFORMING AN AUDIT"

Concept of Materiality

Materiality in the context of an audit

- ❖ Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements.
- ❖ Although financial reporting framework may discuss materiality in different terms, they generally explain that:
 - Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could **reasonably be expected to influence the economic decisions** of users taken on the basis of the financial statements;
 - Judgements about materiality are made in the light of surrounding circumstances, and are affected by size and nature of a misstatement; and
 - Judgements about matters that are material to users of financial statements are based on a consideration of the **common financial information needs** of users as a group.

Performance Materiality

Amount set by the auditor at less than materiality level for the financial statement as a whole. Why?

- ❖ To ensure that aggregate of **uncorrected and undetected misstatements** is less than materiality for the financial statement as a whole.
- ❖ **To reduce risk to an appropriately low level.**
 Similarly, performance materiality relating to a materiality level determined for a particular class of transaction, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure.
- ❖ The determination of performance materiality involves exercise of professional judgement.
 - (i) **Example-** materiality level of ₹ 5 lakh decided. let's say, 40% of materiality level = ₹ 2 lakh decided as performance materiality.
 - (ii) **Example -** While planning, auditor fix the materiality for the travelling expenses as ₹ 2,00,000. During vouching it was observed that some misstatements exist in the samples selected in the range of ₹10,000 to ₹50,000. Auditor was of the view that aggregate of undetected and uncorrected misstatements may exceed ₹ 2 lacs. Therefore, a need arises to determine performance materiality which may be fixed at any amount on judgment of auditor, say ₹ 30,000.

Revision of materiality level

- ❖ The auditor shall revise materiality for the financial statements as a whole and if applicable the materiality levels for particular classes of transactions, account balances or disclosures, in the event

of becoming aware of information during the audit that would have caused the auditor to have determined a different amount initially.

- ❖ However, he should consider whether **Nature, Time and extent of further Audit Procedures will remain appropriate.**
- ❖ He should also determine whether **there is a need to revise the performance materiality.**
- ❖ If the auditor gets additional information, then he should revise materiality. For example, if there is new requirement of law/ regulation/FRF, entity has made a major decision to dispose of a major part of the entity's business, the auditor should revise the materiality level. If materiality is more, the auditor will perform more audit procedures and reduce the overall audit risk.

The auditor may decide to evaluate misstatements even if it is less than materiality level set by him.

Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole

Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

Factors affecting identification of appropriate benchmark:

1. The **elements of the financial statements**; (for example, assets, liabilities, equity, revenue, expenses).
2. Items on which the attention of the users of the particular entity's financial statements tends to be focused;
3. The **nature of the entity**, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
4. The **entity's ownership structure** and the way it is financed. For example, If an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings;
5. The **relative volatility** of the benchmark.

Materiality and Audit Risk

Materiality and Audit Risk are considered throughout the audit, in particular, when:

- (a) **Identifying** and assessing the risks of material misstatement;
- (b) **Determining the nature, timing and extent** of further audit procedures; and
- (c) **Evaluating** the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

Relationship between materiality and audit risk : There is an inverse relationship between materiality and audit risk. Higher the materiality level lower the audit risk and vice versa.

SA 330 "THE AUDITORS RESPONSES TO ASSESSED RISKS "

Objective of this SA

The objective of the auditor is to obtain **sufficient appropriate audit evidence about the assessed risks of material misstatement**, through designing and implementing appropriate responses to those risks.

Auditor's Procedures in response to risk at Assertion Level

Test of Controls (ToC) Compliance Procedures

– Procedures designed to evaluate the operating effectiveness of controls in preventing, detecting or correcting material misstatements at assertion level.

- ❖ Perform **test of controls** to ensure that internal control is designed and

Substantive Procedures

It is an audit procedure designed to detect material misstatement at assertion level.

Substantive Procedures comprise:

- (a) Tests of details (of classes of transactions, account balances and disclosures).
- (b) Substantive analytical Procedures.

effectively operating throughout the period.

- ❖ If control risk is high, perform more test of controls.
- ❖ Communicate material weakness in internal control to Those Charged with Governance.
- ❖ Depending on the results of test of controls, the auditor shall **decide the Nature, Time and Extent of Substantive Procedures.**

Irrespective of the assessed risk of material misstatement, the auditor shall perform substantive procedures for each material class of transactions, account balances and disclosure.

The auditor's substantive procedures shall include

- (a) Agreeing or reconciling the financial statement with the underlying accounting records; and
- (b) Examine material journal entries and other adjustments made during the course of preparing the financial statements.

Result of Responses (ToC + Tod + SAP): - Auditor is required to ascertain whether on the basis of procedures performed, sufficient appropriate audit evidences obtained or not.

- ❖ If obtained, draw conclusion and issue the opinion in form of audit report.
- ❖ If not obtained, perform additional procedures. If still audit evidences not obtained, modify the audit opinion.

Special Considerations

Using Audit Evidence obtained in Interim Period:

- ❖ Obtain audit Evidence for significant changes subsequent to Interim Period.
- ❖ Determine the additional Evidence to be obtain for remaining period.

Using Audit Evidence obtained during previous audits: Establish Continuing relevance of that evidence by determining significant changes subsequent to previous audit

- ❖ **Changes occurs:** Test the controls in current audit.
- ❖ **No Change Occurs:** Test the controls once in three audits.

Factors warranting re-test of controls

1. **Deficient control environment.**
2. **Deficient monitoring** of controls.
3. **Significant manual element** to relevant controls.
4. **Personnel changes** that significantly affect the application of control.
5. **Changing circumstances** that indicate the need for changes in the control.
6. **Deficient general IT-controls.**

Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:

- ❖ Bank balances and other information relevant to banking relationships.
- ❖ Accounts receivable balances and terms.
- ❖ Inventories held by third parties at bonded warehouses for processing or on consignment.
- ❖ Property title deeds held by lawyers or financiers for safe custody or as security.
- ❖ Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.
- ❖ Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
- ❖ Accounts payable balances and terms.

FACTORS THAT MAY ASSIST IN DETERMINING USE OF EXTERNAL CONFIRMATIONS AS SUBSTANTIVE AUDIT PROCEDURES

As per **SA 330 "Responses to Assessed Risks"** factors that may assist the auditor in determining whether external confirmation procedures are to be External confirmations performed as substantive audit procedures include:

1. **The confirming party's knowledge of the subject matter - responses** may be more reliable if provided by a person at the confirming party who has the requisite knowledge about the information being confirmed.
2. **The ability or willingness of the intended confirming party to respond** – for example, the confirming party:
 - May not accept responsibility for responding to a confirmation request;
 - May consider responding too costly or time consuming.
 - May have concerns about the potential legal liability resulting from responding;
 - May account for transactions in different currencies; or
 - May operate in an environment where responding to confirmation requests is not a significant aspect of day-to-day operations.

In such situations, confirming parties may not respond, may respond in a casual manner or may attempt to restrict the reliance placed on the response.
3. **The objectivity of the intended confirming party - if** the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

SA 402 "AUDIT CONSIDERATIONS RELATING TO AN ENTITY USING A SERVICE ORGANISATION"

Scope of this SA

This SA deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity **uses the services of one or more service organisation**.

Meaning of terms used in SA

Service Auditor - An Auditor who at the request of the service organization, provides an assurance report on the controls of a service organization.

Service Organization- A third-party organization that provides services to user entities that are part of those entities that are part of those entities information system relevant to financial reporting.

User Auditor- An Auditor who audits and reports on the financial statements of a user entity.

User Entity - An entity that uses a service organization and whose financial statements are being audited.

Types of Report

Type 1 report is a report that comprises-:

- (i) A description, **prepared by management of the service organisation**, of the service organization's **system, control objectives and related controls** that have been designed and implemented as at a specified date; and
- (ii) A **report by the service auditor** with the objective of conveying reasonable assurance that includes the **service auditor's opinion** on the description of the service organization's system, control objectives and related controls and the suitability of the design of **the controls to achieve the specified control objectives**.

Type 2 report is a report that comprises-:

- (i) A description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls, their design and implementation as at a specified date

or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period; and

- (ii) A report by the **service auditor with the objective of conveying reasonable assurance that includes:**
- - a. The **service auditor's opinion** on the description of the service organisation's system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; and
 - b. A description of **the service auditor's tests of the controls and the results thereof.**

Note :

- ❖ If type 1 and type 2 report includes the design and description of the controls at sub-service organisations it is known as **inclusive method or carve in method of reporting.**
- ❖ If type 1 and type 2 report do not include the design and description of the controls at sub-service organisations it is known as **exclusive method or carve out method of reporting.**

Obtaining an Understanding of the Services

1. When obtaining an understanding of the user entity in accordance with SA 315, the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity's operations, including: -
 - (a) The **nature of the services** provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control. Information on nature of services provided by a user organization may be available from sources such as **user manuals, contract between the user entity and service organization, reports by service auditors** etc.
 - (b) The **nature and materiality of the transactions processed or accounts or financial reporting processes** affected by the service organisation.
 - (c) The degree of interaction between the activities of the service organisation and those of the user entity. The degree of interaction refers to the extent to which a user entity is able to and elects to implement effective controls over the processing performed by the service organisation. **For example,** a high degree of interaction exists between the activities of the user entity and those at the service organisation when the user entity authorises transactions and the service organisation processes and does the accounting for those transactions
 - (d) The **nature of the relationship between the user entity and the service organisation**, including the relevant contractual terms for the activities undertaken by the service organisation.
2. **If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor shall obtain that understanding from one or more of the following procedures:-**
 - (a) **Obtaining** a Type 1 or Type 2 report, if available
 - (b) **Contacting the service organisation**, through the user entity, to obtain specific information
 - (c) **Visiting the service organisation** and performing procedures that will provide the necessary information about the relevant controls at the service organisation or
 - (d) Using another auditor to perform procedures that will provide the necessary information about the relevant controls at the service organisation.

Using Type 1 or Type 2 Report

Using A Type 1 Or Type 2 Report to Support the User Auditor's Understanding of The Service Organisation: In determining the sufficiency and appropriateness of the audit evidence provided by a Type 1 or Type 2 report, the user auditor shall be satisfied as to: -

- a) The **service auditor's professional competence** (except where the service auditor is a member of the Institute of Chartered Accountants of India) and **independence from the service organisation; and**
- b) The **adequacy of the standards** under which the Type 1 or Type 2 report was issued.

If the user auditor plans to use a Type 1 or Type 2 report as audit evidence to support the user auditor's understanding about the design and implementation of controls at the service organisation, the user auditor shall:

- a) Evaluate whether the **description and design of controls at the service organisation** is at a date or for a period that is appropriate for the user auditor's purposes;
- (b) Evaluate the **sufficiency and appropriateness of the evidence** provided by the report for the understanding of the user entity's internal control relevant to the audit; and
- (c) Determine whether **complementary user entity controls identified by service organisation are relevant** to the user entity and, if so, obtain an understanding of whether the user entity has designed and implemented such controls.

Complementary user entity controls refer to controls that the service organisation assumes, in the design of its service, will be implemented by user entities, and which, if necessary to achieve control objectives, are identified in the description of its system.

FACTORS TO BE CONSIDERED BY AUDITOR RELATED TO FINANCIAL REPORTING OF SERVICE ORGANIZATION

As per **SA 402 "Audit Considerations relating to an Entity using a Service Organization"**, services provided by a service organization are relevant to the audit of a user entity's financial statements when those services, and the controls over them, are part of the user entity's information system, including related business processes, relevant to financial reporting.

Although most controls at the service organization are likely to relate to financial reporting, there may be other controls that may also be relevant to the audit, such as controls over the safeguarding of assets. **A service organization's services are part of a user entity's information system, including related business processes, relevant to financial reporting if these services affect any of the following:**

- (a) The classes of transactions in the user entity's operations that are significant to the user entity's financial statements;
- (b) The procedures, within both information technology (IT) and manual systems, by which the user entity's transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
- (c) The related accounting records, either in electronic or manual form, supporting information and specific accounts in the user entity's financial statements that are used to initiate, record, process and report the user entity's transactions; this includes the correction of incorrect information and how information is transferred to the general ledger;
- (d) How the user entity's information system captures events and conditions, other than transactions, that are significant to the financial statements;
- (e) The financial reporting process used to prepare the user entity's financial statements, including significant accounting estimates and disclosures; and
- (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments

Reporting

The user auditor shall modify the opinion in the user auditor's report in accordance with SA 705 if the **user auditor is unable to obtain sufficient appropriate audit evidence** regarding the services provided by the service organisation relevant to the audit of the user entity's financial statements.

The user auditor **shall not refer to the work of a service auditor** in the user auditor's report containing an **unmodified opinion** unless required by law or regulation to do so. If such reference is required by law or regulation, the user auditor's report shall indicate that **the reference does not diminish the user auditor's responsibility for the audit opinion.**

Note :

SAE 3402 applies to auditor of service organization whose duty is to report in type 1 or type 2 to the auditor of user's entity. He shall perform test of controls while providing type 2 report. If controls are not fairly designed and implemented or he is unable to obtain SAAE, modify the opinion.

SA 450 "EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT"

Sources of Misstatement

- ❖ An **inaccuracy** in gathering or processing data from which FS are prepared ;
- ❖ An omission of amount or disclosure
- ❖ An incorrect accounting estimate arising from overlooking , or clear misinterpretation of facts; and
- ❖ Unreasonable judgements of management concerning accounting estimates.
- ❖ Inappropriate selection & application of accounting policies.

Auditors Responsibilities

1. He shall accumulate misstatement identified during the audit, other than those clearly trivial.
2. If misstatement is immaterial, obtain WR that that uncorrected misstatement is immaterial.
3. If Misstatement is material or aggregate of uncorrected misstatement becomes material,
 - Consider adjustment of nature, timing and extend of audit procedures
 - Communicate them to appropriate level of management and request them to correct it
 - If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.
4. Determine whether overall Audit Strategy and Audit Plan need to be revised if :
 - **Nature of identified misstatements and the circumstances** of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material or
 - The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320.

If, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected, the auditor shall perform additional audit procedures to determine whether misstatements remain.

5. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. **In making this determination, the auditor shall consider:**
 - (a) The **size and nature of the misstatements**, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence and
 - (b) The **effect of uncorrected misstatements** related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

SA 500 "AUDIT EVIDENCE"**Methods to obtain Audit Evidence**

- ❖ **Inspection** - examination of records, documents or tangible assets. Inspection of tangible assets may provide reliable audit evidence with respect to their existence.
- ❖ **Observation** - witnessing a process or procedure being performed by others. Technique in which evidence is obtained regarding existence, physical condition and control.
- ❖ **Inquiry and confirmation** -
 - Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity.
 - Inquiry is used extensively throughout the audit in addition to other audit procedures.
 - Evaluating responses to inquiries is an integral part of the inquiry process.
 - Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence.
 - In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.
 - Inquiries may be oral or written. In respect of certain matters, auditor may consider it appropriate to obtain written representation from management. Hence, WR obtained under SA 580 is also an audit evidence but cannot be solely relied upon.
 - The auditor also has to enquire about certain matters as per Section 143(1) of Companies Act, 2013.
- ❖ **Recalculation** - checking mathematical accuracy of documents or records. eg-calculating depreciation.
- ❖ **Reperformance** - Auditor independently executes the procedures again or controls again. eg-recounting of inventory.
- ❖ **Analytical procedures** - studying significant ratios, trends, unusual fluctuation. (sa-520).

Reliability of audit evidence

The following generalisations about the reliability of audit evidence may be useful:

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

Reference to Management Expert

Management's expert is 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.

When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes,;

- (a) Evaluate the **competence, capabilities and objectivity** of that expert {To assess objectivity consider threats to independence and the safeguards applied}
- (b) Obtain an **understanding of the work** of that expert; and
- (c) Evaluate the **appropriateness of that expert's work as audit evidence** for the relevant assertion.

The auditor may also consider the following while evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion:

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

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

1. Personal experience with previous work of the expert.
2. Discussions with that expert.
3. Discussions with others who are familiar with that expert's work.
4. Checking qualification of expert.
5. Published papers or books written by that expert.

Factors effecting Nature, Timing and Extend of Audit Procedures adopted by an Auditor in case of Management Expert

Nature, timing and extent of audit procedures to be adopted by an auditor in case of management's expert, may be affected by such matters as:

- (a) **The nature and complexity of the matter** to which the management's expert relates.
- (b) The **risks of material misstatement** in the matter.
- (c) The availability of **alternative sources of audit evidence**.
- (d) The nature, scope and objectives of **the management's expert's work**.
- (e) Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services.
- (f) The extent to which management can **exercise control or influence** over the work of the management's expert.
- (g) Whether the management's expert is subject to technical performance standards or other professional or industry requirements.
- (h) The nature and extent of any **controls within the entity over the management's expert's work**.
- (i) The auditor's knowledge and experience of the management's expert's field of expertise.
- (j) The auditor's previous experience of the work of that expert.

Point To Remember

The auditor/ auditor's will be held responsible for grossly negligence **if faulty expert's work is used without examining the adequacy of expert's work**.

Inconsistency between audit evidences obtained from 2 sources or audit evidence obtained is not reliable,

- ❖ Consider Modifying appropriately the audit report as per SA 705.
- ❖ Consider effect of this matter on other aspects of audit.

SA 501 “AUDIT EVIDENCE – SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS”

Scope of this SA

This Standard deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence in accordance with SA 330, SA 500 and other relevant standards w.r.t certain aspects of inventory, litigations and claims involving the entity, and segment information in an audit of financial statements.

Requirements w.r.t. Inventory

When inventory is material to the financial statements, the auditor shall obtain SAAE regarding the existence and condition of inventory by attending the physical inventory counting unless impracticable by

- (a) Attendance at Physical Inventory Counting includes :
- (i) Inspecting the inventory to ascertain its existence and evaluate its condition, and performing test counts;
 - (ii) Observing compliance with management's instructions and the performance of procedures for recording and controlling the results of the physical inventory count; and
 - (iii) Obtaining audit evidence as to the reliability of management's count procedures
- (b) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

Special considerations in case of inventory

A. Physical Inventory Counting Conducted other than the Date of the Financial Statements

If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures required above, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date, or dates, and the final inventory records are properly recorded include:

- ❖ Whether the perpetual inventory records are properly adjusted.
- ❖ Reliability of the entity's perpetual inventory records.
- ❖ Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records.

B. Attendance at Physical Inventory Counting becomes impracticable

In some cases, attendance at physical inventory counting may be impracticable.

- This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor.
- The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable.
- Further, as explained in SA 200, the matter of difficulty, time or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.
- Further, where attendance is impractical, the auditor shall perform alternative audit procedures, for example, inspection of documents of the subsequent sale / purchase of specific inventory.
- If SAAE cannot be obtained and alternative procedures cannot be performed, modify the opinion as per SA 705.

C. Unable to attend inventory count due to unforeseen circumstances

If unable to attend inventory counting due to unforeseen circumstances, then perform physical counts on alternative date, and perform audit procedures on intervening transaction. Alternate audit procedures include

1. Reconcile the changes in inventory between date of physical count and period end date.
2. Observe treatment given for discrepancies observed.
3. Ensure appropriate cut off procedures followed or not.
4. Obtain Written Representation.

Matters relevant in planning attendance at physical inventory counting include, for example:

- (i) Nature of inventory.
- (ii) Stages of completion of work in progress.
- (iii) The risks of material misstatement related to inventory.
- (iv) The nature of the internal control related to inventory.
- (v) Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
- (vi) The timing of physical inventory counting.
- (vii) Whether the entity maintains a perpetual inventory system.
- (viii) The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate.
- (ix) Whether the assistance of an auditor's expert is needed.

D. Inventory in custody of 3rd party

As per SA 501, "Audit Evidence—Specific Considerations for Selected Items" when inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

- (i) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.
- (ii) **Perform inspection or other audit procedures appropriate in the circumstances**, for example where information is obtained that raises doubt about the integrity and objectivity of the third party, the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party.

Examples of other audit procedures include:

- ❖ Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.
- ❖ Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
- ❖ Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.
- ❖ Requesting confirmation from other parties when inventory has been pledged as collateral.

Litigations

- ❖ The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give risk of material misstatement including:
 - **Inquiry of management** and, where applicable, others within the entity, including in-house legal counsel.
 - **Reviewing minutes of meetings** of TCWG and correspondence between the entity and its external legal counsel;

➤ **Reviewing legal expense accounts.**

- ❖ Obtain WR that all litigations and claims have been presented in financial statement and disclosed to the auditor.
- ❖ **If the Auditor Assesses a Risk of Material Misstatement regarding Litigation or Claims - Communication with the Entity's External Legal Counsel**
If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek **direct communication with the entity's external legal counsel**.
The auditor shall do so through a **letter of inquiry prepared by the management and sent by the auditor** requesting the entity's external legal counsel to communicate directly with the auditor.
- ❖ In certain circumstances, the auditor may also judge **it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigations or claims**. For example, where the matter is complex or has significant risk. However, such meetings require management permission and are held with a representative of management in attendance.
- ❖ If **management refuses to give permission to auditor to communicate with external legal counsel/law, regulation prohibits the legal counsel to respond, the auditor shall perform alternate procedures and if unable to obtain sufficient audit evidence** by performing alternative procedures, **the auditor shall modify the report as per SA 705**.

Segment Reporting - Presentation & Disclosures

The auditor shall obtain SAAE regarding presentation and disclosure of segment information in accordance with applicable FRF by

- (a) Obtain understanding of such methods used by management in determining segment information in accordance with applicable FRF.
- (b) Performing analytical procedures or other audit procedures appropriate in the circumstance.

Example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:

- (i) Sales, transfers and charges between segments, and elimination of inter-segment amounts.
- (ii) Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
- (iii) The allocation of assets and costs among segments.
- (iv) Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

SA 505 "EXTERNAL CONFIRMATION"

Scope of this SA

This SA deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with requirements of SA 330 and SA 500. It does not address inventories, litigations and claims. SA 501 deals with obtaining sufficient appropriate audit evidence from such inquiries.

Meaning of Basic Terms

External Confirmation- External **confirmation** may be defined as an audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

Positive confirmation request – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.

Negative confirmation request– A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.

Non-response– A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.

Exception – A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

The exception needs to be assessed to the entire population after analyzing the reason for difference.

Basic meaning

Process of external confirmation, ordinarily, consists of the following:

- ❖ Determining the information to be confirmed or requested.
- ❖ Selecting the appropriate confirming party.
- ❖ Designing the confirmation requests, including determining that requests are properly addressed and contain return responses to be sent directly to the auditor; and
- ❖ Sending the requests, including follow-up requests when applicable, to the confirming party.

Two types of requests

- a) **Positive Confirmation-Response mandatory in case of agreement or disagreement.** If response is not received in reasonable time, send additional confirmation request. Regarded as a better mode of confirmation request. **Where risk or materiality level is high, internal control system is not so sound and exception rate is high, it is advisable to send positive confirmation request.**
- b) **Negative confirmation**
 - **Response from the external party is required only in case of disagreement.**
 - Negative confirmations provide less persuasive audit evidence than positive confirmations.
 - Accordingly, the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present:
 - (a) The auditor has assessed the **risk of material misstatement** as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;
 - (b) The population of items subject to negative confirmation procedures comprises a large number of **small, homogeneous, account balances, transactions or conditions**;
 - (c) A very **low exception rate** is expected; and
 - (d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

Examples of areas in which external confirmation is required.

- (a) Bank balance & Other confirmation from bankers.
- (b) Account Receivable/Account Payable Balances.
- (c) Stock Lying with Third Parties.
- (d) Property Title Deed held by third parties.
- (e) Investments Purchased but delivery not taken.
- (f) Loan from Lenders.
- (g) Terms of agreement or Transaction with Third Parties.

Various factors to be considered while designing confirmation request:

As per SA 505, "External Confirmation", **factors to be considered when designing confirmation requests include:**

- (i) The **assertions** being addressed.
- (ii) Specific identified **risks of material misstatement**, including fraud risks.
- (iii) The **layout and presentation** of the confirmation request.
- (iv) **Prior experience** on the audit or similar engagements.
- (v) The **method of communication** (for example, in paper form, or by electronic or other medium).
- (vi) **Management's authorization or encouragement to the confirming parties to respond to the auditor.** Confirming parties may only be willing to respond to a confirmation request containing management's authorization.
- (vii) The **ability of the intended confirming party** to confirm or provide the requested information (for example, individual invoice amount versus total balance).

Reliability of Responses to Confirmation

- **SA 500 indicates that even when audit evidence is obtained from sources external to the entity, circumstances may exist that affect its reliability.**
- All responses carry some risk of interception, alteration or fraud.
- Such risk exists regardless of whether a response is obtained in paper form, or by electronic or other medium.
- **Factors that may indicate doubts about the reliability of a response include that it:**
 - ❖ Was received by the auditor indirectly; or
 - ❖ Appeared not to come from the originally intended confirming party.
- If the auditor determines that response is not reliable, auditor shall evaluate implications on assessment of ROMM.

Audit response/ procedures when management refuses to seek external confirmation.

- (a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;
- (b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatements, including the risk of fraud, and on the nature, time and extent of other audit procedures; and
- (c) Perform alternative audit procedures** designed to obtain relevant and reliable audit evidence.

**If alternative procedures could not be performed, Modify the opinion as per SA 705.

****Examples of alternative audit procedures may include**

- ❖ For accounts receivable balances - examining specific subsequent cash receipts, shipping documentation, and sales near the end period.
- ❖ For account payable balances- examining subsequent cash disbursements or correspondence from third parties, and other records such as goods received notes.

Results of the External Confirmation procedures/ Responses of an auditor to request

When evaluating the results of individual external confirmation requests, the auditor may categorise such results as follows:

A) Reliability of responses to confirmation requests:

If auditor has doubt about reliability of response, auditor to obtain further audit evidence

If auditor determines response is not reliable, auditor to evaluate **the implications on the assessment of risk of material misstatement**, including the risk of fraud, and on the related nature,

timing and extent of other audit procedures. { eg- confirmations received from client whose GST Registration has been cancelled PY}.

- B) **Non-Response:** Auditor shall perform alternative audit procedures.
- C) **When a response to positive confirmation is necessary and the same is not received:** Determine the implications on the audit and the auditor's opinion.
- D) **Exception:** Auditor shall investigate exceptions to determine whether or not they are indicative of misstatement.

SA 510 "INITIAL AUDIT ENGAGEMENTS – OPENING BALANCES"

Meaning of Important Terms

1. Initial Audit Engagement

An engagement in which either

- (i) The financial statements for the prior period were not audited; or
- (ii) The financial statements for the prior period were audited by a predecessor auditor.

2. Opening balances means those account balances that exist at the beginning of the period.

Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period.

Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments

3. Predecessor auditor – The auditor from a different audit firm, who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.

Objective of SA 510 is for the auditor to obtain evidences whether

Opening balance contain **material misstatement in opening balances** is materially affecting the financial statements of the current period.

Accounting Policies used in preceding year **are consistent with that of current year** or change in accounting policies, if any have been properly disclosed and presented as per the FRF.

The closing balances of the preceding year are correctly brought forward in the current period.

Obtaining SAAE about Opening Balances by Auditor

The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

- (a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;
- (b) Determining whether the opening balances reflect the application of appropriate accounting policies; and
- (c) Performing one or more of the following:
 - (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;
 - (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
 - (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

Audit procedure**Financial Statements Audited by another Auditor – Audit Procedure:**

If the prior period's financial statements were audited by a predecessor auditor, **the auditor may be able to obtain sufficient appropriate audit evidence** regarding the opening balances by perusing the copies of the audited financial statements relating to the prior period financial statements such as supporting schedules to the audited financial statements.

Ordinarily, **the current auditor can place reliance on the closing balances** contained in the financial statements for the preceding period, **except** when during the performance of audit procedures for the current period the **possibility of misstatements in opening balances is indicated.**

Audit of Financial Statements for the First Time – Audit Procedure:

When the audit of financial statements is being conducted for the first time, the auditor has to perform **auditing procedures to obtain sufficient appropriate audit evidence**. Since opening balances represent effect of transaction and events of the preceding period and accounting policies applied in the preceding period, **the auditor needs to obtain evidence having regard to nature of opening balances, materiality of the opening balances and accounting policies.**

Since it will not be possible for auditor to perform certain procedures, e.g., observing physical verification of inventories, etc. the auditor may obtain confirmation, etc. and perform suitable procedures in respect of fixed assets, investments, etc. **The auditor can also obtain management representation with regards to the opening balances.**

Consistency of Accounting Policies

Obtain audit evidence as to whether the accounting policies are consistently applied and in case of any changes, whether properly accounted for, presented and disclosed.

Reporting requirements under SA 510

Audit Evidence Regarding opening balance	Reporting Responsibility
The auditor is unable to obtain SAAE regarding opening balances	Qualified or Disclaimer as per SA 705
Auditor concludes that the opening balances contain a misstatement that materially effects the F/S and the effect of the F/S is not properly accounted for or not adequately presented or disclosed	Issue qualified or adverse report as per SA 705
Auditor concludes that current period's accounting policies are not consistently applied in relation to opening balances in accordance with FRF or changes in accounting policies is not properly accounted for or not adequately presented or disclosed as per FRF	Issue qualified or adverse report as per SA 705
Modification to the Opinion in the Predecessor Auditor's Report: If the predecessor auditor's opinion regarding the prior period's financial statements included a modification to the auditor's opinion that <u>remains relevant and material to the current period's financial statements.</u>	Issue modified opinion on the current period's financial statements in accordance with SA 705.

SA 520 "ANALYTICAL PROCEDURES"**What are analytical procedures. For what purposes they can be used?**

Analytical procedures include the consideration of **comparisons of the entity's financial information with, for example:**

- ❖ Comparable information for prior periods.
- ❖ Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- ❖ Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

Analytical procedures also include consideration of relationships, for example:

- ❖ Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
- ❖ Between financial information and relevant non-financial information, such as payroll costs to number of employees.

Techniques of Analytical Procedures

- (i) **Trends-** Analysing account fluctuations by comparing current year to prior year information and, also, to information derived over several years.
- (ii) **Reasonableness-** Tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts. **Examples of accounts that may be reasonably tested are:**
 - a) **Interest expense** against interest bearing obligations.
 - b) **Raw Material Consumption** to Production (quantity).
 - c) **Wastage & Scrap %** against production & raw material consumption (quantity).
 - d) **Work-in-Progress** based on issued of materials & Sales (quantity).
 - e) **Sales discounts** and commissions against sales volume.
 - f) **Rental revenues** based on occupancy of premises.
- (iii) **Ratios-** Analysis by computation of ratios includes the study of relationships between financial statement amounts. Commonly used ratios include:
 - a) Elements of income or loss as a percentage of sales.
 - b) Gross profit turnover.
 - c) Accounts receivable turnover.
 - d) Inventory turnover.
 - e) Profitability, leverage, and liquidity.
- (iv) **Structural Modelling-** It too constructs a statistical model from financial and/or non-financial data of prior-accounting periods to predict current account balances (e.g. Linear regression).

Reliance on Analytical procedures:

- ❖ **Depending upon materiality of items involved-**if more materiality level, perform analytical procedure plus other substantive procedures, if less material, may rely solely on analytical procedures.
- ❖ **Depending upon other inherent risk and control risk-**more risk, more reliance on comprehensive test of details and not solely on analytical procedures.
- ❖ Accuracy of results of analytical procedures.

Factors to be considered for Substantive Audit Procedures**The auditor should consider the following factors for Substantive Audit Procedures:**

- i) **Availability of Data** - The availability of reliable and relevant data will facilitate effective analytical procedures.

- ii) **Disaggregation** - The degree of disaggregation in available data can directly affect the degree of its usefulness in detecting misstatements.
- iii) **Account Type** - Substantive analytical procedures are more useful for certain types of accounts than for others. For example, Income statement accounts.
- iv) **Source** - Analytical procedures are more suitable in case of classes of transactions which tend to be more predictable because they consist of numerous, similar transactions, (e.g., through routine processes).
- v) **Predictability** - Substantive analytical procedures are more appropriate when an account balance or relationships between items of data are predictable (e.g., between sales and cost of sales or between trade receivables and cash receipts).
- vi) **Nature of Assertion** - Substantive analytical procedures may be more effective in providing evidence for some assertions (e.g., completeness or valuation) than for others (e.g., rights and obligations). Predictive analytical procedures using data analytics can be used to address completeness, valuation/measurement and occurrence.
- vii) **Inherent Risk or "What Can Go Wrong"** - When inherent risk is higher, we may design tests of details to address the higher inherent risk. When significant risks have been identified, audit evidence obtained solely from substantive analytical procedures is unlikely to be sufficient.

Analytical Procedures used as Substantive Tests

When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330, the auditor shall: {Considerations to be kept while performing AP }

- ❖ **Suitability**- Determine the suitability of particular substantive Analytical Review Procedure for a given assertion. For example- in case of predictable relationships, analytical procedures are more suitable.
- ❖ **Reliability**- Reliability of data; source of information, relevance of information, comparability of information.
 - (a) **Source of the information available.** For example, information may be more reliable when it is obtained from independent sources outside the entity;
 - (b) **Comparability of the information available.** For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;
 - (c) **Nature and relevance of the information available.** For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and
 - (d) **Controls over the preparation of the information** that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.
- ❖ **Expectations**- To develop an expectation of recorded amount and evaluate whether expectation is sufficiently precise to identify misstatement.
- ❖ **Difference**- Difference of recorded amounts from expected values i.e. acceptable without further investigation.

Suitability of Particular Analytical Procedures for Given Assertions:

- ❖ SAP are generally more applicable to **large volume of transactions** that tend to be predictable over time. However, it also depends upon the **auditor's assessment** of how effective it will be in detecting a misstatement that, individually or in aggregate.
- ❖ **Use of Analytical Procedures in respect of Payroll Incomes and Room Rentals**
 - ✓ **In case of payroll cost**- where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll

costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform test of details on the payroll.

- ✓ **In case of rental income**-AP involves the prediction of total rental income in case of hotel taking the room tariff rates, the number of rooms and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need of further verification by means of Test of Details, provided the elements are appropriately verified.

Investigating results of Analytical Procedures:

If analytical procedures performed in accordance with this SA **identify fluctuations or relationships that are inconsistent** with other relevant information or that differs from expected values by a significant amount, the auditor shall investigate such differences by:

- a) Inquiring of management and obtaining appropriate audit evidence relevant to management resources; and
- b) Performing other audit procedures as may be necessary. The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

SA 530 "AUDIT SAMPLING"

Meaning of Sampling Risk

Risk that auditor's conclusion based on a sample is different from conclusion if entire population were subjected to same audit procedure.

In other words,

Sampling Risk=Opinion based upon selected sample size-Opinion based on cent-percent financial statement/larger sample size.

Sampling risk can lead to two types of erroneous conclusions-

- (i) **In the case of a test of controls, that controls are more effective than they actually are**, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because **it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.**
- (ii) **In the case of a test of controls, that controls are less effective than they actually are**, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects **audit efficiency** as it would usually lead to additional work to establish that initial conclusions were incorrect.

Methods of selection of sample size:

- (1) **Random Sampling:** Random selection ensures that all items in the population or within each stratum have a known chance of selection. It may involve use of random number tables. Random sampling includes two very popular methods which are discussed below-
 - (i) **Simple Random Sampling:** Each item in a population is selected by use of random number table either with a help of computer or picking up a number in a random way (may be randomly from a drum). Today random numbers are also generated using various applications on the cell phones like the random number generator.

This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range i.e it is suitable for a homogeneous population having a similar range.

- (ii) **Stratified Sampling:** This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment.
- (2) **Interval Sampling or Systematic Sampling:** Systematic selection is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerized random number generator or random number tables.
- (3) **Monetary Unit Sampling:** It is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.
- (4) **Haphazard sampling:** Haphazard selection, in which the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling. Haphazard sampling has no structured approach, does not involve judgement and does not even use the random number tables.
- (5) **Block Sampling:** This method involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population.

Principal Method of Design of Samples

SA 530 "Audit Sampling" deals with the auditor's use of statistical and non-statistical sampling when designing and selecting the audit sample, performing tests of control and test of details, and evaluating the results from the sample. Among both methods of designing (Statistical and non-statistical), principal method of design of sample is statistical sampling.

Meaning of statistical sampling:

- ❖ Statistical sampling involves random selection of the same items and use of probability theory to evaluate sample results, including measurement of sampling risk.
- ❖ This method is more scientific and involves use of probability theory.
- ❖ While applying statistical sampling, auditor may also apply stratification, i.e. the process of dividing a population into sub-populations, which are popularly known as stratas.

Stratified Sampling

This method involves dividing the whole population to be tested in to a few groups called strata and taking a sample from each of them. Each stratum is treated as if it were a separate population and proportionate items are selected from each of the stratum. The groups into which the whole population is divided is determined by the auditor on the basis of his judgment. e.g. entire expense vouchers may be divided into:

- (i) Vouchers above ₹ 1,00,000
- (ii) Vouchers between ₹ 25,000 and ₹ 1,00,000
- (iii) Vouchers below ₹ 25,000

The auditor can then decide to check all vouchers above ₹ 1,00,000, 50% between ₹ 25,000 and ₹ 1,00,000 and 25% of those below ₹ 25,000.

The reasoning behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences. This is population, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each strata.

Requirements relating to Sample design, Sample size and Selection of items for testing

According to the said SA, requirements relating to sample design, sample size and selection of items for testing are explained below-

- ❖ **Sample Design -** When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.
- ❖ **Sample Size -** The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.
- ❖ **Selection of Items for Testing -** The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

PERFORMING AUDIT PROCEDURES

- ❖ The auditor shall perform audit procedures, appropriate to purpose, on each item selected.
- ❖ If audit procedure is not applicable to selected item, auditor shall perform procedure on replacement item.
- ❖ If auditor is unable to apply designed audit procedures, or alternative procedures, to selected item, auditor shall treat them as **deviation from prescribed control**, in case of TOC's, or, misstatements in case of TOD's.

Nature and Cause of Deviations and Misstatements

- ❖ The Auditor shall investigate nature and cause of any deviations or misstatements identified, and evaluate possible effect on audit procedures and other areas of audit.
- ❖ In extremely rare circumstances, when auditor considers a misstatement or deviation to be anomaly, auditor shall obtain high degree of certainty that such misstatements or deviation is not representative of population. The Auditor shall obtain this degree of certainty performing additional audit procedures to obtain SAAE that misstatement or deviation does not affect remainder of population.

Factors determining extent of checking on a Sampling Plan

- (i) Size of organisation.
- (ii) State of Internal Control.
- (iii) Adequacy & Reliability of books & records.
- (iv) Tolerable error range.
- (v) Degree of desired confidence.

Special Terms:

A) **Tolerable misstatement**

- When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements.
- Tolerable misstatement is the application of performance materiality, as defined in SA 320 to a particular sampling procedure.
- Tolerable misstatement may be the same amount or an amount less than the performance materiality.

- B) **Tolerable Rate of Deviation-** Rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

****Thus, Tolerable Rate of Deviation is related to deviations in internal control and Tolerable misstatement is connected with Test of Details.**

C) Anomaly

- Anomaly is a misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.
- The exceptional deviation or misstatement that may be presented in the sample size selected for each audit.

Evaluating Results of Audit Sampling

The auditor shall evaluate-

- The results of the sample; and
- Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

If the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may:

- Request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or
- Tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance.

SA 540 "AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE ACCOUNTING ESTIMATES AND RELATED DISCLOSURES"

For the convenience of students, we are dividing SA 540 into 2 parts

- ❖ **Part A-** Meaning of Estimates, Types of Estimates, Risks Involved
- ❖ **PART B-** Audit Considerations w.r.t Accounting Estimates

Part A- Meaning of Estimates, Types of Estimates, Risks Involved

1. Important Definitions

- ❖ **Accounting estimate-** SA 540 defines an accounting estimate as "an approximation of a monetary amount in the absence of a precise means of measurement." This term is used for an amount measured at fair value where there is estimation uncertainty.
- ❖ **Estimation Uncertainty -** The susceptibility of an accounting estimate and related disclosures to an inherent risk of precision in its measurement.

2. ROMM Involved

(A) Some accounting estimates involve relatively lower risks of material misstatements

- ❖ Accounting estimates arising in entities that engage in business activities that are **not complex**.
- ❖ Accounting estimates that are **frequently made and updated** because they relate to routine transactions.
- ❖ Accounting estimates derived from data that is **readily available**.
- ❖ Fair value accounting estimates where the method of measurement prescribed by the applicable financial reporting framework is **simple and applied easily** to the asset or liability requiring measurement at fair value.

Fair value accounting estimates where the model used to measure **the accounting estimate is well-known or generally accepted**, provided that the assumptions or inputs to the model are observable.

(B) Some accounting estimates, however, there may be relatively high estimation uncertainty, and may give rise to higher risks of material misstatements

- ❖ Accounting estimates relating to **the outcome of litigation**.
- ❖ Fair value accounting estimates for **derivative financial instruments not publicly traded**.
- ❖ Fair value accounting estimates for which a **highly specialised entity-developed model** is used or for which, there are assumptions or inputs that cannot be observed in the marketplace.

3. Types of Estimates

(A) Fair value Accounting Estimates & examples

Estimates where current transaction cost basis is used or based on condition prevailing in market.

Examples of Fair Value Accounting Estimates

1. Complex financial instruments.
2. Share based payments.
3. Property or equipment held for disposal.
4. Assets acquired in business combinations.
5. Transactions involving the exchange of assets or liabilities between independent parties without monetary consideration, for example, a non-monetary exchange of plant facilities in different lines of business.

(B) Accounting Estimates & examples

Every estimate other than Fair Value Accounting Estimate.

Examples of Accounting Estimates

- (i) Provision for doubtful debts.
- (ii) Inventory obsolescence.
- (iii) Warranty obligations.
- (iv) Depreciation method or estimating useful life of an asset.
- (v) Outcome of Long-Term Contract.
- (vi) Provision for Contingent Liability.

4. Factors that may influence the degree of estimation uncertainty associated with an accounting estimate.

The degree of estimation uncertainty associated with an accounting estimate may be influenced by factors such as-

- (a) The extent to which the accounting estimate depends on **judgment**.
- (b) The **sensitivity** of the accounting estimate to change in assumptions.
- (c) The existence of recognized measurement techniques that may mitigate the estimation uncertainty (though the subjectivity of the assumptions used as inputs may nevertheless give rise to estimation uncertainty.)
- (d) The **length of the forecast period**, and the relevance of data drawn from past events to forecast future events.
- (e) The **availability of reliable data** from external sources.
- (f) The extent to which the accounting estimate is based on **observable or unobservable inputs**.

5. Examples of indicators of possible management bias with respect to accounting estimates:

- (i) Changes in accounting estimate or the method for making it.
- (ii) Use of entity's own assumptions for fair value accounting estimates which is inconsistent with market assumptions.

- (iii) Selection of a point estimate that may indicate a pattern of optimism or pessimism.

PART B- Audit Considerations w.r.t Accounting Estimates

1. OBJECTIVE OF SA 540

The objective of the auditor is to **obtain sufficient appropriate audit evidence** whether in the context of the applicable financial reporting framework:

- (a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognised or disclosed, **are reasonable**; and
- (b) **related disclosures in the financial statements are adequate.**

2. Risk Assessment Procedures & Related Topics

As per **SA 540 "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"**, 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**:

- (i) The requirements of the applicable financial reporting framework relevant to the accounting estimates, including related disclosures.
- (ii) How Management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed, in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.
- (iii) **The estimation making process adopted by the management including:**
 - (1) The method, including where applicable the model, used in making the accounting estimates.
 - (2) Relevant controls.
 - (3) Whether management has used an expert?
 - (4) The assumption underlying the accounting estimates.
 - (5) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and
 - (6) Whether and, if so, how the management has assessed the effect of estimation uncertainty

Identifying & Assessing ROMM

- a) In identifying and assessing ROMM as required by SA 315, auditor shall evaluate degree of estimation uncertainty.
- b) Auditor shall determine whether any of those accounting estimate that have been identified as having high estimation uncertainty give rise to significant risk.

Responses to Assessed Risks of Material Misstatement

- a) Based on assessed ROMM auditor, shall determine:
 - Whether management has appropriately applied FRF relevant to accounting estimate; and
 - Whether methods for making accounting estimates are appropriate and have been applied consistently.
 - If changes in accounting estimates from prior period, are those appropriate in present circumstances.
- b) **In response to assessed ROMM, auditor shall undertake one or more of the following :**
 - Determine whether events occurring up to date of auditor's report provide sufficient audit evidence regarding accounting estimate.
 - The auditor shall also evaluate whether method used for measurement is appropriate and assumptions made are reasonable in light of measurement objective of FRF.
- c) While determining matters identified or responding to assessed ROMM, auditor shall consider

whether specialized skills or knowledge in relation to one or more aspects of accounting estimates are required in order to obtain SAAE.

3. Written Representation about Accounting Estimates:

Depending of the nature, materiality and extent of estimation uncertainty, written representations about accounting estimates recognized or disclosed in the financial statements may include representations:

- ❖ About the **appropriateness of the measurements process**, including related assumptions and models, used by management in determining accounting estimates in the context of the applicable FRF, and the consistency in application of the processes.
- ❖ That the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity, where relevant to the accounting estimates and disclosures.
- ❖ That disclosure related to accounting estimates are complete and appropriate under the applicable financial reporting framework.
- ❖ That no subsequent event requires adjustment to the accounting estimates and disclosures included in the financial statements.

Further as per SA 580 Written Representation, if management does not provide one or more of the requested written representations, the auditor shall

- (a) Discuss the matter with management;
- (b) Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and
- (c) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705.

4. Review of Prior Period Accounting Estimates

The 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.

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.

The review of prior period accounting estimates may also assist the auditor, in the current period, in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias.

However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at that time.

5. Audit Reporting & Disclosure

If there is difference between auditor's range and estimate by management,

- Ask Management to adjust.
- Issue Qualified/Adverse report if not adjusted by management

SA 550 "RELATED PARTIES"**Meaning of Important Terms****Related Party**

A party that is either

- (i) A related party as defined in the applicable financial reporting framework; or
- (ii) Where the applicable financial reporting framework establishes minimal or no related party requirements:
 - a. A person or other entity that has **control or significant influence**, directly or indirectly through one or more intermediaries, over the reporting entity;
 - b. Another entity over which the reporting entity has **control or significant influence**, directly or indirectly through one or more intermediaries; or
 - c. Another entity that is under common control with the reporting entity through having:
 - i. Common controlling ownership;
 - ii. Owners who are close family members; or
 - iii. Common key management.

However, entities that are under common control by a state (i.e., a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

Control or significant influence

- (a) Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities; and
- (b) Significant influence (which may be gained by share ownership, statute or agreement) is the power to participate in the financial and operating policy decisions of an entity, but is not control over those policies.

Verification of Existence of Related Parties:**Identification of possible sources for Related Parties' information:**

- ❖ As per **SA 550 on, "Related Parties"**, the auditor should review information provided by the management of the entity identifying the names of all known related parties.
- ❖ However, it is the management, which is primarily responsible for identification of related parties.
- ❖ The duties of an auditor with regard to reporting of related party transaction as required by **Accounting Standard 18/Ind-AS 24 "Related Party Disclosures"** is given in SA 550.

As per SA 550 "Related Parties", during the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may **indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor.**

Examples-

- (i) Entity Income Tax Returns.
- (ii) Information supplied by the entity to regulatory authorities.
- (iii) Shareholder registers to identify the entity's principal shareholders.
- (iv) Statements of conflicts of interest from management and those charged with governance.
- (v) Records of the entity's investments and those of its pension plans.
- (vi) Contracts and agreements with key management or those charged with governance.
- (vii) Significant contracts and agreements not in the entity's ordinary course of business.
- (viii) Specific invoices and correspondence from the entity's professional advisors.
- (ix) Life insurance policies acquired by the entity.

- (x) Significant contracts re-negotiated by the entity during the period.
- (xi) Internal Auditor's Report.
- (xii) Documents associated with the entity's filings with a securities regulator (e.g., prospectuses).
- (xiii) Minutes of meetings of shareholders and of those charged with governance.
- (xiv) Such other records or documents as the auditor considers necessary in the circumstances of the entity. (MOA, AOA, Section 189 register, Annual Returns etc.

Fraud Risk Factors Associated with a Related Party with Dominant Influence

- ❖ **Domination of management** by single person or small group of persons without compensating controls is a fraud risk factor.
- ❖ **Indicators of dominant influence exerted by a related party include:**
 - The related party has vetoed significant business decisions taken by management or TCWG.
 - Significant transactions are referred to RP for final approval.
 - There is little or no debate among management and TCWG regarding business proposals initiated by RP.
 - Transactions involving RP are rarely independently reviewed and approved.

Examples of Transactions outside the entity's normal course of business { Auditors Response discussed at end }

1. **Complex equity transactions**, such as corporate restructurings or acquisitions.
2. **Transactions with offshore entities** in jurisdictions with weak corporate laws.
3. The **leasing of premises** or the rendering of management services by the entity to another party if no consideration is exchanged.
4. Sales transactions with unusually **large discounts or returns**.
5. Transactions with **circular arrangements**, for example, sales with a commitment to repurchase.
6. Transactions under contracts whose **terms are changed** before expiry.

Risk Assessment procedures and related activities:

- ❖ Obtain understanding of Entity's RPT and inquire from Management regarding Changes in RP's from prior period, nature of relationship between entity and RP, Type of transaction entered.
- ❖ Enquire about internal controls adopted by the management for the identification, accounting and disclosure of RPT's.
- ❖ During the audit, the auditor shall maintain professional skepticism that whether any instances are there showing the existence of RPT's or relationships that management has not previously identified or disclosed to the auditor. (How to identify discussed).
- ❖ The auditor shall share relevant information obtained about the entity's related parties with the other members of the engagement team.
- ❖ After applying all the above procedures if the auditor identifies fraud risk factors, then the auditor designs and performs further Audit Procedures to obtain Sufficient and Appropriate Audit Evidence about assessed Risk of material misstatement associated with RPT's.

AUDITOR'S REPORTING/RESPONSE TO ASSESSED RISKS

CASES	AUDITOR'S DUTY		
1. When auditor identifies previously unidentified or undisclosed RPT's	❖ Communicate the same to Management and Those Charged With Governance.		
	❖ Request the management to disclose the same.		
	<table border="1"> <tr> <td>If Management agrees to disclose</td><td>Unqualified Report</td></tr> </table>	If Management agrees to disclose	Unqualified Report
If Management agrees to disclose	Unqualified Report		

	If Management refuses to disclose	Modify the report and document reasons for refusal.
2. Where the contract is of abnormally high amount with related party/outside entity's normal course of business	❖ Inspect the underlying contracts or agreements, if any, and evaluate whether: (i) The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets, (ii) The terms of the transactions are consistent with management's explanations; and (iii) The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework. ❖ The auditor should also obtain audit evidence that the transactions have been appropriately authorised and approved. ❖ Evaluate whether fraud risk factors, if any, are present. ❖ Obtain written representations from management and, where appropriate, TCWG that they have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and whether they have been accounted for as per the FRF. ❖ If the related party transactions prevent the financial statements from achieving true and fair presentation, modify the report as per SA 705.	

SA 560 "SUBSEQUENT EVENTS"

Meaning of Subsequent Events

Events occurring after B/s date, but before date of audit report, and includes the facts that have become known to the auditor after the date of audit report.

Objectives of the auditor

- ❖ **Obtain SAAE about whether events occurring** between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements.
- ❖ **Respond appropriately to the facts** that become known to the auditor after the date of the auditor's report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.

Matters to be Inquired by the Auditor from Management to identify Subsequent Events/ Specific inquiries

- (i) Whether **new commitments, borrowings** or guarantees have been entered into.
- (ii) Whether **sales or acquisitions of assets** have occurred or are planned.
- (iii) Whether there have been **increases in capital or issuance of debt instruments**, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
- (iv) Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.
- (v) Whether there have been any **developments regarding contingencies**.
- (vi) Whether any **unusual accounting adjustments** have been made or are contemplated.

- (vii) Whether any events have occurred or are likely to occur that will bring into question the appropriateness of accounting policies used in the F.S., as would be the case, for example, if such events call into question the validity of the going concern assumption.
- (viii) Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the F.S.
- (ix) Whether any events have occurred that are relevant to the **recoverability of assets**.

Types of Subsequent events

AS 4 on "Contingencies and Events Occurring after the Balance Sheet Date" deals with all those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved.

As per Ind-AS 10/AS-4 there are 2 types of events:

Adjusting events- Events the contingency of which exists on the balance sheet date is required to be adjusted on the financial statements.

Non-adjusting events- Events the contingency of which does not exist on the balance sheet date are not required to be adjusted. However, non-adjusting events are required to be disclosed in the director's report. However, if the events effect the substratum (going concern) of the enterprise, adjustment is required in the financial statements. However, there is a difference in treatment in Ind AS 10 w.r.t. matters effecting going concern and rather than making an adjustment, just disclosure is needed.

Audit procedures relating to events occurring between the date of F/s and the date of Auditor's Report

- (i) The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that **require adjustment of, or disclosure in, the financial statements have been identified.**
- (ii) Auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following:
 - a) Obtaining **an understanding of any procedure's** management has established to ensure that subsequent events are identified.
 - b) **Inquiring of management** and, where appropriate, TCWG as to whether any subsequent events have occurred which might affect the financial statements.
 - c) **Reading minutes, if any, of the meetings**, of the entity's owners, management and TCWG, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which **minutes are not yet available.**
 - d) Reading the entity's latest subsequent interim financial statements, if any.

Finally, When the auditor identifies events that require adjustment of, or disclosure in, the financial statements, **the auditor shall determine whether each such event is appropriately reflected in those financial statements.**

The auditor shall also request WR in accordance with SA 580 that all subsequent events requiring adjustment or disclosure have been identified or disclosed.

Auditors Responsibilities regarding S.E

- (A) **Auditor's responsibilities regarding subsequent events between the date of the financial statements and the date of the auditor's report**
 - Perform audit procedures designed to obtain SAE that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified
 - If such subsequent events that require adjustment of, or disclosure in, the financial statements have been identified, it shall be determined whether each such event is appropriately reflected in those financial statements.

- Obtain a written representation from management or TCWG that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

(B) **Auditor's responsibilities after the date of the auditor's report but before the date the financial statements are issued**

- **No obligation for auditor to perform any audit procedures** regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, **the auditor shall**
 - (a) Discuss the matter with management and, where appropriate, those charged with governance.
 - (b) Determine whether the financial statements need amendment and, if so,
 - (c) Inquire how management intends to address the matter in the financial statements.
- **If the management amends the financial statements, the auditor shall**
 - (a) carry out the audit procedures necessary in the circumstances on the amendment
 - (b) Extend the audit procedures, already referred, to the date of the new auditor's report and provide a new auditor's report on the amended financial statements. {The new AR shall not be dated earlier than the date of approval of amended FS}
 - (c) Include in the new auditor's report an Emphasis of Matter paragraph or Other Matter(s) paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided by the auditor.
- **When management does not amend the financial statements** in circumstances where the auditor believes they need to be amended and auditor's report has not been provided to the entity, the auditor shall modify the opinion as required by SA 705 and then provide the auditor's report.
- **If the auditor's report has already been provided to the entity**, the auditor shall notify management not to issue the financial statements to third parties before the necessary amendments have been made. If the financial statements are nevertheless subsequently issued without the necessary amendments, the auditor shall take appropriate action, to seek to prevent reliance on the auditor's report.

(C) **Auditor's responsibilities after the financial statements have been issued- same procedure as B only the modification point won't come as f/s and audit report have been issued.**

SA 570 " GOING CONCERN"

Responsibilities for assessment of entity's ability to continue as Going concern

The preparation of the financial statements requires management to assess the entity's ability to continue as a going concern even if the financial reporting framework does not include an explicit requirement to do so.

Management's assessment of the entity's ability to continue as a going concern involves making a judgment, at a particular point in time, about inherently uncertain future outcomes of events or conditions.

Responsibilities of the Auditor

- ❖ The auditor's responsibilities are to obtain SAAE regarding and conclude on the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements and

- ❖ To conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.
- ❖ However, as described in SA 200, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern.
- ❖ The auditor cannot predict such future events or conditions. Accordingly, the absence of any reference to a material uncertainty about the entity's ability to continue as a going concern in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

Indicators that may cast a significant doubt on going concern

The following are examples of events or conditions that, individually or collectively, may cast **significant doubt on the entity's ability to continue as a going concern.**

Financial Indicators

- (i) Net liability or net current liability position.
- (ii) Fixed-term borrowings approaching maturity **without realistic prospects of renewal** or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- (iii) Indications of **withdrawal of financial support by** creditors.
- (iv) **Negative operating cash flows** indicated by historical or prospective financial statements.
- (v) Adverse key financial ratios.
- (vi) Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- (vii) Arrears or **discontinuance of dividends.**
- (viii) **Inability** to pay creditors on due dates.
- (ix) **Inability** to comply with the terms of loan agreements.
- (x) Change from **credit to cash-on-delivery transactions** with suppliers.
- (xi) Inability to obtain financing for essential new product development or other essential investments.

Operating Indicators

- (i) Management intentions to **liquidate the entity or to cease operations.**
- (ii) **Loss of key management** without replacement.
- (iii) **Loss** of a major market, key customer(s), franchise, license, or principal supplier(s).
- (iv) Labour difficulties.
- (v) Shortages of important supplies.
- (vi) Emergence of a highly successful competitor.

Other Indicators

- (i) Non-compliance with **capital or other statutory or regulatory requirements**, such as solvency or liquidity requirements for financial institutions.
- (ii) **Pending legal or regulatory proceedings** against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- (iii) **Changes in law or regulation** or government policy expected to adversely affect the entity.
- (iv) **Uninsured or underinsured** catastrophes when they occur.

Risk Assessment Procedures and Related Activities/Requirements as per SA 570

When performing RAP as required by SA 315, the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern. In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern and: -

- (a) **If such an assessment has been performed**, the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern and, if so, management's plans to address them or
- (b) **If such an assessment has not yet been performed**, the auditor shall discuss with management the basis for the intended use of the going concern basis of accounting, and inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

The auditor shall remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

Additional Audit Procedures When events or conditions are identified

If events or conditions have been identified that may cast **significant** doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast **significant doubt on the entity's ability to continue as a going concern through performing additional audit procedures, including consideration of mitigating factors.**

- (a) Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.
- (b) Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.
- (c) Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future actions:
 - (i) Evaluating the reliability of the underlying data generated to prepare the forecast; and
 - (ii) Determining whether there is adequate support for the assumptions underlying the forecast.
- (d) Considering whether any additional facts or information have become available since the date on which management made its assessment.
- (e) Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans.

Examples of Audit Procedures when events or conditions are identified

- ❖ Analysing and discussing **cash flow, profit** and other relevant forecasts with management
- ❖ Analysing and discussing the entity's latest available **interim financial statements**
- ❖ Reading the terms of **debentures and loan agreements** and determining whether any have been breached
- ❖ Reading **minutes of the meetings** of shareholders, TCWG and relevant committees for reference to financing difficulties
- ❖ Inquiring of the entity's **legal counsel** regarding the existence of litigation and claims
- ❖ Performing audit procedures regarding **subsequent events** to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern
- ❖ Confirming the existence, terms and adequacy of **borrowing facilities**

"Material Uncertainty relating to Going Concern Paragraph"

When the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a **material uncertainty exists the auditor shall determine whether the financial statements:**

- (a) adequately describe the principal events that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and
- (b) disclose clearly that there is a material uncertainty related to going concern and therefore that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

If adequate disclosure is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "material uncertainty related to going concern" to draw attention to the note in the financial statements and state that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that auditor's opinion is not modified in respect of the matter.

Reporting Responsibility as per SA 570

Going Concern Assumption	Auditor's Opinion
Use of Going Concern Basis of Accounting in Financial Statement is Appropriate	Unmodified Opinion
Use of Going Concern Basis of Accounting in Financial Statement is Appropriate, but material uncertainty exists and adequate disclosure of material uncertainty is made in Financial Statements	Unmodified Opinion but disclose in "Material Uncertainty relating to Going Concern" Para to highlight material uncertainty. (Earlier disclosure was required in EOM Paragraph).
Use of Going Concern Basis of Accounting in Financial Statement is Appropriate, but material uncertainty exists and adequate disclosure of material uncertainty is not made in Financial Statements	Qualified or Adverse Opinion.
Use of Going Concern Basis of Accounting in Financial Statement is In Appropriate	Adverse Opinion.

Note (w.e.f. 1.4.2017) :

Material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern is itself a key audit matter but to be reported as per SA 570.

SA 580-WRITTEN REPRESENTATION "

What is written representation?

A written statement by management provided to the auditor to confirm certain matters or to support another audit evidence. Financial statements, supporting books, records, assertions do not constitute written representation.

Important Note :

Written representation provide necessary audit evidence for the purpose of SA 500. However they do not provide sufficient and appropriate audit evidence. Auditor cannot form his opinion solely on written representation.

Objectives of auditor

- To obtain written representation from the management or TCWG that they believe that **they have fulfilled their responsibility** for the preparation of the financial statements and for the completeness of the information provided to the auditor.

2. To **support other audit evidence** relevant to the financial statements or specific assertions in the financial statements by means of written representations.
3. To **respond appropriately to written representation** provided by management/ TCWG.

Key Points

- ❖ As per Section 143 of Co. Act 2013, Auditors are required to report as to whether they have obtained information and explanation as may be necessary for purpose of audit evidence. WR is one of the ways of obtaining such information.
- ❖ **Written Representation does not relieve the auditor of reporting responsibility.** The auditor will have to perform Substantive Procedures irrespective of the fact that Written Representation has been received.
- ❖ WR should be in the form of a representation letter addressed to Auditor. WR shall be obtained for all financial statements and period(s) referred in Auditor's Report. Date of WR shall be as near as practicable to the date of the Auditor's report.
- ❖ **If management does not provide WR, the responsibilities of auditor are as under**
 - (i) Discuss the matter with management.
 - (ii) **Re-evaluate the integrity of the management** and evaluate its potential effect. (If doubt about managements integrity or WR not provided, give disclaimer.)
 - (iii) Take possible actions. Also consider the effect on auditors' opinion in audit report. (Disclaimer since WR not provided.)
 - (iv) Additionally, not providing of WR will be regarded as limitations on scope of auditor The auditor shall communicate the same to TCWG as per SA 260.
- ❖ **If Written Representation is inconsistent with other audit evidences obtained**, the auditor shall perform **additional audit procedures** to resolve the matter. If the matter remains unresolved, reconsider the reliability of WR. Example. Management provides Written Representation, that there are no frauds in organization. Other evidences indicate existence of fraud.
- ❖ Its professional judgement of auditor to obtain WR. Some standards where WR to be obtained mandatorily in writing.(SA -250, SA-501, SA-505, SA-540, SA-550, SA-560, SA-570).

Date & Periods covered by Written Representation

- ❖ The date of Written Representation shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements.
- ❖ Written Representation shall be for all financial statements and periods referred to in the auditor's report.
- ❖ Situations may arise where current management were not present during all periods referred to in the auditor's report. Such persons may assert that they are not in a position to provide some or all WR because they were not in place during the period. This fact, however, does not diminish such persons responsibilities for the financial statements as a whole.

Basic elements of a Management Representation Letter

- (i) It is a written statement provided to the auditor to confirm certain matter or to support another audit evidence.
- (ii) It does not include Financial Statements, assertions, or supporting books and records.
- (iii) The auditor should request Management to provide a Written Representation that it has fulfilled its responsibility for preparation of Financial Statement in accordance with applicable Financial Reporting Framework.
- (iv) Written Representation shall be for all financial statements and periods referred to in Audit Report.

Disclaimer of Opinion in case of non-reliability of WR

- (a) The auditor concludes that there is sufficient doubt about the integrity of management such that the written representations about management fulfilling its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions are not reliable; or
- (b) Management does not provide the written representations relating to fulfilling its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions.

SA 600 "USING THE WORK OF ANOTHER AUDITOR"**Applicability**

- It is to be applied in situations where an auditor (referred to herein as the '**principal auditor**'), reporting on the financial information of an entity, uses the work of another auditor (referred to herein as the '**other auditor**') with respect to the financial information of one or more components included in the financial information of the entity.
- It also discusses the **principal auditor's responsibility in relation to his use of the work of the other auditor**.
- When the principal auditor uses the work of another auditor, the principal auditor should determine how the work of the other auditor will affect the audit.

It 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**.

Factors to be considered while accepting the position of Principal Auditor

- (i) **Materiality of portion of FS which principal auditor audits.**
- (ii) **Principal auditor's degree of knowledge regarding business of components.**
- (iii) **ROMM in the FS of components audited by other auditor.**
- (iv) **Performance of additional procedures regarding components audited by other auditor resulting in the principal auditor having significant participation in such audit.**

The Principal Auditor's Procedures

1. The principal auditor would normally be entitled to **rely upon the work of such auditor** unless there are special circumstances to make essential for him to visit the component and/or to examine the books of account and other records of the said component.
2. The principal auditor should consider **the professional competence of the other auditor** in the context of specific assignment if the other auditor is not a member of the Institute of Chartered Accountants of India.
3. The principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes,
4. The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a **completed questionnaire or check-list**.
5. The principal auditor may consider it appropriate to discuss with the other auditor and the management of the component, the audit findings or other matters affecting the financial information of the components.

He may also decide as to application of **supplementary procedures** that supplement tests of the records or the financial statements of the component, if deemed necessary. Such tests may, depending upon the circumstances, be performed by the principal auditor or the other auditor.

1. **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

The principal auditor should properly co-ordinate with another auditor i.e. **there should be a sufficient liaison between the principal auditor and other auditor**. For this purpose, the principal auditor may find it necessary to issue written communication to the other auditor.

Other Auditor should coordinate with Principal Auditor:

- ❖ Adhering to time-table.
- ❖ Bringing to the attention of Principal Auditor any significant finding.
- ❖ Compliance with relevant statutory requirements.
- ❖ Respond to detailed questionnaire.

Role of Principal Auditor

- (i) It is necessary to issue written communication(s) as a principal auditor to the other auditor.
- (ii) The principal auditor should advise the other auditor of any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.
- (iii) When considered necessary by him, the principal auditor may require the other auditor to **answer a detailed questionnaire** regarding matters on which the principal auditor requires information for discharging his duties.

Role of Other Auditor

- (i) **The other auditor, knowing the context in which his work is to be used by the principal auditor, should co-ordinate with the principal auditor.** For example, by bringing to the principal auditor's immediate attention any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc.
- (ii) He should ensure compliance with the relevant statutory requirements.
- (iii) The other auditor should respond to the questionnaire on a timely basis sent by Principal Auditor.

There should be **statement of division of responsibility** showing to what extent to which financial statement of component audited by another auditor has been included in financial statement of entity.

Division Responsibility

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.

When the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditors, **his report should state clearly the division of responsibility for the financial information of the entity** by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity.

However, if the Principal Auditor notices any material discrepancies, the same has to be brought to the knowledge of other Auditor. This should be incorporated in the Audit Report.

Reporting consideration

- ❖ When the principal auditor concludes, based on his procedures, that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, **the principal**

auditor should express a qualified opinion or disclaimer of opinion because there is a limitation on the scope of audit.

- ❖ In all circumstances, if the other auditor issues, a modified auditor's report, the principal auditor should consider whether the subject of the modification is of such nature and significance and whether it requires a modification of the principal auditor's report or not.
- ❖ The principal auditors should also include another matters paragraph to inform the users of financial statements that components have been audited by some other auditors.

SA 610 "USING THE WORK OF INTERNAL AUDITORS"

Meaning of Internal Audit Function & Direct Assistance

A function of an entity that performs assurance & consulting activities designed to evaluate and improve the effectiveness of the **entity's governance, risk management and internal control processes**.

Direct Assistance: The use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

Scope of this SA

It deals with the external auditor's responsibilities if using the work of internal auditors. This includes

- (a) using the work of the internal audit function in obtaining audit evidence and
- (b) using internal auditors to provide **direct assistance under the direction, supervision and review of the external auditor**.

SA 610 (Revised) does not apply if the entity does not have an internal audit function.

Factors that external auditor will consider before using the work of internal auditor:

1. Objectivity and its Evaluation

Extend to which internal auditor function's organizational status & relevant policies and procedures support objectivity of internal auditor.

Factors that may affect the external auditor's evaluation in relation to Objectivity include the following:

1. Whether the organizational status of the internal audit function, including the function's authority and accountability, supports **the ability of the function to be free from bias, conflict of interest or undue influence of others** to override professional judgments.
2. Whether TCWG **oversee employment decisions** related to the internal audit function.
3. Whether there are **any constraints or restrictions** placed on the internal audit function **by management or those charged with governance, for example**, in communicating the internal audit function's findings to the external auditor.
4. Whether the internal audit function is **free of any conflicting responsibilities, for example**, having managerial or operational duties or responsibilities that are outside of the internal audit function.

2. Competence and its Evaluation

Factors that may affect the external auditor's determination in relation to competence include the following :

1. Whether the internal audit function is **adequately and appropriately resourced** relative to the size of the entity and the nature of its operations.
2. Whether there are established policies for hiring, training and assigning internal auditors to internal audit engagements.
3. Whether the internal auditors have **adequate technical training and proficiency in auditing**.
4. Whether the internal auditors possess the **required knowledge relating to the entity's financial reporting and the applicable financial reporting framework**.

3. Application of a Systematic and Disciplined Approach

Factors that may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach include the following :

1. The existence, adequacy and use of documented internal audit procedures or guidance covering such areas as risk assessments, work programs, documentation and reporting, the nature and extent of which is commensurate with the size and circumstances of an entity.
2. Whether the internal audit function has **appropriate quality control policies and procedures**.

Further, the external auditor shall not use the work of the internal audit function if the external auditor determines that:

- (i) The function's organizational status and relevant policies and procedures **do not adequately support the objectivity of internal auditors;**
- (ii) The function **lacks sufficient competence;** or
- (iii) The function **does not apply a systematic and disciplined approach, including quality control.**

Further the auditor will determine in what areas & to what extent work of internal auditor can be used (Depending on his judgement & assessed risk of material misstatement, significance of threats, and the objectivity and independence of internal auditor.)

Before using the specific work of the internal Auditor, The external auditor shall ensure the following:

- ❖ Whether work was performed by internal auditors having adequate technical training and proficiency;
- ❖ Whether the work was properly supervised, reviewed and documented;
- ❖ Whether the internal auditor has obtained adequate audit evidence to draw reasonable conclusions;
- ❖ Whether the conclusions reached are appropriate in the circumstances and the reports prepared by the internal auditors are consistent with the results of the work performed;
- ❖ Whether the exceptions or unusual matters, if any, disclosed by the internal auditors are properly resolved.

DETERMINING THE NATURE AND EXTENT OF WORK OF THE INTERNAL AUDIT FUNCTION THAT CAN BE USED

The external auditor shall consider the nature and scope of the work performed by Internal audit function.

Work of the internal audit function that can be used by the external auditor include the following:

- ❖ Testing of the operating effectiveness of controls.
- ❖ Substantive procedures involving limited judgment.
- ❖ Observations of inventory counts.
- ❖ Tracing transactions through the information system relevant to financial reporting.
- ❖ Testing of compliance with regulatory requirements.
- ❖ In some circumstances, audits or reviews of the financial information of subsidiaries that are not significant components to the group (where this does not conflict with the requirements of SA 600).

Circumstances in which the external auditor shall plan to use less of the work of the Internal Audit Function and perform more of the work directly

- ❖ More judgment is involved in Planning and performing relevant audit procedures; and Evaluating the audit evidence gathered.
- ❖ As explained in SA 200, the higher the assessed risks of material misstatement, the more persuasive the audit evidence required by the external auditor will need to be, and, therefore, the external auditor will need to perform more of the work directly. { Eg:inventories are being held for considerably long period before being sold. The internal audit reports have not taken this aspect into consideration.}
- ❖ The less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors; and

- ❖ The lower the level of competence of the internal audit function.

Concept of Direct Assistance:

The statu auditor has to determine whether direct assistance can be used i.e. to use work of the internal auditor under his direction, supervision and review. It is allowed when

- It is not prohibition by law or regulation.
- There should be no significant threats to objectivity of Internal Auditor.
- Internal auditor should be competent and capable.

Further, he will determine the Nature, Time and Extent on which direct assistance can be taken.

Prior to using internal auditors to provide direct assistance for purposes of the audit, the external auditor shall:

- Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and
- Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

Direct assistance is not advisable on the following:

- Matters involving Significant Judgements in Audit- Significant judgments include the following:**
 - Assessing the risks of material misstatement;
 - Evaluating the sufficiency of tests performed;
 - Evaluating the appropriateness of management's use of the going concern assumption;
 - Evaluating significant accounting estimates; and
 - Evaluating the adequacy of disclosures in the financial statements, and other matters affecting the auditor's report.
- Matters on which Risk of Material Misstatement is high.**
- Matters in which Internal Auditor is already involved.**
- When internal auditor is not objective, competent and capable.**

The external auditor shall not use an internal auditor to provide direct assistance if:

- ❖ There are significant threats to the objectivity of the auditor.
- ❖ The internal auditor lacks sufficient competence to perform the proposed work. As the function of Internal Auditor is again a concept of evaluation of Internal Control mechanism, it would amount to weaknesses in Internal Control System in case internal auditor does not apply required test procedures considering the Materiality aspects. This would in turn result in Higher Audit Risks.

Direct Assistance from internal auditor in case of External Confirmation Procedures:

- SA 610 provide relevant guidance in determining the nature and extent of work that may be assigned to internal auditors.
- In determining the nature of work of work that may be assigned to internal auditors, the external auditor is careful to limit such work to those areas that would be appropriate to be assigned.
- In accordance with SA 505, the external auditor is required to maintain control over external confirmation requests and evaluate the results of external confirmation procedures, it would not be appropriate to assign these responsibilities to internal auditors.
- It would not be appropriate to use direct assistance w.r.t. obtaining external confirmation requests and their evaluation.** Assistance may be used in assembling information necessary for the external auditor to resolve exceptions in confirmation responses.

If the External Auditor uses Internal Auditors to Provide Direct Assistance on the Audit, the External Auditor shall include in the Audit Documentation

- (a) The evaluation of the existence and significance of threats to the objectivity of the internal auditors, and the level of competence of the internal auditors used to provide direct assistance;
- (b) The basis for the decision regarding the nature and extent of the work performed by the internal auditors;
- (c) Who reviewed the work performed and the date and extent of that review in accordance with SA 230 Audit Documentation;
- (d) The written agreements obtained from an authorized representative of the entity and the internal auditors; and
- (e) The working papers prepared by the internal auditors who provided direct assistance on the audit engagement.

SA 620 "USING THE WORK OF AUDITOR'S EXPERT"

Meaning of Auditor's expert

An individual or organization 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 SAAE. Auditors' expert may be internal auditors' expert or external auditors' expert.

Meaning of Management's expert

An individual or organization 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.

Scope of SA 620

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.
- ❖ The auditor's use of the work of an individual or organization 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.**

The objectives of the auditor are:

- (a) To determine whether to use the work of an auditor's expert; and
- (b) If using the work of an auditor's expert, to determine whether that work is adequate for the auditor's purposes.

Types of Reports /Opinions auditors can obtain from auditor's expert

- (i) 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.
- (ii) The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans.
- (iii) The estimation of oil and gas reserves.
- (iv) The valuation of environmental liabilities, and site clean-up costs.
- (v) The interpretation of contracts, laws and regulations.
- (vi) The analysis of complex or unusual tax compliance issues.

Procedures to be followed while using the work of auditor's expert**1. Determining need for an Auditor's Expert**

An auditor's expert may be needed to assist the auditor for the followings:

- Obtaining an understanding of entity & its environment, including IC.
- Identifying and assessing the risks of material misstatement.
- Determining & implementing overall responses to assessed risks.
- Designing and performing further audit procedures to respond to assessed risks.
- Evaluating the sufficiency and appropriateness of audit evidence obtained.

2. Evaluate Competence, Capability and Objectivity of the Expert

Source of Information for evaluation:

- Personal Experience with previous work.
- Discussion with that expert.
- Discussion with other Auditors.
- Knowledge of expert's qualification, memberships, other forms of recognitions.
- Published books or papers.
- Auditor's firm Quality Control Policies and Procedures.

3. Obtain an understanding of expert work

- To enable the auditor to determine the nature, scope and objectives of that expert's work for auditor's purposes.
- Evaluate the adequacy of that work for the auditor's purposes.

4. Agreement with Auditor's Expert

It needs to be in writing and cover the followings

- Nature, scope and Objectives of Auditor's Expert work.
- Respective Role and Responsibilities of Auditor and auditor's Expert.
- NTE of Communication including form of report.
- Confidentiality requirements to be observed by Auditor's Expert.

The factors which suggest the need for detailed and written agreement between the auditor and the auditor's expert.

- (i) The auditor's expert will have access to sensitive or confidential entity information.
- (ii) The respective roles or responsibilities of the auditor and the auditor's expert are different from those normally expected.
- (iii) Multi-jurisdictional legal or regulatory requirements apply.
- (iv) The matter to which the auditor's expert's work relates is highly complex.
- (v) The auditor has not previously used work performed by that expert.
- (vi) The greater the extent of the auditor's expert's work, and its significance in the context of the audit

Evaluating The Adequacy Of The Auditor's Expert's Work

The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including:

- (a) The **relevance and reasonableness of that expert's findings or conclusions**, and their **consistency with other audit evidence**;
 - **Specific procedures to evaluate the adequacy of the auditor's expert's work for the auditor's purposes may include:**
 1. **Inquiries** of the auditor's expert.

2. **Reviewing the auditor's expert's** working papers and reports.
 3. **Corroborative procedures**, such as:
 - Observing **the auditor's expert's work**;
 - Examining **published data, such as statistical reports** from reputable, authoritative sources;
 - Confirming **relevant matters with third parties**;
 - Performing **detailed analytical procedures** to see whether Principles of materiality aspects considered; and
 - **Re-performing calculations**.
 4. **Discussion with another expert with relevant expertise** when, for example, the findings or conclusions of the auditor's expert are not consistent with other audit evidence.
 5. **Discussing the auditor's expert's report with management**.
- (b) If that expert's work involves use of **significant assumptions and methods**, the relevance and reasonableness of those assumptions and methods in the circumstances;
- (c) 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

Work Of The Auditor's Expert Not Adequate For The Auditor's Purposes

If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, the auditor shall:

- (a) Agree with that expert on the nature and extent of further work to be performed by that expert; or
- (b) Perform further audit procedures appropriate to the circumstances.

If Auditor concludes that work of auditor's expert is not adequate for the auditor's purposes and auditor cannot resolve the matter through the additional audit procedures, it may be necessary to express a modified opinion.

Can Experts name be included in auditor's report ?

Yes, **but only after prior consent of expert**. However, auditor should indicate in audit report that such reference would not reduce auditor's responsibility.

Factors Influencing The Auditor's Decision W.R.T. Use Of Auditor's Expert When Management Had Used A Management Expert

SA 620 "Using the work of an Auditor's Expert" deals with the auditor's responsibilities regarding the use of an individual or organization's work in a field of expertise other than accounting or auditing, when that work is used to assist the auditor's decision w.r.t. use of auditor's expert when management had used a management expert are:

1. The **nature, scope and objective of the management's expert's work**.
2. Whether the **management's expert is employed by the entity**, or is a party engaged by it to provide relevant services.
3. The **extent to which management can exercise control or influence** over the work of the management's expert.
4. The **management's expert's competence and capabilities**.
5. Whether **the management's expert is subject to technical performance** standards or other professional of industry requirements.
6. Any **control within the entity over the management's expert's work**

The following factors may suggest the need for different or more extensive procedures than would otherwise be the case:

- ❖ The work of the auditor's expert relates to a **significant matter that involves subjective and complex judgments**.
- ❖ The **auditor has not previously used the work of the auditor's expert**, and has no prior knowledge of that expert's competence, capabilities and objectivity.
- ❖ The auditor's expert is performing procedures that are **integral to the audit**, rather than being consulted to provide advice on an individual matter.
- ❖ The **expert is an auditor's external expert** and is not, therefore, subject to the firm's quality control policies and procedures.

SA 710 "COMPARATIVE INFORMATION – CORRESPONDING FIGURES AND COMPARATIVE FINANCIAL STATEMENTS"

Meaning

- a) **Comparative information** – The amounts and disclosures included in the financial statements **in respect of one or more prior periods** in accordance with the applicable financial reporting framework.
- b) **Corresponding figures** – Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as "**current period figures**").
- c) **Comparative financial statements** – Comparative information where amounts and other disclosures **for the prior period are included for comparison with the financial statements of the current period** but, if audited, are referred to in the auditor's opinion.

Objective of the auditor

The objectives of the auditor are to **obtain sufficient appropriate audit evidence** about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework; and to report in accordance with the auditor's reporting responsibilities.

There are two different broad approaches to the auditor's responsibilities in respect of comparative information: **Corresponding figures and Comparative financial statement**.

The essential audit reporting differences between the approaches are:

- (a) For corresponding figures, the auditor's opinion on the financial statements **refers to the current period only; whereas**
- (b) For comparative financial statements, **the auditor's opinion refers to each period for which financial statements are presented**.

Audit Procedures/ Auditor's responsibilities/ duties for reporting of comparatives under SA-710

1. **Determine**
 - (a) Whether F.S. include Comparative information required by FRF, &
 - (b) Whether such information is classified appropriately.
2. **Evaluate and Obtain SAAE whether corresponding figures meet requirement of FRF. This involves assessing whether**
 - (a) Whether the comparative information agrees with the amounts and other disclosures presented in the prior period; and

- (b) Whether the accounting policies reflected in the comparative information are consistent with those applied in the current period.
- (c) Whether, changes in accounting policies, if any, have been properly accounted for and adequately presented and disclosed.

3. **Doubt over existence of misstatement in comparative information**

Apply Professional skepticism as per SA 200, perform additional audit procedures to obtain sufficient appropriate audit evidence to determine existence of material misstatement as per SA 500.

Note: SA 560 "Subsequent Event" also applies if auditor had audited the prior period F.S.

If prior period financial statement has been audited by another auditor/unaudited - Apply SA 510 to audit of opening balances and State in Other Matters PARA.

Include Other Matters para:

- That corresponding FS are unaudited.
- But this does not relieve the auditor from need to obtain SAAE that opening balances do not contain misstatements that can potentially affect current FS.

4. **Obtain WR**

From management to re-affirm that the WR it previously made with respect to the prior period remains appropriate.

a) **Reporting Requirement-Corresponding figures**

When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the following circumstances:

- If the auditor's report of the previous period contains other than an unqualified opinion.
- If the auditor is of the opinion, and he has sufficient evidence in this regard, that a material misstatement exists in the financial statement of prior period, which was not addressed earlier.

If the prior period financial statement are not audited, than he should obtain sufficient audit evidence that the opening balance does not contain any material misstatement.

Previous Auditor's Report	Current Year Report	Auditor's Responsibility
Unmodified	Unmodified	Don't refer to corresponding figures
Modified	Unresolved	Modify current period F/s also . In Basis of Modification Para, refer both current year figures and corresponding figures.
Modified	Resolved	Auditor need not refer to previous modification.
Unaudited/Audited by another Auditor		State in Other Matter Para

(b) **With Reference to Comparative Financial Statement - When comparative financial statement are presented -**

- The auditor's opinion shall refer to **each period** for which the financial statements are presented.
- When reporting on current period's audit, if the auditor's opinion on such prior period financial statement differs from the opinion previously issued on such financial statement, the auditor shall **disclose the substantive reason for the different opinion in other matter paragraph in his report.**

- If the auditor concludes that a material misstatement is present in the previously audited figures of financial statement, he should report it to the appropriate level of the management and request that **the predecessor auditor be informed**. If then the prior years statements **are amended with new report by the predecessor auditor, then the auditor shall report only on the current period**.
- (c) **Reporting treatment common to both (for corresponding figures and comparative information):**
 - (i) **If the financial statement of the prior period were audited by a predecessor auditor, the auditor (is permitted by law or regulation to refer to the predecessor audit report-** on case of corresponding figures and decides to do so) shall state in his audit report:
 - That the financial statement of the prior period were audited by a predecessor auditor;
 - The type of the opinion expressed by the predecessor auditor;
 - The date of that audit report.
 - (iii) **If the prior period financial statement were not audited then he shall report the same in other matter paragraph** in his audit report that the corresponding/comparative figures are unaudited.

SA 720 "THE AUDITOR'S RESPONSIBILITIES IN RELATION TO OTHER INFORMATION"

Scope

SA 720 deals with auditor's responsibilities relating to other information, **whether financial or non-financial information included in an entity's annual report**. Auditor's opinion on the F.S. does not cover the other information, nor does this SA require the auditor to obtain audit evidence beyond that required to form an opinion on the F.S. These responsibilities do not require the auditor to give assurance on other information.

Definition of Other Information:

Other information refers to Financial or non-financial information (other than F.S and the auditor's report thereon) included in the entity's annual report.

Examples of other information-Financial ratios, Corporate Governance Report, Management Discussion and Analysis Report, Financial summaries, Director's Report, Chairman Speech, Corporate Social Responsibility Report.

Requirements of SA 720 as to obtaining the other information:

The auditor shall:

- (a) determine, through discussion with management, which document comprises the annual report, and the entity's planned manner and timing of the issuance of such documents;
- (b) make appropriate arrangements with management obtain in a timely manner and if possible prior to the date of the auditor's report the final version of the document comprising the annual report; and
- (c) when some or all of the document determined above will not be available until after the date of the auditor report **request management to provide a written representation that the final version of the documents will be provided to the auditor when available** and prior to its issuance by the entity, such that the auditor can complete the procedures required by this SA.

Requirements of SA 720 as to reading & considering the other information:

The auditor shall read the other information and in doing so shall:

- (a) consider whether there is a material inconsistency between the other information and the financial statements. As the basis for this consideration **the auditor shall evaluate their consistency, compare selected amounts or other items in the other information** (that are intended to be the same as, to summarize, or to provide greater detail about the amounts or other items in the financial statements) with such amounts or other items in the financial statements; and

- (b) consider whether there is a **material inconsistency** between the other information and the auditor's knowledge obtained in the audit in the context of audit evidence obtained and conclusions reached in the audit.

While reading the other information **the auditor shall remain alert for indication** that the other information not related to the financial statements or the auditor's knowledge obtained in the audit appears to be materially misstates.

Auditors Response in the following situation:

Material misstatement/Material inconsistency exists in other information	❖ If Material inconsistency identified in other information prior to audit report ❖ Ask Management to make the correction. ❖ If management refuses to make the correction, the auditor shall communicate the matter with TCWG and request that the correction be made. ❖ If other information is not corrected even after communicating to TCWG, then consider the implication for auditor's report and communicate with TCWG about how auditor plans to address material misstatement in auditor's report. ❖ Possible implications may be reporting in the section "Other Information" Paragraph and auditor may also consider "Withdrawal from Engagement, if permissible,"
Material inconsistency /Material misstatement exists subsequent to date of Audit Report	❖ Material inconsistency identified in other information subsequent- to audit report-apply SA-560 if such misstatements effect the financial statements. ❖ If not corrected by the management, take appropriate action considering legal rights and obligations.

Other information section shall include: { it will be placed after the heading KAM Para }

- Statement that **management is responsible** for other information.
- Identification of other information obtained **prior to the date of auditor's report.**
- In case of listed entity, identification of other information expected to be obtained after date of auditor's report.
- A statement that **auditor's opinion** on the financial statements does not cover the other information and accordingly auditor does not express any opinion or conclusion thereon.
- Description of **auditor's responsibilities** relating to obtaining, reading, considering and reporting other information as required by this SA.
- When other information has been obtained prior to date of audit report**, a statement that auditor he has not identified any misstatement in other information and we have nothing to report in this regard or a statement that describes uncorrected misstatement of the other information.

Examples of Amounts or Other Items that may be included in Other Information

Amounts

- ❖ Items in a summary of key financial results such as **net income earnings per share dividends, sales and other operating revenues, and purchase and operating expenses.**
- ❖ **Selected operating data** such as income from continuing operations by major operating area or sales by geographical segment or product line.
- ❖ Special items, such as **assets dispositions, litigation provisions, asset impairments, tax adjustments etc.**

- ❖ **Liquidity and capital resource information**, such as cash, cash equivalents and marketable securities; dividends; and debt, capital lease and minority interest obligation.
- ❖ **Capital expenditures by segment or division.**
- ❖ Amounts involved in, and related financial effects of, **off-balance sheet arrangements.**
- ❖ Amounts involved in **guarantees, contractual obligations, legal or environmental claims, and other contingencies.**
- ❖ **Financial measures or ratios** such as gross margin returns on average capital employed, return on average shareholders' equity, current ratio, interest coverage ratio and ratio.

Other items:

- ❖ Explanations of **critical accounting estimates and related assumptions**
- ❖ identification of **related parties and descriptions of transactions with them.**
- ❖ descriptions of the **nature of off-balance sheet arrangements.**
- ❖ **descriptions of guarantees**, indemnifications, contractual obligations, litigation or environmental liability cases, and other contingencies.
- ❖ **descriptions of changes in legal or regulatory requirements** such as new tax or environmental regulations, that have materially impacted the entity's operations or fiscal position' or will have a material impact on the entity's future financial prospects.
- ❖ general **descriptions of the business environment and outlook.**
- ❖ **overview of strategy.**
- ❖ descriptions of **trends in market prices of key commodities or raw materials.**

SA 800 - SPECIAL CONSIDERATIONS - AUDITS OF FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH SPECIAL PURPOSE FRAMEWORKS

Scope of this SA

This SA is written in the context of a complete set of financial statements prepared in accordance with a special purpose framework.

Basic definitions:

1. **Special purpose financial statements** - Financial statements prepared in accordance with a special purpose framework
2. **Special purpose framework** - A financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework.

Examples of special purpose frameworks are:

- The cash receipts and disbursements basis of accounting for cash flow information that an entity may be requested to prepare for creditors;
- The financial reporting provisions established by a regulator to meet the requirements of that regulator; or
- The financial reporting provisions of a contract, such as a bond indenture, a loan agreement, or a project grant.

Requirements of SA 800

- A. **Considerations when accepting the engagement**
 - SA 210 requires the auditor to determine the acceptability of the financial reporting framework applied in the preparation of the financial statements⁴. In an audit of special purpose financial statements, the auditor shall obtain an understanding of:

- (a) The **purpose** for which the financial statements are prepared;
- (b) The **intended users**; and
- (c) The steps taken by management to determine that the **applicable financial reporting framework** is acceptable in the circumstances.

Point To Remember

1. If special purpose framework is developed by authorised standard setting organisation, its presumed to be acceptable if established and transparent process is followed.
2. If FRF is developed by Law or Regulation, acceptable if there are no indications to contrary.
3. If FRF is developed as per contract/ other sources, it's acceptable if it exhibits attributes of acceptable frf as per SA 210.

B. Considerations when planning and performing

- SA 200 requires the auditor to comply with (a) relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements, and (b) all SAs relevant to the audit. { Auditor may judge to depart from relevant requirement of SA by performing alternative audit procedures }.
- Obtain an understanding of the entity's selection and application of accounting policies {SA 315}. In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall obtain an understanding of any significant interpretations of the contract that management made in the preparation of those financial statements.
- Application of some of the requirements of the SAs in an audit of special purpose financial statements may require special consideration by the auditor. For example, in SA 320, judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. In the case of an audit of special purpose financial statements, however, those judgments are based on a consideration of the financial information needs of the intended users.

C. Forming an Opinion and Reporting Considerations

- When forming an opinion and reporting on special purpose financial statements, the auditor shall apply the requirements in SA 700 (Revised).

D. Description of the Applicable FRF

- SA 700 (Revised) requires the auditor to evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework. In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall evaluate whether the financial statements adequately describe any significant interpretations of the contract on which the financial statements are based.
- **SA 700 (Revised) deals with the form and content of the auditor's report. In the case of an auditor's report on special purpose financial statements:**
 - (a) The auditor's report shall also describe the purpose for which the financial statements are prepared and, if necessary, the intended users, or refer to a note in the special purpose financial statements that contains that information; and
 - (b) If management has a choice of financial reporting frameworks in the preparation of such financial statements, the explanation of management's responsibility for the financial statements shall also make reference to its responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances.

E. Alerting readers that the Financial statements are prepared in Accordance with a Special Purpose Framework

- The auditor's report on special purpose financial statements shall include an Emphasis of Matter paragraph alerting users of the auditor's report that the financial statements are prepared in accordance with a special purpose framework.
- In addition to the alert required, the auditor may consider it appropriate to indicate that the auditor's report is intended solely for the specific users.

SA 805- SPECIAL CONSIDERATIONS—AUDITS OF SINGLE FINANCIAL STATEMENTS AND SPECIFIC ELEMENTS, ACCOUNTS OR ITEMS OF A FINANCIAL STATEMENT

Scope of this SA

1. This SA deals with special considerations in the application of those SAs to an audit of a single financial statement or of a specific element, account or item of a financial statement. The single financial statement or the specific element, account or item of a financial statement may be prepared in accordance with a general or special purpose framework.
2. **This SA does not apply to the report of a component auditor**, issued as a result of work performed on the financial information of a component at the request of a group engagement team for purposes of an audit of group financial statements.

Definitions

1. **"Element of a financial statement" or "element"** means an "element, account or item of a financial statement";

Examples of Specific Elements, Accounts or Items of a Financial Statement

- **Accounts receivable, allowance for doubtful accounts receivable, inventory**, the liability for accrued benefits of a private pension plan, the recorded value of identified intangible assets, or the liability for "incurred but not reported" claims in an insurance portfolio, including related notes.
 - A schedule of **externally managed assets** and income of a private pension plan, including related notes.
 - A schedule of **net tangible assets**, including related notes.
 - A schedule of **disbursements in relation to a lease property**, including explanatory notes.
 - A schedule of **profit participation or employee bonuses**, including explanatory notes.
2. **"A single financial statement"** is to be distinguished from complete set of F/s. Example : Cash flow statement.

Considerations when accepting the Engagement

- A. **Application of SA's**
 - SA 200 requires the Auditor to comply with the Standards of Auditing relevant for Audit. If the Auditor is unable to comply with standards of auditing for his audit purpose, he shall not accept the engagement. The auditor shall determine whether the audit of a single financial statement or of a specific element of those financial statements in accordance with SAs is practicable.
 - Compliance with the requirements of SAs relevant to the audit of a single financial statement or of a specific element of a financial statement may not be practicable when the auditor is not also engaged to audit the entity's complete set of financial statements. In such cases, the auditor often does not have the same understanding of the entity and its environment, including its internal control, as an auditor who also audits the entity's complete set of financial statements. The auditor also does not have audit evidence about the general quality of the accounting records or other accounting information that would be acquired in an audit of the entity's complete set of financial statements. Accordingly, the auditor may need further evidence to corroborate audit evidence acquired from the accounting records.

- In the case of an audit of a specific element of a financial statement, certain SAs require audit work that may be disproportionate to the element being audited. For example, although the requirements of SA 570 are likely to be relevant in the circumstances of an audit of a schedule of accounts receivable, complying with those requirements may not be practicable because of the audit effort required. If the auditor concludes that an audit of a single financial statement or of a specific element of a financial statement in accordance with SAs may not be practicable, the auditor may discuss with management whether another type of engagement might be more practicable.

B. Acceptability of the FRF

- SA 210 requires the auditor to determine the acceptability of the financial reporting framework applied in the preparation of the financial statements.
- A single financial statement or a specific element of a financial statement may be prepared in accordance with an applicable financial reporting framework that is based on a financial reporting framework established by an authorised or recognised standards setting organisation for the preparation of a complete set of financial statements.

If this is the case, determination of the acceptability of the applicable framework may involve considering **whether that framework includes all the requirements of the framework on which it is based that are relevant to the presentation of a single financial statement** or of a specific element of a financial statement that provides adequate disclosures.

Considerations when Planning and Performing the Audit

- ❖ In planning and performing the audit of a single financial statement or of a specific element of a financial statement, **the auditor shall adapt all SAs relevant to the audit** as necessary in the circumstances of the engagement.
- ❖ When auditing a single financial statement or a specific element of a financial statement in conjunction with the audit of the entity's complete set of financial statements, **the auditor may be able to use audit evidence obtained as part of the audit of the entity's complete set of financial statements in the audit of the financial statement or the element.**
- ❖ When auditing a single financial statement or a specific element of a financial statement, **the auditor may not be able to consider the financial statement or the element in isolation.** Consequently, the auditor may need to perform procedures in relation to the interrelated items to meet the objective of the audit.
- ❖ **Materiality determined for a single f/s or specific element may be lower than the materiality determined for the complete set of f/s.**

Form of Opinion

- ❖ SA 210 requires that the agreed terms of the audit engagement include the expected form of any reports to be issued by the auditor. In the case of an audit of a single financial statement or of a specific element of a financial statement, the auditor shall consider whether the expected form of opinion is appropriate in the circumstances

Forming an Opinion and Reporting Considerations

- A. Apply the requirements in SA 700 (Revised), adapted as necessary in the circumstances of the engagement.
- B. **Reporting on the Entity's Complete Set of Financial Statements and on a Single Financial Statement or on a Specific Element of Those Financial Statements**
 - If the auditor undertakes an engagement to report on a single financial statement or on a specific element of a financial statement in conjunction with an engagement to audit the entity's complete set of financial statements, the auditor shall express a separate opinion for each engagement.

- An audited single financial statement or an audited specific element of a financial statement may be published together with the entity's audited complete set of financial statements. If the auditor concludes that the presentation of the single financial statement or of the specific element of a financial statement does not differentiate it sufficiently from the complete set of financial statements, the auditor shall ask management to rectify the situation. The auditor shall not issue the auditor's report containing the opinion on the single financial statement or on the specific element of a financial statement until satisfied with the differentiation.

C. **Modified Opinion, Emphasis of Matter Paragraph or Other Matter Paragraph in the Auditor's Report on the Entity's Complete Set of Financial Statements**

- If the opinion in the auditor's report on an entity's complete set of financial statements is modified, or that report includes an Emphasis of Matter paragraph or an Other Matter paragraph, the auditor shall determine the effect that this may have on the auditor's report on a single financial statement or on a specific element of those financial statements.
- The auditor shall not express an unmodified opinion on a single financial statement of a complete set of financial statements if the auditor has expressed an adverse opinion or disclaimed an opinion on the complete set of financial statements as a whole.
- Exceptions {Situation when Auditor may give unmodified opinion on single financial statements when expresses adverse/disclaimer in complete set of financial statements}
 - (a) The auditor is not prohibited by law or regulation from doing so;
 - (b) That opinion is expressed in an auditor's report that is not published together with the auditor's report containing the adverse opinion or disclaimer of opinion; and
 - (c) The specific element does not constitute a major portion of the entity's complete set of financial statements.

SA 810- Engagements to Report on Summary Financial Statements

Scope of this SA

This Standard on Auditing (SA) deals with the auditor's responsibilities when undertaking an engagement to report on summary financial statements derived from financial statements audited in accordance with SAs by that same auditor.

Definitions

- (a) **Applied criteria** - The criteria applied by management in the preparation of the summary financial statements.
- (b) **Audited financial statements** - Financial statements¹ audited by the auditor in accordance with SAs, and from which the summary financial statements are derived.
- (c) **Summary financial statements** - Historical financial information that is derived from financial statements but that contains less detail than the financial statements, while still providing a structured representation consistent with that provided by the financial statements of the entity's economic resources or obligations at a point in time or the changes therein for a period of time.

Requirements

A. **Considerations when accepting the Engagement**

1. The auditor shall, ordinarily, accept an engagement to report on summary financial statements in accordance with this SA only when the auditor has been engaged to conduct an audit in accordance with SAs of the financial statements from which the summary financial statements are derived.
2. Before accepting an engagement to report on summary financial statements, the auditor shall
 - (a) Determine whether the applied criteria are acceptable;

Factors that may affect the auditor's determination of the acceptability of the applied criteria include:

- The **nature** of the entity;
 - The **purpose** of the summary financial statements;
 - The **information needs** of the intended users of the summary financial statements;
 - Whether the applied criteria will result in summary financial statements that are **not misleading** in the circumstances.
- (b) Obtain the agreement of management that it acknowledges and understands its responsibility:
- a. For the preparation of the summary financial statements in accordance with the applied criteria;
 - b. To make the audited financial statements available to the intended users of the summary financial statements without undue difficulty
 - c. To include the auditor's report on the summary financial statements in any document that contains the summary financial statements and that indicates that the auditor has reported on them.
- (c) Agree with management the form of opinion to be expressed on the summary financial statements.
3. If the auditor concludes that the applied criteria are unacceptable or is unable to obtain the agreement of management set out in paragraph 6(b), the auditor shall not accept the engagement

B. Nature of Audit Procedures

The auditor shall perform the following procedures, and any other procedures that the auditor may consider necessary, as the basis for the auditor's opinion on the summary financial statements:

- (a) Evaluate whether the summary financial statements adequately **disclose their summarised nature** and identify the audited financial statements.
- (b) When summary financial statements are not accompanied by the audited financial statements, evaluate whether they describe clearly:
 - (i) From whom or where the audited financial statements are available; or
 - (ii) The law or regulation that specifies that the audited financial statements need not be made available to the intended users of the summary financial statements and establishes the criteria for the preparation of the summary financial statements.
- (c) **Evaluate** whether the summary financial statements adequately disclose the applied criteria.
- (d) **Compare the summary** financial statements with the related information in the audited financial statements to determine whether the summary financial statements agree with or can be re-calculated from the related information in the audited financial statements.
- (e) Evaluate whether the **summary financial statements** are prepared in accordance with the applied criteria.
- (f) Evaluate, in view of the purpose of the summary financial statements, whether the summary financial statements contain the information necessary, and are at an appropriate level of aggregation, so as not to be misleading in the circumstances.
- (g) Evaluate whether the audited financial statements are available to the intended users of the summary financial statements without undue difficulty, unless law or regulation provides that they need not be made available and establishes the criteria for the preparation of the summary financial statements.

C. Form of Opinion

Unmodified Opinion on SFS- Include in auditor's opinion

- SFS are consistent , in all material respects , with audited FS, in accordance with {applied criteria}

➤ SFS are a fair summary of audited FS in accordance with {applicable criteria}

D. **Timing of Work and Events Subsequent to the Date of the Auditor's Report on the Audited Financial Statements**

When the auditor reports on the summary financial statements after the completion of the audit of the financial statements, the auditor is not required to obtain additional audit evidence on the audited financial statements, or report on the effects of events that occurred subsequent to the date of the auditor's report on the audited financial statements since the summary financial statements are derived from the audited financial statements.

E. **Auditor's Report on Summary Financial statements**

Elements of Auditor's Report

(a) **Title**

(b) An addressee

(c) **Introductory Paragraph that identifies summary FS and audited FS and statement that reading summary FS is not a substitute for reading audited FS.**

(d) A description of management's responsibility for the summary financial statements, explaining that management is responsible for the preparation of the summary financial statements in accordance with the applied criteria.

(e) A statement that the auditor is responsible for expressing an opinion on the summary financial statements based on the procedures required by this SA.

(f) A paragraph clearly expressing an opinion.

(g) The auditor's signature along with the firm registration number, wherever applicable, and the membership number assigned by the Institute of Chartered Accountants of India (ICAI).

(h) The date of the auditor's report.

Date of the report on SFS shall be no earlier than

a. Date on which the auditor has obtained audit evidence for performing the audit procedures on the SFS and management have asserted their responsibility for the SFS and

b. Date of report on the Audited FS

(i) The place of signature.

F. **Opinion on Audited Financial Statements different from SFS**

Audited Financial Statement	Summary Financial Statements
Qualified opinion, an Emphasis of Matter paragraph, or an Other Matter paragraph in AFS	Auditor is satisfied that SFS are consistent in all material respects or a fair summary of audited FS then, ❖ Report on SFS should state that report on AFS contains Q/EOM/OM ❖ Describe the basis of the above ❖ Effect, if any of the same on the SFS
Adverse opinion/Disclaimer of opinion on AFS	Report on SFS should state the following ❖ Statement that report on AFS contains Adverse opinion/ Disclaimer of opinion ❖ Describe the basis of the above ❖ Statement that as a result of the above, it is inappropriate to express an opinion of the SFS

Unmodified opinion on audited FS but modified opinion on SFS	If the summary financial statements are not consistent, in all material respects, with or are not a fair summary of the audited financial statements, in accordance with the applied criteria, and management does not agree to make the necessary changes, the auditor shall express an adverse opinion on the summary financial statements.
Distribution or use of the auditor's report on the audited financial statements is restricted or Alerting Readers that the audited financial statements are prepared in accordance with a special purpose framework	The auditor shall include a similar restriction or alert in the auditor's report on the summary financial statements.

G. Comparatives

- (1) If the audited financial statements contain comparatives, but the summary financial statements do not, the auditor shall determine whether such omission is reasonable in the circumstances of the engagement.
- (2) If the summary financial statements contain comparatives that were reported on by another auditor, the auditor's report on the summary financial statements shall also contain the matters that SA 710 requires the auditor to include in the auditor's report on the audited financial statements.

H. Unaudited Supplementary Information Presented with Summary Financial Statements

- (1) Evaluate whether any unaudited supplementary information presented with the summary financial statements is clearly differentiated from the summary financial statements.
- (2) If the auditor concludes that the entity's presentation of the unaudited supplementary information is not clearly differentiated from the summary financial statements, the auditor shall ask management to change the presentation of the unaudited supplementary information.
- (3) If management refuses to do so, the auditor shall explain in the auditor's report on the summary financial statements that such information is not covered by that report.

I. Other Information in Documents Containing Summary Financial Statements

- (1) The auditor shall read the other information included in a document containing the summary financial statements and related auditor's report to consider whether there is a material inconsistency between the other information and the summary financial statements.
- (2) If the auditor identifies a material inconsistency, the auditor shall determine whether the summary financial statements or the other information needs to be revised.
- (3) If, the auditor becomes aware that the other information needs to be revised, the auditor shall discuss the matter with management.

J. Auditor's Association

- (1) If the auditor becomes aware that the entity plans to state that the auditor has reported on summary financial statements in a document containing the summary financial statements, but does not plan to include the related auditor's report, the auditor shall request management to include the auditor's report in the document.
- (2) If management does not do so, the auditor shall determine and carry out other appropriate actions designed to prevent management from inappropriately associating the auditor with the summary financial statements in that document.

- (3) Other appropriate actions the auditor may take when management does not take the requested action may include informing the intended users and other known third-party users of the inappropriate reference to the auditor/seek legal advice.

INTRODUCTION TO STANDARDS ON REVIEW ENGAGEMENTS {SRE'S}

(Requirement of SQC-1 is applicable)

1.1. What is Review ?

"Review" is a limited assurance engagement. Limited assurance is the level of assurance obtained where engagement risk is reduced to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for expressing a conclusion. In simpler terms, limited assurance engagement provides lower level of assurance than audit.

1.2 Audit vs Review

Audit	Review
Audit is a type of reasonable assurance engagement providing reasonable level of assurance.	Review is a type of limited assurance engagement providing a lower level of assurance than reasonable assurance engagement.
It performs elaborate and extensive procedures including tests of controls and substantive procedures.	It performs fewer procedures primarily focusing on inquiry and analytical procedures.
It draws reasonable conclusions on the basis of sufficient appropriate evidence.	It draws limited conclusions on the basis of sufficient appropriate evidence.
It provides an assurance opinion. The language of assurance opinion is positively worded. {Positive Assurance }	It provides an assurance conclusion. The language of assurance conclusion is negatively worded. { Negative Assurance }

1.3 Type of Review Standards

There are 2 types of Review Standards

SRE 2400	Where the reviewer is not the statutory auditor of the auditee
SRE 2410	Where the reviewer is also the statutory auditor of the auditee

1.4 UDIN has also to be generated and stated for review engagement as it is also in nature of an assurance engagement. UDIN has to be stated for engagements performed in accordance with SRE 2400 or SRE 2410.

SRE 2400- ENGAGEMENTS TO REVIEW HISTORICAL FINANCIAL STATEMENTS

1. **Objective in a review of financial statements in accordance with SRE 2400**

- Obtain limited assurance, primarily by making an inquiry and performing analytical procedures, about whether the financial statements as a whole are free from material misstatement, thereby enabling the practitioner to express a conclusion on whether anything has come to his attention that causes him to believe the financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework
 - Report on the financial statements as a whole and communicate, as required by this SRE.
- The practitioner {other than the auditor of the client} reviews the financial statements.**
 - The practitioner is required to follow SCQ1.**

4. The practitioner shall comply with relevant ethical requirements, including those pertaining to independence. { Fundamental principles are : Integrity ; Objectivity; Professional competence and due care ; Confidentiality and Professional behaviour }
5. **Factors affecting Acceptance and Continuance of Client Relationships and Review Engagements:**
Unless required by law or regulation, the practitioner shall not accept a review engagement if
 - (a) The practitioner is not satisfied that there is rational purpose for the engagement and that review is appropriate in the circumstances.
 - (b) The practitioner has reason to believe that relevant ethical requirements, including independence, will not be satisfied.
 - (c) The practitioner's preliminary understanding of the engagement circumstances indicates that information needed to perform the review engagement is likely to be unavailable or unreliable.
 - (d) The practitioner has cause to doubt management's integrity such that it is likely to affect proper performance of review
 - (e) Management or TCWG has imposed limitations on practitioners work and the practitioner believes that the limitation will result in the practitioner disclaiming a conclusion on the financial statements.
6. **Preconditions for accepting the review Engagement**
 - (a) Determine whether the financial reporting framework applied in the preparation of the financial statements is acceptable
 - (b) **Obtain the agreement of management that it acknowledges and understands its responsibilities:**
 1. For preparation of the financial statements in accordance with the applicable financial reporting framework;
 2. For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error;
 3. To provide the practitioner with:
 - i. Access to all information of which management is aware that is relevant to the preparation of the financial statements, such as records, documentation and other matters;
 - ii. Additional information that the practitioner may request from management for the purpose of the review; and
 - iii. Unrestricted access to persons within the entity from whom the practitioner determines it necessary to obtain evidence.

Point To Remember

1. The reviewer shall not accept such engagement if preconditions are not agreed upon by management.
2. If preconditions are not satisfied after the engagement is accepted, the practitioner shall discuss the matter with management or TCWG and shall determine whether the matter can be resolved and whether it is appropriate to communicate with the engagement.

7. **Agreeing to the terms of Engagement**
 - The agreed terms of engagement shall be recorded in an engagement letter or other suitable form of written agreement.

- The practitioner shall not agree to a change in the terms of the engagement where there is no reasonable justification for doing so.
 - If the terms of engagement are changed during the course of the engagement, the practitioner and the management or those charged with governance, as appropriate, shall agree on and record the new terms of engagement in an engagement letter or any other suitable form of written agreement.
8. The practitioner shall plan and perform the engagement with **professional skepticism** recognizing that circumstances may exist that cause the financial statements to be materially misstated.
 9. The review of historical financial statements is a limited assurance engagement. The practitioner's conclusion is based on the practitioner obtaining limited assurance.
 10. The practitioner performs primarily inquiry and analytical procedures and discussions with management to obtain sufficient appropriate evidence as the basis for a conclusion on the financial statements as a whole, expressed in accordance with the requirements of this SRE.

Inquiry	1. Inquiry includes seeking information from management and other persons within the entity, as the practitioner considers appropriate in the engagement circumstances. 2. Inquiries may include matters w.r.t Accounting Estimates, Related Party Transactions, Complex or unusual transactions, existence of actual, suspected or alleged frauds, subsequent events, events affecting going concern of entity, contingencies and commitments etc. 3. The practitioner may also extend Inquiries to obtain non-financial data if appropriate 4. Evaluating the responses provided by the management is integral to the inquiry process.
Analytical Procedures	Review In designing analytical procedures, the practitioner shall consider whether the data from the entity's accounting system and accounting records are adequate for the purpose of performing the analytical procedures.

11. The practitioner shall communicate all significant matters with management or those charged with governance.
12. The standard emphasizes the use of professional judgement throughout the review engagement process, including assessing risks, designing and performing procedures, and evaluating the evidence obtained.
13. **The practitioner shall consider Materiality when planning and performing review procedures. {Determination and Revision of Materiality Levels}**
14. **Understanding of the Entity**
 - A. The practitioner shall obtain an understanding of the entity and its environment, and the applicable financial reporting framework, to identify areas in the financial statements where material misstatements are likely to arise and thereby provide a basis for designing procedures to address those areas.
 - B. **The practitioner's understanding shall include the following:**
 - a. Relevant industry, regulatory, and other external factors including the applicable financial reporting framework;
 - b. The nature of the entity, including:
 - Its operations;

- Its ownership and governance structure;
 - The types of investments that the entity is making and plans to make;
 - The way that the entity is structured and how it is financed; and
 - The entity's objectives and strategies;
- c. The entity's accounting systems and accounting records; and
- d. The entity's selection and application of accounting policies.

15. **Procedures to address specific circumstances**

Related parties	- During the review, the practitioner shall remain alert for arrangements or information that may indicate the existence of related party relationships or transactions that the management has not previously identified or disclosed to the practitioner. - If the practitioner identifies significant transactions outside the entity's normal course of business during the course of review, the practitioner shall inquire with the management about the nature of those transactions, possible involvement of related parties and the business rationale (or lack thereof) of those transactions.
Fraud or non compliance with laws or regulation	- When there is an indication that fraud or non-compliance with laws or regulations, or suspected fraud or non-compliance with laws or regulations, has occurred in the entity, the practitioner shall communicate that matter to the appropriate level of senior management or TCWGs appropriate and request management's assessment of the effects, if any, on the financial statements. - The practitioner has to consider the effect, if any, of management's assessment of the effects of fraud or non-compliance with laws or regulations communicated to him on his conclusion on the financial statements and on his report and determine whether there is a responsibility to report the occurrence or suspicion of fraud or illegal acts to a party outside the entity.
Going concern	If, during the performance of the review, the practitioner becomes aware of events or conditions that may cast significant doubt about the entity's ability to continue as a going concern, the practitioner shall: Inquire of management about plans for future actions affecting the entity's ability to continue as a going concern and about the feasibility of those plans, and also whether management believes that the outcome of those plans will improve the situation regarding the entity's ability to continue as a going concern. Evaluate the response of those inquiries to consider whether management response provide a sufficient basis to continue to present the financial statement on a going concern basis or to conclude whether financial misstatements are materially misstated, or otherwise misleading regarding entity's ability to continue as going concern. Consider management's responses in light of all relevant information of which the practitioner is aware as a result of the review.

16. Additional procedures are required under this SRE if the practitioner becomes aware of a matter that causes the practitioner to believe the financial statements may be materially misstated.

Additional procedures focus on obtaining sufficient appropriate evidence to enable the practitioner to form a conclusion on matters that the practitioner believes may cause the financial statements to be materially misstated. The procedures may be:

- ❖ Additional inquiry or analytical procedures, for example, being performed in greater detail or being focused on the affected items (i.e. amounts or disclosures concerning the affected accounts or transactions as reflected in the financial statements); or
- ❖ Other types of procedures, for example, substantive test of details or external confirmations.

17. **Written Representation from Management**

1. **The practitioner shall request management to provide a written representation that management has fulfilled its responsibilities described in the agreed terms of engagement.**
2. **Obtain additional representation from management that Mgt has provided all information regarding**
 - a. The identity of the entity's related parties and all the related party relationships of which management is aware
 - b. Significant facts relating to any frauds or suspected frauds known to management that may have affected the entity;
 - c. Known actual or possible non-compliance with laws and regulations for which the effects of non-compliance affect the entity's financial statements;
 - d. All information relevant to use of the going concern assumption in the financial statements
 - e. That all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure, have been adjusted or disclosed;
3. If management does not provide one or more of the requested written representations, the practitioner shall:
 - (a) **Discuss matter with Management and TCWG**
 - (b) **Re-evaluate the integrity of management**, and evaluate the effect that this may have on the reliability of representations (oral or written) and evidence in general; and
 - (c) **Take appropriate actions**, including determining the possible effect on the conclusion in the practitioner's report in accordance with this SRE.
4. **The practitioner shall disclaim a conclusion on the financial statements, or withdraw from the engagement if withdrawal is possible under applicable law or regulation, as appropriate, if**
 - (a) The practitioner concludes that there is sufficient doubt about the integrity of management such that the written representations are not reliable or
 - (b) Management does not provide the required representations in respect of its responsibilities for preparation of financial statements and recording of all transactions in financial statements.

18. **Type of Conclusion**

A. **Unmodified Conclusion**

When the practitioner expresses an unmodified conclusion, the practitioner shall, unless otherwise required by law or regulation, use one of the following phrases, as appropriate: -

1. "Based on our review, nothing has come to our attention that causes us to believe that the financial statements do not give a true and fair view (or do not present fairly, in all material respects), in accordance with the applicable financial reporting framework," (for financial statements prepared using a fair presentation framework); or
2. "Based on our review, nothing has come to our attention that causes us to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework," (for financial statements prepared using a compliance framework).

B. Modified Conclusion

The practitioner shall express a modified conclusion in the practitioner's report on the financial statements as a whole when

- (a) practitioner determines, based on the procedures performed and the evidence obtained, **that the financial statements are materially misstated or**
- (b) **The practitioner is unable to obtain sufficient and appropriate evidence** in relation to one or more items in the financial statements that are material in relation to the financial statement as a whole.

When the practitioner modifies the conclusion expressed on the financial statements, the practitioner shall

1. **Use the heading "Qualified Conclusion," "Adverse Conclusion" or "Disclaimer of Conclusion," as appropriate, for the conclusion paragraph in the practitioner's**
2. **Provide a description of the matter giving rise to the modification.;**

Financial statements are materially misstated	Inability to obtain SAAE
1. <u>Qualified opinion-</u> When practitioner concludes that effects of matter giving rise to modification are material, but not pervasive to financial statements; or 2. <u>Adverse opinion-</u> When practitioner concludes that effects of matter giving rise to modification are material, and pervasive to financial statements	1. <u>Qualified opinion-</u> When practitioner concludes that possible effects on the financial statements on the financial statements could be material but not pervasive. 2. <u>Disclaim -</u> When practitioner concludes that possible effects on the financial statements on the financial statements could be material and pervasive.

19. Withdrawal from Engagement:

The practitioner shall withdraw from the engagement if the possible conditions are present

- **Limitations imposed on scope of review as a result of which practitioner is unable to obtain SAAE to form a conclusion.**
- When practitioner concludes that possible effects on the financial statements of undetected misstatements are material and pervasive
- **Withdrawal is possible under applicable law or regulation.**

20. Elements of Practitioners Report

- (a) **Title**
- (b) **Addressee**

(c) **Introductory Paragraph**

- Identifies the financial statements reviewed, including identification of the title of each of the statements contained in the set of financial statements and the date and period covered by each financial statement
- Refers to the summary of significant accounting policies and other explanatory information and
- States that the financial statements have been reviewed

(d) Description of Management Responsibility {Regarding FRF and IC}

(e) If the financial statements are special purpose financial statements - description of purpose, intended user and applicable FRF.

(f) Description of practitioner responsibility

(g) Description of review of financial statement and its limitations

(h) A paragraph under the heading "Conclusion" that contains practitioners conclusion as appropriate and reference to applicable FRF used to prepare the F/S.

(i) When the practitioner's conclusion on the financial statement is modified :

- a. A paragraph under the appropriate heading that contains the practitioner's modified conclusion as appropriate and
- b. A paragraph, under an appropriate heading, that provides a description of the matter(s) giving rise to the modification

(j) A reference to the practitioner's obligation under this SRE to comply with relevant ethical requirements

(k) **The date of the practitioner's report:** The practitioner shall date the report no earlier than the date on which the practitioner has obtained sufficient appropriate evidence.

(l) The practitioner's signature

(m) Place of signature

21. The practitioner may also include EOM or OM para in practitioners report.

SRE 2410-REVIEW OF INTERIM FINANCIAL INFORMATION

1. SRE 2410 applies **when review of interim financial information** is performed by the independent auditor of the financial statements of the entity.
2. **Interim financial information** is financial information that is prepared and presented in accordance with an applicable financial reporting framework and comprises either a complete or a condensed set of financial statements for a period that is shorter than the entity's financial year. For example, interim financial information may relate to financial statements of a quarter of financial year.
3. The objective of an engagement to review interim financial information is to enable the auditor to express a conclusion whether, on the basis of the review, anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with an applicable financial reporting framework.
4. The auditor makes inquiries and performs analytical and other review procedures in order to reduce to a moderate level risk of expressing an inappropriate conclusion when the interim financial information is materially misstated.
5. The auditor and the client should agree on the terms of the engagement. The agreed terms of the engagement are ordinarily recorded in an engagement letter.
6. The auditor should have an understanding of the entity and its environment, including its internal control, as it relates to the preparation of both annual and interim financial information.

7. **In planning a review of interim financial information**, the auditor updates this understanding. The auditor also obtains a sufficient understanding of internal control as it relates to the preparation of interim financial information as it may differ from internal control as it relates to annual financial information.
8. **Some of the procedures performed by the auditor to update the understanding of the entity and its environment, including its internal control, ordinarily include the following**
 - Reading the documentation, to the extent necessary, of the preceding year's audit and reviews of prior interim period(s) of the current year and corresponding interim period(s) of the prior year, to enable the auditor to identify matters that may affect the current-period interim financial information.
 - Considering any significant risks, including the risk of management override of controls, that were identified in the audit of the prior year's financial statements.
 - Reading the most recent annual and comparable prior period interim financial information.
 - Considering the nature of any corrected material misstatements and any identified uncorrected immaterial misstatements in the prior year's financial statements.
 - Inquiring of management about the results of management's assessment of the risk that the interim financial information may be materially misstated as a result of fraud.
 - Inquiring of management about the effect of changes in the entity's business activities.
 - Inquiring of management about any significant changes in internal control and the potential effect of any such changes on the preparation of interim financial information.
 - Inquiring of management of the process by which the interim financial information has been prepared and the reliability of the underlying accounting records to which the interim financial information is agreed or reconciled.
9. **Review Procedures {Inquiries, Analytical and other Review Procedures}**
The auditor mainly performs the following procedures
 - Reading the minutes of the meetings of shareholders, those charged with governance, and other appropriate committees to identify matters that may affect the interim financial information.
 - Considering the effect, if any, of matters giving rise to a modification of the audit or review report, accounting adjustments or unadjusted misstatements, at the time of the previous audit or reviews.
 - Communicating, where appropriate, with other auditors who are performing a review of the interim financial information of the reporting entity's significant components.
 - Applying analytical procedures to the interim financial information designed to identify relationships and individual items that appear to be unusual and that may reflect a material misstatement in the interim financial information.
 - Reading the interim financial information, and considering whether anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework.
 - Inquiring of members of management responsible for financial and accounting matters, and others as appropriate.
10. In **SRE 2410**, The Reviewer is required to **conduct Inquiry of members of management responsible for financial and accounting matters, and others as appropriate about the following :**
 - i. Whether the interim financial information has been prepared and presented in accordance with the **applicable financial reporting framework**.

- ii. Whether there have been any **changes in accounting principles** or in the methods of applying them.
 - iii. Whether any **new transactions have necessitated** the application of a new accounting principle.
 - iv. Whether the interim financial information contains **any known uncorrected misstatements**.
 - v. **Unusual or complex situations** that may have affected the interim financial information, such as a business combination or disposal of a segment of the business.
 - vi. Whether **related party transactions** have been appropriately accounted for and disclosed in the interim financial information.
 - vii. **Significant changes** in commitments and contractual obligations.
 - viii. Significant changes in **contingent liabilities** including litigation or claims.
 - ix. Compliance with **debt covenants**.
 - x. **Knowledge of any allegations of fraud**, or suspected fraud, affecting the entity's interim financial information communicated by employees, former employees, analysts, regulators, or others.
 - xi. Knowledge of any actual or **possible non-compliance with laws and regulations** that could have a material effect on the interim financial information.
 - xii. whether management has **identified all events** up to the date of the review report that may require adjustment to or disclosure in the interim financial information.
 - xiii. whether management has changed **its assessment of the entity's ability** to continue as **a going concern**.
 - xiv. **Events or conditions which may cast significant doubt** on the entity's ability to continue as a going concern
11. **A review of interim financial information ordinarily does not require corroborating the inquiries about litigation or claims.** It is, therefore, ordinarily not necessary to send an inquiry letter to the entity's lawyer. Direct communication with the entity's lawyer with respect to litigation or claims may, however, be appropriate if a matter comes to the auditor's attention that causes the auditor to question whether the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework, and the auditor believes the entity's lawyer may have pertinent information.
12. **Special considerations**
- **Events or conditions casting doubt on Going concern** - When such events or conditions come to the auditor's attention, the auditor inquires of management as to its plans for future action, such as its plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital. The auditor also inquires as to the feasibility of management's plans and whether management believes that the outcome of these plans will improve the situation
 - **Material adjustments needed-** When a matter comes to the auditor's attention that leads the auditor to question whether a material adjustment should be made for the interim financial information to be prepared, in all material respects, in accordance with the applicable financial reporting framework, the auditor should make additional inquiries or perform other procedures to enable the auditor to express a conclusion in the review report. **For example**, if the auditor's review procedures lead the auditor to question whether a significant sales transaction is recorded in accordance with the applicable financial reporting framework, the auditor performs additional procedures sufficient to resolve the auditor's questions, such as discussing the terms of the transaction with senior marketing and accounting personnel, or reading the sales contract.
13. The auditor should evaluate, individually and in the aggregate, whether uncorrected misstatements that have come to the auditor's attention are material to the interim financial information.

14. **The auditor should obtain written representation from management that**

- (a) It acknowledges its responsibility for the design and implementation of internal control to prevent and detect fraud and error
- (b) The interim financial information is prepared and presented in accordance with the applicable financial reporting framework
- (c) It believes the effect of those uncorrected misstatements aggregated by the auditor during the review are immaterial, both individually and in the aggregate, to the interim financial information taken as a whole
- (d) It has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity
- (e) It has disclosed to the auditor all known actual or possible non-compliance with laws and regulations whose effects are to be considered when preparing the interim financial information; and
- (f) It has disclosed to the auditor all significant events that have occurred subsequent to the balance sheet date and through to the date of the review report that may require adjustment to or disclosure in the interim financial information

15. **Auditor's Responsibilities for Accompany Information**

- (a) The auditor should read the other information that accompanies the interim financial information to consider whether any such information is materially inconsistent with the interim financial information.
- (b) If the auditor identifies a material inconsistency, the auditor considers whether the interim financial information or the other information needs to be amended. If an amendment is necessary in the interim financial information and management refuses to make such amendment, the auditor considers the implications for the review report.
- (c) Consider the other principles given in SA 720

16. **Communication**

- When a matter comes to the auditor's attention that causes the auditor to believe that it is necessary to make a material adjustment to the interim financial information for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework, the auditor should communicate this matter as soon as practicable to the appropriate level of management.
- When, in the auditor's judgment, management does not respond appropriately within a reasonable period of time, the auditor should inform TCWG{ oral or written}.
- When in auditor's judgement TCWG does not respond within a reasonable period, the auditor shall consider
 - (a) Whether to modify the report or
 - (b) The possibility of withdrawing from the engagement
 - (c) The possibility of resigning from the appointment to audit the annual financial statements.

17. **Reporting the Nature, Extent and Results of the Review of Interim Financial Information {Contents of a written report }**

- (a) An appropriate title
- (b) An addressee, as required by the circumstances of the engagement
- (c) Identification of the interim financial information reviewed { including title, components, time period}
- (d) If the interim financial information comprises **a complete set of general-purpose financial statements** prepared in accordance with a financial reporting framework designed to achieve fair

presentation, a statement that management is responsible for the preparation and fair presentation of the interim financial information in accordance with the applicable financial reporting framework.

- (e) Statement that management is responsible for the preparation and presentation of the interim financial information in accordance with the applicable financial reporting framework
- (f) A statement that the auditor is responsible for expressing a conclusion on the interim financial information based on the review.
- (g) A statement that the review of the interim financial information was conducted in accordance with Standard on Review Engagements (SRE) 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity," and a statement that that such a review consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures.
- (h) A statement that a review is substantially less in scope than an audit conducted in accordance with Standards on Auditing and consequently does not enable the auditor to obtain assurance that the auditor would become aware of all significant matters that might be identified in an audit and that accordingly no audit opinion is expressed.
- (i) If the interim financial information comprises a complete set of general purpose financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation, a conclusion as to whether anything has come to the auditor's attention that causes the auditor to believe that the interim financial information does not give a true and fair view, or does not present fairly, in all material respects, in accordance with the applicable financial reporting framework.
- (j) In other circumstances, a conclusion as to whether anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework
- (k) The date of the report.
- (l) Place of Signature.
- (m) The auditor's signature and membership number assigned by the Institute of Chartered Accountants of India (ICAI).
- (n) The Firm's registration number of the member of the Institute, wherever applicable, as allotted by ICAI.

18. **Departure from Applicable FRF**

- The auditor should express qualified or adverse conclusion when a matter has come to the auditor's attention that causes the auditor to believe that a material adjustment should be made to the interim financial information for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework.
- The modification describes the nature of the departure and, if practicable, states the effects on the interim financial information.
- When the effect of the departure is so material and pervasive to the interim financial information that the auditor concludes a qualified conclusion is not adequate to disclose the misleading or incomplete nature of the interim financial information, the auditor expresses an adverse conclusion.

19. **Going Concern and Significant Uncertainties**

- If, as a result of inquiries or other review procedures, a material uncertainty relating to an event or condition comes to the auditor's attention that may cast significant doubt on the entity's ability to continue as a going concern, and adequate disclosure is made in the interim financial information the auditor modifies the review report by adding an emphasis of matter paragraph.

- If a material uncertainty that casts significant doubt about the entity's ability to continue as a going concern is not adequately disclosed in the interim financial information, the auditor should express a qualified or adverse conclusion, as appropriate. The report should include specific reference to the fact that there is such a material uncertainty.

20. Limitation of Scope

- The auditor does not accept an engagement to review the interim financial information if the auditor's preliminary knowledge of the engagement circumstances indicates that the auditor would be unable to complete the review because there will be a limitation on the scope of the auditor's review imposed by the management of the entity.
- If, after accepting the engagement, management imposes a limitation on the scope of the review, the auditor requests the removal of that limitation. If management refuses to do so, the auditor is unable to complete the review and express a conclusion. In such cases, the auditor communicates, in writing, to the appropriate level of management and TCWG the reason why the review cannot be completed.
- The auditor also considers the legal and regulatory responsibilities, including whether there is a requirement for the auditor to issue a report. If there is such a requirement, the auditor disclaims a conclusion, and provides in the review report the reason why the review cannot be completed.

21. Documentation

The auditor should prepare review documentation that is sufficient and appropriate to provide a basis for the auditor's conclusion and to provide evidence that the review was performed in accordance with this SRE and applicable legal and regulatory requirements.

INTRODUCTION TO STANDARDS ON RELATED SERVICES {SRS}

(Requirement of SQC-1 is applicable)

1.1 Introduction

Chartered Accountants in practice are often asked to provide services to clients which do not involve the expression of an opinion on the truth and fairness of the financial statements.

For the purpose of standardising the procedures to perform such kind of non-assurance services, the AASB of ICAI issued two Standards on two different services i.e. **Standards on Related Services**.

SRS 4400	Engagements to Perform Agreed-upon Procedures Regarding Financial Information
SRS 4410	Compilation Engagements

1.2 What are Agreed upon Procedures

In an engagement to perform agreed-upon procedures, the auditor is engaged by the client to issue a report of factual findings, based on specified procedures performed on specified subject matter of specified elements, accounts or items of a financial statement.

For example, an engagement to perform agreed-upon procedures may require the auditor to perform certain procedures concerning individual items of financial data, say, accounts payable, accounts receivable, purchases from related parties and sales and profits of a segment of an entity, or a financial statement, say, a balance sheet or even a complete set of financial statements.

However, a person performing related services need not necessarily be the auditor of the entity's financial statements.

1.3 Audit vs Agreed Upon Procedures

A key difference between an audit and agreed-upon procedures relates to assurance. An audit expresses an opinion and provides assurance to users. However, in an agreed-procedures engagement, only a report of

the factual findings of agreed-upon procedures is provided. No assurance is given to users. Instead, users draw their own conclusions based on factual findings stated in the report.

1.4 What are Compilation Engagement

Compilation engagement is an engagement in which a practitioner applies accounting and financial reporting expertise to assist management in the preparation and presentation of financial information of an entity in accordance with an applicable financial reporting framework and issues a report.

Management may request a professional accountant in public practice to assist with the preparation and presentation of financial information of an entity.

SRS 4400 – ENGAGEMENTS TO PERFORM AGREED UPON PROCEDURES REGARDING FINANCIAL INFORMATION

1. Objective in Accordance with SRS 4400

The objective of an agreed-upon procedures engagement is for the auditor to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings.

2. General Principles of Agreed Upon Procedures

The auditor should comply with the Code of Ethics, issued by the Institute of Chartered Accountants of India. Ethical principles governing the auditor's professional responsibilities for this type of engagement include integrity, objectivity, professional competence and due care, confidentiality, professional conduct and technical standards.

Point To Remember

Independence is not a requirement for agreed-upon procedures engagement. However, the terms or objective of the engagement may require the auditor to comply with the independence requirements of the Code of Ethics issued by the Institute of Chartered Accountants of India. Where the auditor is not independent, a statement to that effect should be made in the report of factual findings.

3. Defining the terms of the Engagement

The auditor should ensure with representatives of the entity and, ordinarily, other specified parties who will receive copies of the report of factual findings, that there is a clear understanding regarding the agreed procedures and the conditions of the engagement.

Matters to be agreed include the following:

- Nature of the engagement including the fact that the procedures performed will not constitute an audit or a review and that accordingly no assurance will be expressed
- Stated purpose for the engagement**
- Identification of the financial information to which agreed upon procedure will be applied.**
- Nature, extent and timing of specific procedures to be applied**
- Limitations on distribution of the report of factual findings. When such limitation would be in conflict with the legal requirements, if any, the auditor would not accept the engagement.
- A statement that the distribution of the report of factual findings would be restricted to the specified parties who have agreed to the procedures to be performed.

4. Planning

The auditor should plan the work so that an effective engagement will be performed.

5. Procedures and Evidence

The procedures applied in an engagement to perform agreed-upon procedures may include:

- Inquiry and analysis

- Re computation, comparison and other clerical accuracy checks
- Observation
- Inspection
- Obtaining confirmations

6. **Reporting**

The report on an agreed-upon procedures engagement needs to describe the purpose and the agreed-upon procedures of the engagement in sufficient detail to enable the reader to understand the nature and the extent of the work performed. The report should also clearly mention that no audit or review has been performed.

SRS 4410-COMPILATION ENGAGEMENT

1. **Objective in Accordance with SRS 4410**

The practitioner's objectives in a compilation engagement under this SRS are to: -

- (a) Apply accounting and financial reporting expertise to assist management in the preparation and presentation of financial information in accordance with an applicable financial reporting framework based on information provided by management and
- (b) Report in accordance with the requirements of this SRS

2. **Ethical Requirements**

The practitioner shall comply with relevant ethical requirements. In complying with the Code of Ethics, threats to the practitioner's compliance with relevant ethical requirements are required to be identified and appropriately addressed.

Being in nature of non-assurance engagement, independence requirements do not apply to compilation engagements. However, laws or regulations may specify requirements or disclosure rules pertaining to independence.

3. **Management Responsibilities in Compilation Engagement**

- The financial information, and for the preparation and presentation thereof, in accordance with a financial reporting framework that is acceptable in view of the intended use of the financial information and the intended users.
- Design, implementation and maintenance of such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.
- The accuracy and completeness of the records, documents, explanations and other information provided by management for the compilation engagement.
- Judgments needed in the preparation and presentation of the financial information, including those for which the practitioner may provide assistance in the course of the compilation engagement.

4. **Terms of Engagement shall include**

- (a) The intended use and distribution of the financial information, and any restrictions on either its use or its distribution where applicable
- (b) Identification of applicable FRF
- (c) The objective and scope of the compilation engagement
- (d) The responsibilities of practitioner, including the requirements to comply with relevant ethical requirements
- (e) Responsibilities of Management
- (f) The expected form and content of Management report

5. Performing the Engagement {Procedures Performed}

- Obtain an Understanding of the entity business and its operations { including accounting system and accounting records } & applicable FRF to be able to perform the compilation engagement.
- The practitioner shall **compile the financial information** using the records, documents, explanations and other information, including significant judgments, provided by management.
- The practitioner shall **discuss with management, or TCWG** as appropriate, those significant judgments, for which the practitioner has provided assistance in the course of compiling the financial information.
- Prior to completion of the compilation engagement, the practitioner shall **read the compiled financial information in light of the practitioner's understanding of the entity's business and operations, and of the applicable financial reporting framework.**
- **If, in the course of the compilation engagement, the practitioner becomes aware that the records, documents, explanations or other information,** including significant judgments, provided by management for the compilation engagement are incomplete, inaccurate or otherwise unsatisfactory, the practitioner shall bring that to the attention of management and request the additional or corrected information.
- If the practitioner is **unable to complete the engagement** because management has failed to provide records, documents, explanations or other information, including significant judgments, as requested, the practitioner shall withdraw from the engagement and inform management and TCWG of the reasons for withdrawing.
- If the practitioner becomes aware during the course of engagement that the compiled F/s are not as per applicable FRF or F/s are misstated or misleading, **the practitioner shall propose the appropriate amendments to management.**
- If management declines, or does not permit the practitioner to make the proposed amendments to the compiled financial information, the practitioner shall withdraw from the engagement and inform management and TCWG of the reasons for withdrawing.
- If withdrawal from the engagement is not possible, the practitioner shall determine the professional and legal responsibilities applicable in the circumstances.
- The practitioner shall obtain an acknowledgement from management or those charged with governance, as appropriate, that they have taken responsibility for the final version of the compiled financial information.

6. Elements of Practitioner's Report

- (a) **Title**
- (b) **The Addressee**
- (c) **A statement** that the practitioner has compiled the financial information based on information provided by management
- (d) **A description of the responsibilities of management**, or TCWG as appropriate, in relation to the compilation engagement, and in relation to the financial information
- (e) **Identification of the applicable financial reporting framework** and, if a special purpose financial reporting framework is used, a description or reference to the description of that special purpose financial reporting framework in the financial information
- (f) **Identification of the financial information**, including the title of each element of the financial information if it comprises more than one element, and the date of the financial information or the period to which it relates

- (g) A **description of the practitioner's responsibilities** in compiling the financial information, including that the engagement was performed in accordance with this SRS, and that the practitioner has complied with relevant ethical requirements
- (h) A description of what a compilation engagement entails in accordance with this SRS
- (i) **Explanation that** Since a compilation engagement is not an assurance engagement, the practitioner is not required to verify the accuracy or completeness of the information provided by management for the compilation and Accordingly, the practitioner does not express an audit opinion or a review on whether F/s is as per FRF.
- (j) If the financial information is prepared using a special purpose financial reporting framework, an explanatory paragraph describing the purpose and the reference of intended users for whom it is meant and draw attention to users of F/s that F/s is prepared in accordance with special purpose framework.
- (k) Date of the practitioners report
- (l) **The practitioner's signature**
- (m) **The place of signature**

STANDARDS ON ASSURANCE ENGAGEMENTS

(Requirement of SQC-1 is applicable)

An assurance engagement may relate to examination of subject matters other than examination of financial statements prepared on basis of "historical financial information". In such type of assurance engagements, examination may relate to prospective financial information or to providing assurance regarding non-financial matters like design and operation of internal control in an entity.

Standards on Assurance Engagements deal with responsibilities of professional accountants in assurance engagements dealing such matters. The level of assurance provided by these Standards on Assurance Engagements is moderate.

Following Standards on Assurance Engagements have been issued: -

- ❖ **SAE 3400** The Examination of Prospective Financial Information
- ❖ **SAE 3402** Assurance Reports on Controls at a Service Organisation
- ❖ **SAE 3420** Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus

SAE 3400- THE EXAMINATION OF PROSPECTIVE FINANCIAL INFORMATION

1. What is Prospective financial information?

Prospective Financial information based on:

- Assumptions about events that may occur in the future and
- Possible actions by an entity.

It is highly subjective in nature and its preparation requires the exercise of considerable judgment. Prospective financial information can be in the form of :

- a forecast, {assumptions based on prior information}
- a projection, {hypothetical assumptions }
- or a combination of both (for example a 1 year , forecast plus a 5 year , projection)

2. Responsibility of the Preparation and Presentation of Prospective Financial Information

Management is responsible for the preparation and presentation of the prospective financial information including the :

- Identification and disclosure of Prospective Financial Information;
- Explaining the basis of the forecast;
- Underlying assumptions

3. **Factors to be considered before accepting the audit engagement**

Acceptance of Engagement: As per **SAE 3400, "The Examination of Prospective Financial Information"**, before accepting an engagement to examine prospective financial information, the auditor would consider, amongst other things:

- the intended use of the information;
- whether the information will be for general or limited distribution;
- the nature of the assumptions, that is, whether they are best estimates or hypothetical assumptions;
- the elements to be included in the information; and
- the period covered by the information.

Further, the auditor should not accept, or should withdraw from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use. In accordance with **SA 210, "Terms of Audit Engagement"**, it is necessary that the auditor and the client should agree on the terms of the engagement.

4. **Audit evidence to be obtained for Reporting on Projected Financial Statements:**

The auditor should document matters, which are important in providing evidence to support his report on examination of prospective financial information, and evidence that such examination was carried out.

The audit evidence in form of working papers will include:

- the **sources** of information,
- **basis of forecasts** and
- the **assumptions** made in arriving the forecasts,
- hypothetical assumptions, evidence supporting the assumptions,
- management **representations** regarding the intended use and
- distribution of the information, completeness of material assumptions,
- **management's acceptance** of its responsibility for the information,
- audit plan,
- **the nature, timing and extent** of examination procedures performed, and,

If the auditor expresses a modified opinion or withdraws from the engagement, state the reasons which form the basis of such decision.

5. **Examination Procedures**

When determining the nature, timing and extent of examination procedures, the following matters should be considered such a-s:

Examination Procedures	(a) the knowledge obtained during any previous engagements
	(b) management's competence regarding the preparation of prospective financial information
	(c) the likelihood of material misstatement
	(d) the extent to which the prospective financial information is affected by the management's judgment

	(e)	the sources of information considered by the management for the purpose, the adequacy, reliability of the underlying data, including data derived from third part such as industry statistics, to support the assumptions
	(f)	the stability of entity's business and
	(g)	the engagement team's experience with the business and the industry in which entity operates and with reporting on prospective financial information

6. Presentation and Disclosure

When assessing the presentation and disclosure of the prospective financial information and the underlying assumptions, in addition to the specific requirements of any relevant statutes, regulations as well as the relevant professional pronouncements, it needs to be considered whether;

- Presentation of PFI is informative and not misleading
- The accounting policies are clearly disclosed in the notes to the PFI
- Assumptions are clearly disclosed in the notes to the PFI
- The date on which PFI was prepared is disclosed and Management needs to confirm that assumptions are appropriate as of this date
- The basis of establishing points in a range is clearly indicated and the range is not selected in a biased or misleading manner when results shown in PFI are expressed in terms of range
- If there is any change in the accounting policy of the entity from that disclosed in the most recent historical financial statements, whether the reason for the change and the effect of such change on the PFI has been adequately noticed

7. Reporting on PFI

Such a report would

- state whether, based on the examination of the evidence supporting the assumptions, anything has come to attention, which causes the belief that the assumptions do not provide a reasonable basis for the prospective financial information
- Express an opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework.
- **State that Actual results are likely to be different from the PFI since anticipated events frequently do not occur as expected and the variation could be material. Likewise, when the prospective financial information is expressed as a range, it would be stated that there can be no assurance that actual results will fall within the range.**

When it is believed that the presentation and disclosure of the prospective financial information is not adequate, a qualified or adverse opinion in the report on the prospective financial information should be expressed or withdrawal from engagement should be made as appropriate.

An example would be where financial information fails to disclose adequately the consequences of any assumptions, which are highly sensitive.

SAE 3402-ASSURANCE REPORTS ON CONTROLS AT A SERVICE ORGANISATION

{Many topics are common between SA 402 and SAE 3402. Common topics have been skipped}

1. Applicability

- SAE 3402 applies to auditor of service organization whose duty is to report in Type 1 or Type 2 to the auditor of user entity.

- The report is likely to be relevant to user entity's Internal control as it relates to financial reporting.
- Reports prepared in accordance with this SAE are capable of providing appropriate evidence under SA 402.

2. Responsibilities of Service Auditor

To express an opinion on the service organization's description, on the design of controls related to the control objectives stated in that description and, in the case of a type 2 report, on the operating effectiveness of those controls, based on the service auditor's procedures.

3. Type 1 vs Type 2 Report

(A) Type 1 Report is a report that comprises of

- (i) The service organization's description of its system;
- (ii) A written assertion by the service organization that, in all material respects, and based on suitable criteria:
 - a. The description fairly presents the service organization's system as designed and implemented at the specified date
 - b. The controls related to the control objectives stated in the service organization's description of its system were suitably designed and
- (iii) A service auditor's assurance report that conveys reasonable assurance about the matters referred to in (ii)

(B) Type 2 Report- Contents of Type 1 Report plus Additional Matters Additional matters requiring reporting in type 2 Report

- The service auditor's assurance report shall include a separate section after the opinion, or an attachment, that describes the tests of controls that were performed and the results of those tests.
- In describing the tests of controls, the service auditor shall clearly state which controls were tested, identify whether the items tested represent all or a selection of the items in the population, and indicate the nature of the tests in sufficient detail to enable user auditors to determine the effect of such tests on their risk assessments.
- If deviations have been identified, the service auditor shall include the extent of testing performed that led to identification of the deviations (including the sample size where sampling has been used), and the number and nature of the deviations noted.
- The service auditor shall report deviations even if, on the basis of tests performed, the service auditor has concluded that the related control objective was achieved.

4. STEPS INVOLVED IN SAE 3402 { How such Engagement is Proceeded with ?}

- 1) Compliance with ethical requirements - service auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to assurance engagements.
- 2) Determination of Management and TCWG and communication with them- The service auditor shall determine the appropriate persons within the service organization's management or governance structure with whom to interact.
- 3) Acceptance and changes in terms of engagement
 - Ensure self competence and capability before accepting the engagement.
 - Ensure that criteria to be applied by the service organization to prepare the description of its system will be suitable and available to user entities and their auditors and the scope of the engagement and the service organization's description of its system will not be so limited that they are unlikely to be useful to user entities and their auditors.

- If the service organization requests a change in the scope of the engagement before the completion of the engagement, the service auditor shall be satisfied that there is a reasonable justification for the change.
4. **Assessing the suitability of the Criteria-** The service auditor shall assess whether the service organization has used suitable criteria in preparing the description of its system, in evaluating whether controls are suitably designed, and, in the case of a type 2 reports, in evaluating whether controls are operating effectively.
 5. **Determination of materiality -** When planning and performing the engagement, the service auditor shall consider materiality with respect to the fair presentation of the description, the suitability of the design of controls and, in the case of a type 2 report, the operating effectiveness of controls.
 6. **Obtaining an Understanding of the Service organisation's system-The service Auditor** shall obtain an understanding of the service organization's system, including controls that are included in the scope of engagement.
 7. **Obtaining evidence regarding the description-** The service auditor shall obtain and read the service organization's description of its system and evaluate whether those aspects of the description included in the scope of engagement are fairly presented.
 8. **Obtaining evidence regarding the designing of controls-** The service auditor shall determine which of the controls at the service organization are necessary to achieve the control objectives stated in the service organization's description of its system and shall assess whether those controls were suitably designed.
 9. **Obtain evidence regarding operating effectiveness of controls -**When providing a type 2 report, the service auditor shall test those controls that the service auditor has determined are necessary to achieve the control objectives stated in the service organization's description of its system, and assess their operating effectiveness throughout the period.
 10. **Understanding the internal audit function-** If the service organization has an internal audit function, the service auditor shall obtain an understanding of the nature of the responsibilities of the internal audit function and of the activities performed in order to determine whether the internal audit function is likely to be relevant to the engagement in order for the service auditor to use specific work of the internal auditors.
 11. **Subsequent Events-** The service auditor shall inquire whether the service organization is aware of any events subsequent to the period covered by the service organization's description of its system up to the date of the service auditor's assurance report that could have a significant effect on the service auditor's assurance report.
 12. **Asking for Written Representation from S.O regarding**
 - a) That reaffirm the assertion accompanying the description of the system
 - b) That it has provided the service auditor with all relevant information and access agreed to and
 - c) That it has disclosed to the service auditor any of the following of which it is aware
 - i. Non compliance with laws and regulations, fraud or uncorrected deviations attributable to the service organization that may effect one or more user entities
 - ii. Design deficiencies in control
 - iii. Instances where controls have not operated as described
 - iv. Any events subsequent to the periods covered by the S.O's description of its system upto the date of the service auditor's assurance report that could have a significant effect on the service auditor's assurance report.

5. **Modified Opinions**

IF Service Auditor concludes that

- (a) The S.O description does not fairly present in all material respects, the system as designed and implemented or
- (b) The controls related to the control objectives stated in the description were not suitably designed , in all material respects
- (c) In case of type 2 report , the controls tested did not operate effectively, in all material respects or
- (d) The service auditor is unable to obtain sufficient appropriate evidence, the service auditor's opinion shall be modified , and the service auditor's assurance report shall contain a clear description of all the reasons of the modification.

6. REPORTING

- (i) Title clearly indicates the report is an independent service auditor's assurance report.
- (ii) An addressee
- (iii) **Identification of -S.O description system, parts of S.O system not covered by Service Auditor's opinion.**
- (iv) **Identification of the criteria , and the party specifying the control objective.**
- (v) A statement that the report and, in the case of a type 2 report, the description of tests of controls are intended only for user entities and their auditors, who have a sufficient understanding to consider it.
- (vi) Statement of Service Organisation responsibilities
- (vii) Statement of Service Auditor's responsibilities
- (viii) **A statement that the engagement was performed in accordance with SAE 3402**
- (ix) A summary of the service auditor's procedures to obtain reasonable assurance and a statement of the service auditor's belief that the evidence obtained is sufficient and appropriate to provide a basis for the service auditor's opinion, and, in the case of a type 1 report, a statement that the service auditor has not performed any procedures regarding the operating effectiveness of controls and therefore no opinion is expressed thereon.
- (x) A statement of the limitations of controls and, in the case of a type 2 report, of the risk of projecting to future periods any evaluation of the operating effectiveness of controls.
- (xi) The service auditor's opinion, expressed in the positive form, on whether, in all material respects, based on suitable criteria.
- (xii) The date of the service auditor's assurance report, which shall be no earlier than the date on which the service auditor has obtained sufficient appropriate evidence on which to base the opinion.
- (xiii) Signature-The report should be signed by the practitioner.
- (xiv) The place of signature - the report should name specific location, which is ordinarily the city where the report is signed.

7. S.O 's opinion based on suitable criteria**A. In Case of type 1 report**

- (i) The description fairly presents the service organization's system that had been designed and implemented as at the specified date and
- (ii) The controls related to the control objectives stated in the service organization's description of its system were suitably designed as at the specified date.

B. In Case of type 2 report

- (i) The description fairly presents the service organization's system that had been designed and implemented throughout the specified period;
- (ii) The controls related to the control objectives stated in the service organization's description of its system were suitably designed throughout the specified period; and
- (iii) The controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the specified period.

SAE 3420-ASSURANCE ENGAGEMENT TO REPORT ON THE COMPILATION OF PRO FORMA FINANCIAL INFORMATION INCLUDED IN A PROSPECTUS

1. Scope

- SAE 3420 deals with reasonable assurance engagements undertaken by a practitioner to report on the responsible party's compilation of pro forma financial information included in a prospectus.
- It applies where such reporting is required by securities law or regulation of the security exchange in the jurisdiction in which the prospectus is to be issued or this reporting is generally accepted practice in such jurisdiction.

2. Objective in Accordance with SAE 3420

The objectives of the practitioner in accordance with SA 3420 are: -

- (a) To obtain reasonable assurance about whether the pro forma financial information has been compiled, in all material respects, by the responsible party on the basis of the applicable criteria; and
- (b) To report in accordance with the practitioner's findings.

3. Meaning and Purpose of Pro Forma Financial Information Included in a Prospectus:

Meaning

Pro forma financial information refers to financial information shown together with adjustments to illustrate the impact of an event or transaction on unadjusted financial information as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration.

In this SAE, it is presumed that pro forma financial information is presented in columnar format consisting of:

- (i) the unadjusted financial information;
- (ii) the pro forma adjustments; and
- (iii) the resulting pro forma column.

Purpose

- The purpose of pro forma financial information included in a prospectus is solely to illustrate the impact of a significant event or transaction on unadjusted financial information of the entity as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration.
- This is achieved by applying pro forma adjustments to the unadjusted financial information.
- Pro forma financial information does not represent the entity's actual financial position, financial performance, or cash flows.

Example

The entity may acquire a number of businesses prior to an initial public offering. In such circumstances, the responsible party may choose to present a pro forma net asset statement to illustrate the impact of the acquisitions on the entity's financial position and key ratios such as debt to equity as if the

acquired businesses had been combined with the entity at an earlier date. The responsible party may also choose to present a pro forma income statement to illustrate what the results of operations might have been for the period ended on that date. In such cases, the nature of the pro forma financial information may be described by titles such as "Pro Forma Balance Sheet as at March 31, 20X1" and "Pro Forma Statement of profit and loss for the Year Ended March 31, 20X1."

4. **Compilation of Pro Forma Financial Information:**

The compilation of pro forma financial information involves the responsible party gathering, classifying, summarizing and presenting financial information that illustrates the impact of a significant event or transaction on unadjusted financial information of the entity as if the event had occurred or the transaction had been undertaken at the selected date.

Steps involved in this process include:

- a. Identifying the source of the unadjusted financial information to be used in compiling the pro forma financial information, and extracting the unadjusted financial information from that source;
- b. Making pro forma adjustments to the unadjusted financial information for the purpose for which the pro forma financial information is presented; and
- c. Presenting the resulting pro forma financial information with accompanying disclosures.

5. **Nature of the Practitioner's Responsibility:**

- In an engagement performed under this SAE, the practitioner has no responsibility to compile the pro forma financial information for the entity; such responsibility rests with the responsible party.
- The practitioner's sole responsibility is to report on whether the pro forma financial information has been compiled, in all material respects, by the responsible party on the basis of the applicable criteria.

6. **Steps involved in such an Engagement**

Step 1- Engagement Acceptance

Step 2- Planning and Performing the Engagement

Step 3- Written Representation

Step 4- Forming the opinion

Step 5- Preparing the assurance report

7. **Factors to be considered before accepting such assurance engagement:**

- a. Determine that the practitioner has the **capabilities and competence** to perform the engagement;
- b. Determine that the **applicable criteria** are suitable and that it is unlikely that the pro forma financial information will be misleading for the purpose for which it is intended;
- c. Evaluate the wording of the opinion prescribed by the relevant law or regulation, if any, to determine that the practitioner will likely be able to express the opinion so prescribed based on performing the procedures specified in this SAE;
- d. Where the sources from which the unadjusted financial information and any acquiree or divestee financial information have been extracted have been audited or reviewed;
- e. If the entity's historical financial information has never been audited or reviewed, consider whether the practitioner can obtain a sufficient understanding of the entity and its accounting and financial reporting practices to perform the engagement;
- f. If the event or transaction includes an acquisition and the acquiree's historical financial information has never been audited or reviewed, consider whether the practitioner can obtain a

sufficient understanding of the acquiree and its accounting and financial reporting practices to perform the engagement.

g. **Obtain the agreement of the responsible party that it acknowledges and understands its responsibility for**

- i. Adequately disclosing and describing the applicable criteria to the intended users if these are not publicly available.
- ii. Compiling the proforma information on the basis of the applicable criteria and.
- iii. Providing the practitioner with :
 - a. Access to all information needed for purpose of engagement;
 - b. Additional information that practitioner may request from responsibility party;
 - c. Access to relevant persons within the entity; and
 - d. Access to appropriate individuals within the acquiree(s) in a business combination, whenever needed.

8. **Planning and Performing the Engagement**

- The practitioner shall assess whether the applicable criteria are suitable, as required by the Framework for Assurance Engagements.
- When planning and performing the engagement, the practitioner shall consider materiality with respect to evaluating whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria.
- An understanding of how the responsible party has compiled the pro forma financial Information and other engagement circumstances.
- The practitioner shall obtain evidence about the appropriateness of the source from which the unadjusted financial information has been extracted.
- If there is no audit or review report on the source from which the unadjusted financial information has been extracted, the practitioner shall perform procedures to be satisfied that the source is appropriate.
- The practitioner shall determine whether the responsible party has appropriately extracted the unadjusted financial information from the source.
- The practitioner shall obtain evidence about the appropriateness of the pro forma adjustments.
- The practitioner shall evaluate the presentation of pro forma financial information.
- The practitioner shall read the other information included in the Prospectus containing the pro forma financial information to identify material inconsistencies, if any, with pro forma financial information.

9. **Written Representations:**

The practitioner shall request written representations from the responsible party that:

- a. In compiling the pro forma financial information, the responsible party has identified all appropriate pro forma adjustments necessary to illustrate the impact of the event or transaction at the date or for the period of the illustration; and
- b. The pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria.

10. **Forming an Opinion**

- (i) **Unmodified Opinion-** If pro forma financial information has been compiled, in all material respects, by the responsible party on the basis of the applicable criteria.
- (ii) **Modified Opinion-** If pro forma financial information has not been compiled, in all material respects, by the responsible party on the basis of the applicable criteria.

- (iii) **Emphasis of Matter Paragraph-** Such a paragraph shall refer only to information presented or disclosed in the pro forma financial Information or the accompanying explanatory notes. Such a para would be included when, in the practitioner's opinion, the matter is of such importance that it is fundamental to the user's understanding of whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria.

Point To Remember

Where the relevant law or regulation precludes publication of a prospectus that contains a modified opinion with regard to whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria and the practitioner concludes that a modified opinion is nevertheless appropriate in accordance with the Framework for Assurance Engagements, the practitioner shall discuss the matter with the responsible party.

If the responsible party does not agree to make the necessary changes

- ❖ Withdraw from the engagement or
- ❖ Consider seeking legal advice.

11. **Relationship with Other Professional Pronouncement:**

During the course of this engagement, the practitioners should:

- Comply with the independence and other requirements of the Code of Ethics, issued by the Institute of Chartered Accountants of India; and
- Implement quality control procedures that are applicable to the individual engagement.

12. **Basic Elements of such assurance report:**

- A. Title;
- B. Addressee;
- C. **Introductory Paragraph identifying**
 - the pro forma financial information,
 - The source from which the unadjusted financial information has been extracted and whether or not an audit or review report on such a source has been published
 - The period covered by, or the date of, the pro forma financial information and
 - Reference to applicable criteria used for compilation and its source
- D. A statement that the responsible party is responsible for compiling the pro forma financial information on the basis of the applicable criteria;
- E. Description of the practitioner's responsibilities clearly specifying that the practitioner does not provide any assurance that the actual outcome of the event or transaction at that date would have been as presented;
- F. A statement that the engagement was performed in accordance with SAE 3420, 'Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus';
- G. **Statements that:**
 - the applicable criteria used by the responsible party in the compilation of the pro forma financial information provide a reasonable basis for presenting the significant effects directly attributable to the event or transaction;
 - the procedures selected depend on the practitioner's judgment, having regard to the practitioner's understanding of the nature of the entity, the event or transaction in respect of which the pro forma financial information has been compiled, and other relevant engagement circumstances; and

- The engagement also involves evaluating the overall presentation of the pro forma financial information.

- H. **Opinion paragraph:** Unless otherwise required by law or regulation, the practitioner's opinion using one of the following phrases, which are regarded as being equivalent:
 - a. The pro forma financial information has been compiled, in all material respects, on the basis of the [applicable criteria]; or
 - b. The pro forma financial information has been properly compiled on the basis stated;
- I. The practitioner's Signature;
- J. Date of Report and
- K. Place of Signature

13. **Documentation**

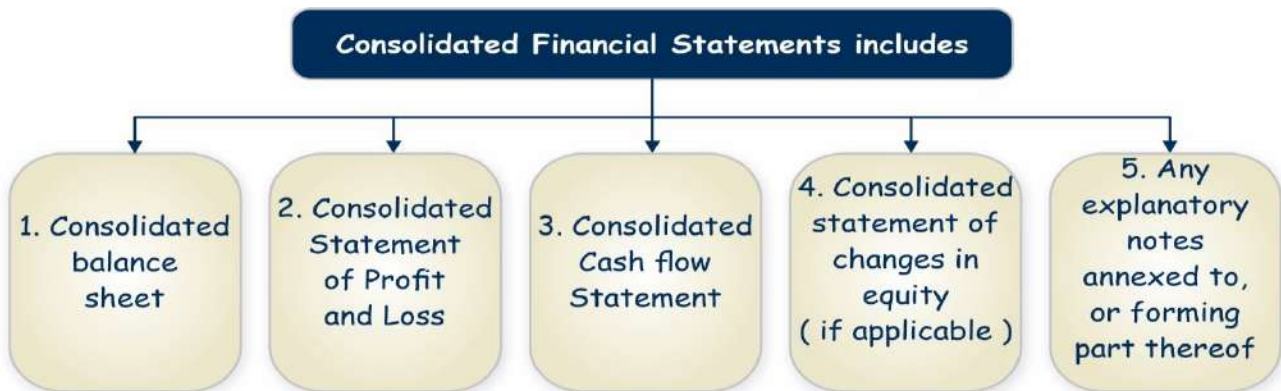
As in case of all assurance engagements, documentation has to be ensured by the practitioner while performing engagement under SAE 3420.

CHAPTER 02

GROUP AUDITS -SUMMARY

AUDIT OF CONSOLIDATED FINANCIAL STATEMENTS

1. MEANING OF CONSOLIDATED FINANCIAL STATEMENTS (CFS)



- ❖ Accounting Standard (AS) 21 'Consolidated Financial Statements' and Indian Accounting Standard (Ind AS) 110, 'Consolidated Financial Statements' lay down principles and procedures for preparation and presentation of consolidated financial statements under AS and Ind AS respectively.

1.2 Mandatory Requirement of Consolidation as per Companies Act, 2013

- ❖ According to Section 129(3) of the Companies Act, 2013, Where a company has one or more subsidiaries or associate companies, it shall, in addition to financial statements, prepare a consolidated financial statement of the company and of all the subsidiaries and associate companies as per the applicable accounting standards.
- ❖ The CFS shall also be approved by the Board of Directors before they are signed on behalf of the Board, along with its standalone financial statements and shall also be laid before the annual general meeting of the company along with the laying of its standalone financial statement.
- ❖ Company is also required to attach along with its financial statement, a separate statement about details of its subsidiary or subsidiaries and associate company or companies in prescribed Form (AOC-1).
- ❖ The consolidation of financial statements shall be made as per Schedule III of the Act and the applicable AS.
- ❖ A company which is not required to prepare CFS under the Accounting Standards, it shall be sufficient if the company complies with provisions of CFS provided in Schedule III of the Act.

1.3 Exemption from Consolidation

A. Exemption as per Companies Act

CFS shall not apply to a company if it meets the following conditions: -

- it is a wholly-owned or a partially-owned subsidiary of another company and all its other members, including those not otherwise entitled to vote, (intimated in writing and the proof of delivery is available), do not object to the company not presenting consolidated F.S.;
- it is a company whose securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India; and
- its ultimate or any intermediate holding company files consolidated F.S. with the Registrar which are in compliance with the applicable accounting standards".

B. Exemption as per Para 11 of AS 11

A subsidiary should be excluded from consolidation when:

- (a) control is intended to be **temporary (subsequent disposal in the near future)**; or
- (b) it operates under **severe long-term restrictions** which significantly impair its ability to transfer funds to the parent. In CFS, investments in such subsidiaries should be accounted as per AS 13, Accounting for Investments.

C. Exemption as per PARA 31 of IND AS 110

An investment entity shall not consolidate its subsidiaries. Instead, an investment entity shall measure an investment in a subsidiary at **fair value through profit or loss** in accordance with **Ind AS 109 (Financial Instruments)**.

However as per Para 33, parent of an investment entity shall consolidate all entities that it controls, including those controlled through an investment entity subsidiary, **unless the parent itself is an investment entity.**

2. RESPONSIBILITY OF PARENT COMPANY FOR PREPARATION OF CFS

- ❖ As per Section 129(3) of Co's Act 2013, where a company has more than one subsidiary, in addition to own F/S, a CFS of Company and all its subsidiaries are to be prepared.
- ❖ **Some of the responsibilities while preparation of CFS includes-**
 - **identifying components**, and including the financial information of the components.
 - where appropriate, identifying **reportable segments** for segmental reporting;
 - identifying **related parties** and related party transactions for reporting;
 - obtaining **accurate and complete** financial information from components; and
 - making appropriate **consolidation adjustments**.
 - **harmonization** of accounting policies and accounting framework; and
 - Generally accepted accounting principles (**GAAP's conversion**), where applicable.

Note- As per AS 16, **proposed dividend** is not to be adjusted in computation of results of associates.

3. RESPONSIBILITIES OF AUDITORS OF CFS**3.1 Points for Consideration for Principal Auditor before accepting the assignment**

The principal auditor should consider whether their own participation is sufficient to be able to act as the principal auditor.

For this purpose, the auditor would consider:

- (a) **the materiality** of financial information which the principal auditor audits;
- (b) the principal auditor's **degree of knowledge** regarding the business of the components;
- (c) the **risk of material misstatements** in the financial information of the components audited by the other auditor; and
- (d) the performance of **additional procedures** regarding the components audited by other auditor resulting in the **principal auditor having significant participation in such audit.**

3.2 Objective of an Auditor in an Audit of CFS

- (a) to satisfy himself that the CFS have been prepared in accordance applicable **financial reporting framework**;
- (b) to enable himself to express an opinion on the **true and fair view** presented by the CFS.
- (c) to enquire into the matters under **section 143(1)** of the Companies Act, 2013; and.

3.3 Audit Considerations while preparing an Audit of CFS

The following features of CFS have an impact on the related audit procedures:

- (a) The CFS are prepared on the basis of separate financial statements of the parent and its components.
- (b) The auditor of the CFS may use the work of other auditors as per requirement **unless the auditor of CFS is also the auditor of the other components of the group.**

When an auditor accepts the audit of CFS, the auditor should assess whether based on his work alone he would be able to express an opinion on the **true and fair view** presented by the CFS.

If the auditor is of the view that his own participation may not be enough or sufficient, **he should consider using the work of 'other auditors'.**

3.4 AUDITING THE CONSOLIDATION

❖ The auditor should make plans, among other things, for the following:

- (a) Understanding of the **group structure and group-wide controls** including assessment of Information Technology (IT) system and IT related controls (manual and automated) for consolidation process;
- (b) understanding of **accounting policies** and consolidation process of the parent and its components including translation of financial statements of foreign components;
- (c) determining and programming the **nature, timing, and extent** of the audit procedures to be performed based on the assessment of the risk of material misstatement in consolidation process;
- (d) determining the extent of **use of other auditor's work** in the audit; and
- (e) **coordinating** the work to be performed.

❖ Auditor's Procedures in Auditing the CFS

- (a) The auditor should obtain a list of subsidiaries, associates & joint ventures included in CFS.
- (b) The auditor should review the information provided by the management of the parent identifying the **subsidiaries, associates and joint ventures.**
- (c) The auditor should verify that all the subsidiaries, associates and joint venture have been included in the consolidated financial statements.
- (d) In respect of completeness of this information, the auditor should perform the following procedures:
 - review his **working papers** for the prior years for the known components;
 - review the **parent's procedures** for identification of various components;
 - make **inquiries of the management** to identify any new components or any component which goes out of consolidated financial statements;
 - **review the investments** of parent as well as its components to determine the shareholding in other entities;
 - review the joint ventures and joint arrangements as applicable;
 - review the other arrangements entered into by the parent **that have not been included in the CFS of the group;**
 - review the statutory records maintained by the parent, for example registers under **section 186, 190** of the Companies Act, 2013;
 - Identify the **changes in the shareholding** that might have taken place during the reporting period.
- (e) The auditor should verify that the **adjustments** required by the relevant AS have been made.
- (f) **Where a component is excluded from the CFS**, the auditor should examine the reasons for exclusion and whether such exclusion is in conformity with the applicable FRF.
- (g) **The auditor should also examine whether there is any change in the status of a component** (e.g., subsidiary to associate, JV to associate or vice - versa).
- (h) De-facto control should also be considered.

De facto control means an investor with less than the majority of the voting rights has the practical ability to direct the relevant activities unilaterally.

Examples of FRF applicable for CFS

A. In preparing CFS in accordance with the Companies (Accounting Standards) Rules, 2006

1. Consolidation is done by the parent company in accordance with the requirement of AS 21 "Consolidated F/s "
2. A parent that has an interest in a jointly controlled entity, reports its interest in the CFS using proportionate consolidation method in accordance with Accounting Standard (AS) 27, "Financial Reporting of Interests in Joint Ventures"

B. For consolidation of subsidiaries in accordance with the Companies (Indian Accounting Standards) Rules, 2015:

- the financial statements of the parent and its subsidiaries are combined as per Ind AS 110, "Consolidated Financial Statements" on a line-by-line basis by adding together like items of assets, liabilities, income, expenses and cash flows;
- related **goodwill/ capital reserve** (or gain on bargain purchase) and non-controlling interest is determined as per Ind AS 103.
- business combinations involving entities or businesses under **common control** shall be accounted for using the **pooling of interest method** in accordance with **Ind AS 103**.
- adjustments like **elimination of intra-group transactions**, balances, unrealised profits and deferred tax etc. are made in accordance with the requirements of **Ind AS 110**.
- investments in associates and joint ventures are accounted for using the **Equity Method** as prescribed in **(Ind AS) 28**, "Investments in Associates and Joint Ventures".
- **Interests in assets, liabilities, revenues and expenses** in a joint operation are accounted for as part of separate financial statements of the entity in accordance with (Ind AS) 111, "Joint Arrangements";

4. TYPES OF CONSOLIDATION ADJUSTMENTS

4.1 Permanent Consolidation Adjustments

- ❖ Permanent consolidation adjustments are those adjustments that are **made only on the first occasion or subsequent occasions** in which there is a **change in the shareholding** of a particular entity which is consolidated.
- ❖ **Permanent consolidation adjustments are:**
 - (a) Determination of goodwill or capital reserve as per applicable AS
 - (b) Determination of amount of equity attributable to minority/non-controlling interests.
- ❖ The auditor should verify that the above calculations have been made appropriately :
 - The auditor should pay particular attention to the determination of **pre-acquisition reserves** of the components. Date(s) of investment in components assumes importance.
 - The auditor should examine whether the pre-acquisition reserves have been **allocated appropriately** between the parent and the minority interests/ non-controlling interests of the Subsidiary.
 - The auditor should also verify the changes that have taken place in these permanent consolidation adjustments on account of subsequent acquisition of shares in the components, disposal of the components in the subsequent years.

4.2 CURRENT PERIOD CONSOLIDATION ADJUSTMENT

- ❖ Current period adjustments are those adjustments that are **made in the accounting period for which the consolidation of financial statements is done.**
- ❖ Current period consolidation adjustments primarily relate to the **elimination of intra-group transactions and account balances** including:
 - a) **intra-group interest** paid and received, or management fees, etc.;
 - b) **unrealised intra-group profits** on assets acquired/ transferred from/ to other subsidiaries;
 - c) **record deferred taxes** on unrealised intercompany profits elimination in accordance with Ind AS 12;
 - d) intra-group **indebtedness**;
 - e) adjustments related to **harmonising** the different accounting policies being followed by the parent and its components;
 - f) adjustments to the financial statements (of the parent and the components being consolidated) for **recognized subsequent events** or transactions that occur between the balance sheet date and the date of the auditor's report on the CFS of the group.
 - g) Adjustment for harmonizing different accounting policies
 - h) In case of a foreign component, adjustments to convert a component's audited financial statements prepared under the **component's local GAAP to the GAAP** under which the CFS are prepared;
 - i) Treatment of **minority interest**
 - j) adjustments relating to deferred tax on account of **temporary differences** arising out of elimination of profit and losses resulting from intergroup transactions (where the parent's accounts are maintained in Ind AS)
- ❖ **Auditors Role**
 - **review the memorandum records** to verify the adjustment entries made in the preparation of consolidated financial statements.
 - verify that the intra group transactions and account balances have been **eliminated**
 - verify that the CFS have been prepared **using uniform accounting policies** for like transactions and other events in similar circumstances
- ❖ verify the adjustments made to **harmonise the different accounting policies** including adjustments made by management to convert a component's financial statements prepared under the component's GAAP to the GAAP under which the CFS are prepared.
- ❖ verify the calculation of **minorities/non-controlling interest.**
- ❖ Verify the adjustments relating to **deferred tax** on account of temporary differences arising out of elimination of profit and losses resulting from intergroup transactions (where the parent's accounts are maintained in Ind AS).
- ❖ The auditor should examine whether any **impairment loss** has been determined by the parent. If yes, the auditor should examine the procedure followed for determination of impairment loss. The auditor should satisfy himself that the amount of impairment loss determined is fair.
- ❖ Apart from verifying that the calculation and disclosures regarding **minorities/non-controlling interest** have been made appropriately, the auditor also determines, in cases where the minority interests' share of the losses exceed the minority/non-controlling interests' share of the equity, the excess, and any further losses applicable to the minority interest, have been accounted for in accordance with the relevant accounting standards.

5. DISCLOSURES NOT REQUIRED IN CONSOLIDATED FINANCIAL STATEMENTS

- ❖ **Source from which bonus shares are issued**, e.g., capitalisation of profits or reserves or from securities premium account.

- ❖ Disclosure of **all unutilised monies** out of the issue indicating the form in which such unutilised funds have been invested.
- ❖ Disclosure required under **(MSME)** Micro, Small and Medium Enterprises Development Act, 2006.
- ❖ **A statement of investments** (whether shown under "financial assets or non-financial assets as stock-in-trade) separately classifying trade investments and other investments, showing the names of the body's corporate in whose shares or debentures, investments have been made and the nature and extent of the investment so made in each such body corporate.
- ❖ **Value of imports** calculated on C.I.F. basis by the company during the financial year in respect of: raw materials, components and spare parts and capital goods.
- ❖ **Expenditure in foreign currency** during the financial year on account of royalty, know-how, professional and consultation fees, interest, and other matters.
- ❖ **Value of all imported raw materials**, spare parts and components consumed during the financial year and the value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption.
- ❖ The amount remitted during the year in **foreign currencies on account of dividends**, with a specific mention of the number of **non-resident shareholders**.
- ❖ **Earnings in foreign exchange** classified under the following heads, namely:
 - export of goods calculated on F.O.B. basis;
 - royalty, know-how, professional and consultation fees;
 - interest and dividend;
 - other income, indicating the nature thereof

6. MANAGEMENT REPRESENTATION

- ❖ **SA 580, "Written Representations"** requires the auditor to obtain written representations from management and, where appropriate, those charged with governance.
- ❖ The auditor of the CFS should obtain evidence that the **management of the parent acknowledges its responsibility** for a true and fair presentation of the CFS in accordance with the financial reporting framework applicable to the parent and that parent management has approved the consolidated financial statements.
- ❖ In addition, the auditor of the CFS obtains written representations from parent management on matters material to the consolidated financial statements.
- ❖ **Examples of such representation with respect to CFS includes**
 - a) **Completeness of components** included in the CFS
 - b) **Identification of reportable segments** for segmental reporting
 - c) **Identification of related parties** and related party transactions for reporting
 - d) **Appropriateness and completeness** of permanent and current period consolidation adjustments, including the elimination of intra-group transactions.

7. REPORTING

Audit Considerations while Reporting

- ❖ The auditor should, while preparing the report, consider the requirements of Standard on Auditing **(SA) 700, SA 705, and SA 706**.
- ❖ Where, the auditor uses the work of other auditors in the audit of consolidated financial statements, the requirements of **SA 600**.

7.1 When the Parent's Auditor is also the Auditor of all its Components

While drafting the audit report, the auditor should report:

- ❖ Whether principles and procedures for preparation and presentation of CFS as laid down in the AS/Ind-AS have been followed.
In case of any departure or deviation, the auditor should consider the requirements given in **SA 705**, so that users of the CFS are aware of such deviation.
- ❖ Auditor should issue an audit report expressing opinion **whether the CFS give a true and fair view of the state of affairs of the Group** as on balance sheet date and as to whether consolidated profit and loss statement gives true and fair view of the results of consolidated profit or losses of the Group for the period under audit.
- ❖ Where the CFS also include a **cash flow statement**, the auditor should also give his opinion on the **true and fair view** of the cash flows presented by the consolidated cash flow statements.

7.2 When the Parent's Auditor is not the Auditor of all its Components

- ❖ In a case where the parent's auditor is not the auditor of all the components included in the consolidated financial statements, the auditor of the CFS should also consider the requirement of **SA 600 "Using the Work of another Auditor"**.
- ❖ As prescribed in SA 706, if the auditor considers it necessary to make reference to the audit of the other auditors, the auditor's report on the CFS should disclose clearly **the magnitude of the portion of the financial statements audited by the other auditor(s)**.
- ❖ This may be done by stating aggregate rupee amounts or percentages of total assets, revenues and cash flows of components included in the CFS **not audited by the parent's auditor**.

7.3 When the Component(s) Auditor Reports on Financial Statements under an Accounting Framework Different than that of the Parent

- ❖ The parent may have components located in **multiple geographies outside India** applying an accounting framework (GAAP) that is **different than that of the parent**. Local component auditors may be unable to report on financial statements prepared using the parent's GAAP because of their **unfamiliarity with such GAAP**.
- ❖ The parent's management **perform a conversion of the components' audited financial statements** from the framework used by the component to the framework under which the CFS are prepared.
- ❖ The conversion adjustments are audited by the **principal auditor** to ensure that the financial information of the component(s) is suitable and appropriate for the purposes of consolidation.
- ❖ **In case the component has prepared financial statements on the basis of group accounting policy**, the local component auditor can then audit and issue an audit report on the components of financial statements.
- ❖ The parent company auditor can then decide whether or not to rely on such audit report issued by component's auditor.

7.4 When the Component(s) Auditor Reports under an Auditing Framework Different than that of the Parent

- ❖ Normally, audits of financial statements, including consolidated financial statements, are performed under auditing standards generally accepted in India ("**Indian GAAS**")
- ❖ In order to maintain **consistency of the auditing framework** and to enable the parent auditor to rely and refer to the other auditor's audit report on the consolidated financial statements, the components' financial statements should also be audited under a framework that corresponds to Indian GAAS.

7.5 Where the financial statements of one or more components is not audited

- ❖ Where the financial statements of one or more components continue to remain unaudited, the auditor reporting on the CFS should consider unaudited components in evaluating a possible modification to his report on the consolidated financial statements.
- ❖ The evaluation is necessary because the auditor has not been able to obtain sufficient appropriate audit evidence in relation to such consolidated amounts/balances.

- ❖ In such cases, the auditor should evaluate **both qualitative and quantitative factors** on the possible effect of such amounts remaining unaudited when reporting on the CFS using the guidance provided in SA 705.

8. STANDARD ON AUDITING (SA) 600, 'USING THE WORK OF ANOTHER AUDITOR'

SA 600 establishes standards when an auditor, reporting on the financial statements of an entity (the group—in the case of consolidated financial statements), uses the work of another auditor on the financial information of one or more components included in the financial statements of the entity.

In carrying out the audit of the standalone financial statements, **the computation of materiality** for the purpose of issuing an opinion on the standalone financial statements of each component would be done component-wise on a standalone basis. However, with regard to determination of materiality during the audit of CFS(CFS), **the auditor should consider the following:**

- ❖ The auditor is required to compute **the materiality for the group as a whole**. This materiality should be used to assess the **appropriateness of the consolidation adjustments** that are made by the management in the preparation of CFS.
- ❖ The parent auditor can also use the materiality computed on the group level to determine whether the **component's financial statements** are material to the group.
- ❖ The principal auditor also computes **the materiality for each component** and communicates to the component auditor, if he believes is required for a true and fair view on CFS.
- ❖ The principal auditor also obtains certain confirmations from component auditors like independence, code of ethics, certain information required for consolidation and disclosure requirements etc.

However, while considering the observations (for instance modification and /or emphasis of matter in accordance with SA (705/706) of the component auditor in his report on the standalone financial statements, **the principles of SA 600 need to be considered.**

CHAPTER 09

AUDITOR REPORT

SA 700 "FORMING AN OPINION AND REPORTING ON FINANCIAL STATEMENTS"**Scope of this SA**

SA-700 mainly deals with **unmodified opinion and form and content of Independent Auditor's Report**. Unmodified opinion means that the entire financial statement has been prepared in accordance with applicable FRF.

Definitions

General purpose framework - This Financial Reporting Framework is designed to meet the common **financial information** needs of the users of financial statements.

IT MAY BE OF TWO TYPES:

- a) **Fair presentation framework** -FRF that requires compliance with the requirements of FRF and acknowledgement that
 - (i) Management may provide disclosures beyond those specifically required the framework.
 - (ii) Management may depart from a requirement of framework to achieve fair presentation of financial statements (in very rare case). Example; Financial statements of a company.
- b) **Compliance framework** -FRF requiring compliance with requirements of the framework but does not contain acknowledgement as above.

Forming an Opinion on FS/Specific Evaluations to be made

To form this opinion, auditor needs to conclude as to whether he has obtained **reasonable assurance** the financial statements as a whole are free from material misstatements, whether due to fraud or error. **As per SA 700, to conclude that reasonable assurance has been obtained, auditor shall consider**

- a) If sufficient appropriate audit evidence has been obtained.
- b) Whether uncorrected misstatements are material, individually or in aggregate and appropriate steps have been taken.
- c) The results of evaluation in which auditor is required to evaluate **whether financial statements are prepared in accordance with applicable FRF by evaluating:**
 - Significant policies selected and applied are adequately disclosed.
 - Accounting policies so selected and applied are consistent with framework requirements.
 - Management's estimates are reasonable.
 - Financial statements fulfil qualitative requirements i.e. relevance, reliability, understand ability, comparability etc.
 - Adequate disclosures have been made.
 - Terminology used, including the title of financial statements is appropriate.
- d) When the financial statements are prepared in accordance with a fair presentation framework, the auditor shall also evaluate as to whether the financial statements achieve **fair presentation**

Basis for Unqualified Opinion

An unqualified opinion indicated the following:

1. The financial statements have been prepared using the generally accepted accounting principles and being constantly followed.
2. The financial statements comply with relevant statutory requirements and regulations.
3. All material matters relevant to proper presentation of the financial information, subject to statutory requirement, if applicable, have been adequately disclosed.

Contents of Audit Report

1. Title	The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor.
2. Addressee	The auditor's report shall be addressed as required by the circumstances of the engagement.
3. Auditor's Opinion	The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion." <u>The Opinion section of the auditor's report shall also:</u> 1. Identify the entity whose financial statements are audited 2. State that financial statements have been audited 3. Identify the title of financial statements that comprise complete set of F/S 4. Refer to the summary of important policies and other explanatory information 5. Specify the time period covered by audited F/S
4. Basis for Opinion:	The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that: a) States that the audit was conducted in accordance with Standards on Auditing; b) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs; c) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit; d) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.
5. Going Concern	Reporting as per SA 570
6. Key Audit Matters	Reporting as per SA 701
7. Other Information	Where applicable, the auditor shall report in accordance with SA 720.
8. Management's Responsibility	1. F/s is prepared by the management as per FRF and is free from material misstatement. 2. Designing and Implementation of internal control. 3. Assessing the entity's ability to continue as going concern and whether going concern basis of accounting is appropriate.

9. Auditor's Responsibility***	Discussed at the end of the table
10. Location of the description of the auditor's responsibilities for the audit of the financial statements.	<u>The description of the auditor's responsibilities for the audit of financial statements shall be included</u> (i) Within the body of the auditor's report. (ii) Within an appendix to the auditor's report (Reference to the location of the appendix shall be mentioned in auditor's report). (iii) By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority, where law, regulation or the auditing standards expressly permit the auditor to do so.
11. Other reporting responsibilities	1. It shall be addressed in a separate heading titled "Reporting on Other Legal and Regulatory Requirements". 2. It may include reporting of CARO, 2020 and reporting u/s 143(3) of Companies Act, 2013.
12. Signature of the Auditor	In personal name of engagement partner and name of firm, along with the membership number, firm registration number and UDIN number.
13. Date of Auditor's Report	The auditor's report shall be dated no earlier than the date on which the auditor has obtained SAAE .
14. Place of signature-	It is ordinarily the city where audit report is signed.

*** Auditor's Responsibility

- This section of the auditor's report shall State that:**
 - The objectives of the auditor are to:
 - Obtain **reasonable assurance** about whether the financial statements as a whole are **free from material misstatement**, whether due to fraud or error; and
 - Issue **an auditor's report** that includes the auditor's opinion.
 - State that reasonable assurance is a **high level of assurance, but is not a guarantee** that an audit conducted in accordance with SAs will always detect a material misstatement when it exists; and
- The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report shall further state**
 - The auditor exercises professional judgment and maintains professional skepticism throughout the audit; and**
 - Describe an audit by stating that the auditor's responsibilities are:**
 - To identify and assess **the risks of material misstatements** of financial statement, whether due to fraud or error; **The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error.**
 - To obtain an understanding of **internal control** relevant to the audit in order to **design audit procedures**, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.
 - To evaluate the **appropriateness of accounting policies used** and the **reasonableness of accounting estimates and related disclosures** made by management.

- (iv) To conclude on the **appropriateness of management's use of the going concern basis** of accounting and, based on the audit evidence obtained,
- (v) **When the financial statements are prepared in accordance with a fair presentation framework**, to evaluate the **overall presentation structure and content of the financial statements**.
- (c) When **SA 600, "Using the Work of Another Auditor"**, applies, further describe the auditor's responsibilities in a group audit engagement by stating,
 - **the division of responsibility** for the financial information of the entity e.g., the number of divisions/branches/subsidiaries or other components audited by other auditors.

3. The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report also shall:

- (a) **State that the auditor communicates with TCWG regarding, among other matters like the planned scope and timing of the audit**, significant audit findings, and including any **significant deficiencies in internal control** that the auditor identifies during the audit;
- (b) **State that the auditor provides TCWG with the statement that the auditor has** complied with relevant **ethical requirements regarding independence**.
- (c) For audits of financial statements of all such entities **for which key audit matters are communicated in accordance with SA 701**, The auditor shall determine those matters that were of most significance in the audit of the financial statements of the current period and same has been communicated to TCWG

Concept of UDIN

It was noticed that financial documents/ certificates attested by third person misrepresenting themselves as CA Members were misleading the Authorities and Stakeholders. ICAI also received number of complaints of signatures of CAs being forged by non CAs. To curb the malpractices, the Professional Development Committee of ICAI implemented in phased manner an innovative concept of UDIN i.e. Unique Document Identification Number. All Certificates were made mandatory with effect from 1st February, 2019

Supplementary Information Presented with the Financial Statements

Supplementary information is any information presented in addition to the financial statements that is not necessary to fairly present the financial statements. This information may be presented with the financials or in a separate document.

- ❖ If supplementary information that is not required by the applicable FRF is considered an integral part of the audited financial statements, **the supplementary information shall be covered by the auditor's opinion.**
- ❖ If supplementary information that is not required by the applicable FRF is not considered an integral part of the audited financial statements,
 - the auditor shall evaluate whether such supplementary information is presented in a way that **sufficiently and clearly differentiates it from the audited financial statements.**
 - If this is not the case, then the auditor shall **ask management to change how the unaudited supplementary information is presented by:**
 - i. **Removing any cross-references from the financial statements** to unaudited supplementary schedules or unaudited notes so that the demarcation between the audited and unaudited information is sufficiently clear.
 - ii. Placing the **unaudited supplementary information outside of the financial statements** or, if that is not possible in the circumstances, at a minimum placing the unaudited notes together at the end of the required notes to the financial statements and clearly labelling them as unaudited. Unaudited notes that are intermingled with audited notes can be misinterpreted as being audited.

- If management refuses to do so, the auditor shall identify the unaudited supplementary information and explain in the auditor's report that such supplementary information has not been audited.
- The fact that supplementary information is unaudited does not relieve the auditor of the responsibilities described in SA 720.

Examples:

- ❖ When the notes to the financial statements include an explanation or the reconciliation of the extent to which the financial statements comply with another financial reporting framework, the auditor may consider this to be supplementary information that cannot be clearly differentiated from the financial statements, **the auditor's opinion would also cover notes or supplementary schedules that are cross referenced from the financial statements.**
- ❖ When an additional profit and loss account that discloses specific items of expenditure is disclosed as a separate schedule included as an appendix to the financial statements, the auditor may consider this to be supplementary information that can be clearly differentiated from the financial statements.

Auditor's Report for Audits Conducted in Accordance with both SA's & International Standards on Audit

1. Auditor may be required to conduct audit in accordance with, in addition to SA's issued by ICAI, International Standards on Auditing or auditing Standards of any other jurisdiction.
If this is the case, the auditor's report may refer to Standards on Auditing in addition to the International Standards on Auditing or auditing standards of such other jurisdiction, **but the auditor shall do so only if:**
 - (a) There is **no conflict** between the requirements in the ISAs or such auditing standards of other jurisdiction and those in SAs that would lead the auditor:
 - (i) **to form a different opinion**, or
 - (ii) **not to include an Emphasis of Matter paragraph or Other Matter paragraph** that, in the particular circumstances, is required by SAs; and
 - (b) The auditor's report includes, at a minimum, each of the elements set out in Auditor's Report prescribed by Law or Regulation discussed above when the auditor uses the layout or wording specified by the Standards on Auditing.
However, reference to "law or regulation" in above paragraph shall be read as reference to the Standards on Auditing. The auditor's report shall thereby identify such Standards on Auditing.
2. When the auditor's report refers to both the ISAs or the auditing standards of a specific jurisdiction and the Standards on Auditing issued by ICAI, the auditor's report shall clearly identify the same including the jurisdiction of origin of the other auditing standards.

Certificate for Special Purpose vs. Audit Report

A certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. The term 'certificate' is, therefore, used where the auditor verifies the accuracy of facts. An auditor may thus, certify the circulation figures of a newspaper or the value of imports or exports of a company. An auditor's certificate represents that he has verified certain figures and is in a position to vouch safe their accuracy as per his examination of documents and books of account.

A report, on the other hand, is a formal statement usually made after an enquiry, examination or review of specified matters under report and includes the reporting auditor's opinion thereon. Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein. On the other hand, when a reporting auditor gives a report, he is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill. The 'report' involves expression of opinion which may differ from one professional to

another. There is no question of exactitude in case of a report since the information contained therein is based on estimates and involves judgement element.

SA 701 "COMMUNICATING KEY AUDIT MATTERS IN THE INDEPENDENT AUDITOR'S REPORT"

Applicability of this SA-Listed entities/as the auditor determines as per circumstances/reqd as per Law. { Not to be included when Auditor issues a disclaimer}

Meaning and Purpose of KAM

Those matters that in the auditor's judgment were of **most significance in audit of financial statement of current period**. These are selected from matters communicated with TCWG.

Purpose-

- To enhance the communicative value of the auditor's report by providing greater transparency.
- To provide additional information to intended users of F.S. to assist them in understating those matters that in auditor's judgment were of most significance.
- To assist intended users in understanding the entity & areas of significant management judgment.
- To provide a basis to further engage with management and TCWG about certain matters relating to the entity.

Scope of this SA

Communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. **Communicating key audit matters in the auditor's report is not:**

- A substitute for disclosures in the financial statements.
- A **substitute for the auditor expressing a modified opinion**.
- A substitute for reporting in accordance with SA 570 (Revised).
- A separate opinion on individual matters.

Some popular examples of key audit matters: Assessment of Impairment , Provisions and Estimates, Revenue Recognition , valuation of financial instruments, taxation complexities etc.

Determining Key Audit Matters

Key audit Matters are to be determined from the matters communicated to TCWG, considering the following:

- Areas of higher assessed RMM or significant risks identified in accordance with SA 315.
- Significant auditor judgment relating to financial statement that involved management judgment for Ex. Accounting estimates having high estimation uncertainty.
- Effect of significant event or transactions occurred during the year.

For each KAM auditor shall

- Give reference to the related disclosure, if any, in the financial statements.
- Explain why the matter was considered as one of the most significant matter.
- Explain how the matter was addressed (resolved) in the audit.

Communicating Key Audit Matters

The introductory language in this section of the auditor's report shall state that

- Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statement (of the current period); and

- (b) These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereof, and the auditor does not provide a separate opinion on these matters.

In case there are no Key Audit Matter to communicate, the auditors' report must specifically mention that by carrying a Key Audit Matter Paragraph and under which they shall mention that there are no Key Audit matter to communicate.

Circumstances in which a matter determined to be a Key Audit Matter is not communicated in the Auditor's Report

- ❖ Law or regulation precludes public disclosure about the matter; or
- ❖ In extremely rare circumstances, the auditor determines that the matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication. This shall not apply if the entity has publicly disclosed information about the matter.

SA 705 "MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT"

Types of Modified Opinions

(i) **Qualified opinion**

The auditor shall express a qualified opinion when:

- (a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Drafting of Qualified Opinion: -

In our opinion and to the best of information and explanation given to us, except for the matter described in Basis of Qualified Opinion paragraph, the financial statement reflects a true and fair view.

- (ii) **Adverse opinion-** The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Example, there is significant doubt on going concern and entity has omitted disclosure in the financial statements

Drafting of Adverse Opinion: -

In auditor's opinion, because of significance of the matters described in "Basis of Adverse Opinion" section, the F.S. does not give a true and fair view of _____ in accordance with [applicable FRF].

- (iii) **Disclaimer -** The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

Example, auditor is unable to obtain sufficient appropriate audit evidence about the financial information of a joint venture investment that represents over 90% of the entity's net assets.

Drafting of Disclaimer of Opinion Para: -

Because of the significance of matters described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on financial statements.

Notes :

- ❖ Unless required by law or regulation, when the auditor disclaims an opinion on the financial statements, the auditor's report shall not include a Key Audit Matters section in accordance with SA 701.

Special Considerations required for Qualified Opinion:

Special consideration required when the auditor expresses a qualified opinion due to a material misstatement in the financial statements the Auditor shall state that in the Auditor opinion except for the effects of the matter(s) described in the basis for qualified opinion section.

- 1) When reporting in according with a fair presentation framework, in accompanying financial statements present fairly in all materials respects (or give a true and fair view of) in accordance with (the applicable FRF) or
- 2) When reporting in according with a compliance framework, the accompanying financial statements have been prepared in all material respects in accordance with (the applicable FRF).

When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor shall use the corresponding phrase "except for the possible effects of the matter (s) "for the modified opinion.

Special Consideration required for expressing Adverse Opinion:

When the auditor expresses an adverse opinion, the auditor shall state that in the auditor's opinion because of the significance of the matter (s) described ion the basis for adverse opinion section:

- 1) When reporting in accordance with a fair presentation framework, the accompanying financial statement do not present fairly (or give true and fair view of) in accordance with (the applicable FRF); or
- 2) When reporting in accordance with a compliance framework the accompanying financial statements have not been prepared in all material respects in accordance with (the applicable FRF).

Special Consideration required for expressing Disclaimer of Opinion:

When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall:

- 1) State that the auditor does not express an opinion on the accompanying financial statements;
- 2) State that because of the significance of the matter (s) described in the basis for disclaimer of opinion section the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
- 3) Amend the statement required in SA 700 (revised) which indicates that the financial statements have been audited to state that the auditor was engaged to audit the financial statements.

Consequence of an Inability to Obtain Sufficient Appropriate Audit Evidence Due to a Management imposed Limitation after the Auditor has accepted the Engagement

1. If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit,

The auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.

If management refuses to remove the limitation, the auditor shall communicate the matter to TCWG, unless all of those charged with governance are involved in managing the entity, and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

2. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:

- (a) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, **could be material but not pervasive, the auditor shall qualify the opinion; or**
- (b) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, **could be both material and pervasive** so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:
 - (i) **Withdraw from the audit**, where practicable and possible under applicable law or regulation; or
 - (ii) If withdrawal from the audit before issuing the auditor's report is not practicable or possible, **disclaim an opinion on the financial statements.**

Basis for Opinion Paragraph

When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by SA 700 (Revised):

- ❖ Amend the heading "Basis for Opinion" required by SA 700 (Revised) to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate; and
- ❖ Within this section, include a description of the matter giving rise to the modification.

Contents of the PARA

- Description and quantification of the financial effects of the misstatement, unless impracticable.
- If it is not practicable to quantify the financial effects, the auditor shall so state in this section.
- If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the Basis for Opinion section the reasons for that inability.
- When the auditor disclaims an opinion on the financial statements, the auditor's report shall not include the following elements required by SA 700 (Revised).
 - (a) A reference to the section of the auditor's report where the auditor's responsibilities are described; and
 - (b) A statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Description of Auditor's Responsibilities for the Audit of the Financial Statements When the Auditor Disclaims an Opinion on the Financial Statements

When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by SA 700 (Revised) to include only the following:

- (a) A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report;
- (b) A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
- (c) The statement about auditor independence and other ethical responsibilities required by SA 700 (Revised).

Auditors proposes to resign -Listed Entities

- Within 45 days from end of quarter- issue report for such quarter
- After 45 days from end of quarter- issue report for such quarter as well the next quarter
- If report is issued for all 3 quarters-issue report for full year before resigning.

SA 706 "EMPHASIS OF MATTER PARAGRAPH & OTHER MATTER PARAGRAPH IN THE INDEPENDENT AUDITOR'S REPORT"

Meaning of EOM Para

Emphasis of Matter paragraph: If the auditor considers it necessary to draw user's attention to matter presented or disclosed in the financial statements that in the auditor's judgment, is of such significance that it is fundamental to user's understanding of the F/S, the auditor shall include an EOM para provided that Auditor is not required to modify the opinion and the matter has not been determined as a key audit matter.

Requirements of EOM Para:

- (i) EOM Para is not a substitute of Modified opinion or KAM or GC Para.
- (ii) EOM Para should be included within a separate section titled as **"Emphasis of Matter"**.
- (iii) EOM Para should refer to that information only which is appropriately presented / disclosed in F/S and a clear reference to where the matter could be found in F/S should be given.
- (iv) It must be indicated that auditor's opinion is not modified in respect of this matter.
- (v) **EOM Para should be included in the auditor's report immediately following the "Basis for opinion Section".**

Drafting of Emphasis of matter Para

"Without qualifying our opinion, we draw attention to Note x of Schedule.....to the financial statement.

Meaning of OM Para

Other matters Para- If the auditor considers it necessary to draw user's attention to matter other than those presented or disclosed in the financial statements that in the auditor's judgment, is of such matter that it is fundamental to user's understanding of the F/S, the auditor shall include an OM para provided: this is not prohibited by law and the matter has not been determined as a key audit matter.

If the auditor expects to include an EOM or an Other Matter paragraph in the auditor's report, the auditor shall communicate with TCWG regarding this expectation and the proposed wording of this paragraph.

Requirements of OM Para:

- (i) OM Para is not a substitute of KAM.
- (ii) OM Para should be included in the audit report in a separate section titled as "Other Matter".
- (iii) **OM Para should be located in the auditor's report immediately after "KAM".**
- (iv) If other matter is related with other legal and regulatory requirements, it is to be placed in **"Reporting on Other Legal and Regulatory Requirement"** section.

Example of Other matter para drafting

We did not audit the financial statement of one subsidiary whose financial statements reflect total assets (net) of XXXX as at March 31, 2020, total revenues of XXXX and net cash outflows amounting to XXXX for the year then ended. These financial statements have been audited by other auditor's M/s XYZ company, chartered accountants' reports have been furnished to us by the management and our opinion is based solely on the reports of the other auditors. Our opinion is not qualified in respect of this matter.

Section-143 Powers & Duties of an Auditor

Section-143(1) - Rights & Duties

A. Rights to access Books

- Every auditor of a company shall have a right of access at all times{ of Co, subsidiary and its associates} to the books of account and vouchers of the company, whether kept at the registered office or at any other place.
- Shall be entitled to require from the officers of the company such information and explanation as he may consider necessary.

B. Enquiry under section 143 (1)

- a. Loans and advances made by the company on the basis of security.
 - (a) Whether they are properly secured.
 - (b) The terms on which they have been made are prejudicial to the interests of the company or its members.
- b. Book entries are prejudicial to the interests of the company
Whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company.
- c. Shares or other securities have been sold at a price less than purchase price
Where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company.
- d. Loans and advances made by the company shown as deposits
Whether loans and advances made by the company have been shown as deposits.
- e. Personal expenses charged to revenue account;
Whether personal expenses have been charged to revenue account;{ its allowed if done as per contractual obligation }
- f. Shares issued for Cash
Where it is stated in the books and documents of the company that any shares have been allotted for cash.
 - (a) Whether cash has actually been received.
 - (b) If no cash has actually been so received, whether the position stated in books and balance sheet is correct and not misleading.

Special Points

- ❖ The auditor is required to make only enquiries and not investigate into the matters specified.

Audit report under section-143 (2) of Co's Act

The Auditor shall make a report to the members of the company on accounts examined by him and report whether the f/s give a true and fair view of the state of affairs of the company.

Matters to be stated in Auditor's Report (Section-143 (3) of co's Act, 2013)

The auditor's report shall also state—

- (a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements.
- (b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him.
- (c) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditor has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report.

- (d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns.
- (e) whether, in his opinion, the financial statements comply with the accounting standards
- (f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company.
- (g) whether any director is disqualified from being appointed as a director **under sub- section (2) of section 164.**
- (h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith.
- (i) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls. { N.A. to OPC, Small co and Pvt co having turnover < Rs 50 cr and aggregate of borrowings from Banks, FI and Body corporate < Rs 25 cr }

Other matters to be included in Auditor's Report - Rule 11 of companies (Audit and auditor's rule, 2014)

1. **Delay in transfer to IEPF**
2. **Pending Litigations-** report whether the company has disclosed the impact, if any, of pending litigations on its financial position in financial statement.
3. **Provision for Losses-** Whether the company has made provision, for material foreseeable losses, if any, on long term contracts including derivative contracts.
4. **Management representation-**
 - (i)) Whether the management has represented that, no funds have been **advanced or loaned or invested** by the company to or in any other person ("Intermediaries"), with the understanding, , that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company .
 - (ii) Whether the management has represented, that, **no funds have been received by the company from any person** with the understanding, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party; and
 - (iii) Based on such audit procedures **that the auditor has considered reasonable and appropriate in the circumstances, nothing has come to their notice that has caused them to believe that the representations under sub-clause (i) and (ii) contain any material mis-statement.**
5. **Compliance with section 123-** Whether the **dividend declared or paid** during the year by the company is in compliance with section 123 of the Companies Act, 2013.
6. **Relevant accounting software-** **[Whether the company, in respect of financial years commencing on or after the 1st April, 2022, has used such accounting software for maintaining its books of account which has a feature of **recording audit trail (edit log)** facility and the same has been operated throughout the year for all transactions recorded in the software and the audit trail feature has not been tampered with and the audit trail has been preserved by the company as per the statutory requirements for record retention.]**

Section-143 (3) Additional Reporting

Whether remuneration paid to any director is in excess of the limit laid down under this section and give such other details as may be prescribed" **(as per section 197(16) of the Companies Act, 2013)**

Section-143 (5) Power of CAG

- ❖ The Comptroller and Auditor-General of India shall appoint the auditor under **Section 139(5) or (7).**
- ❖ CAG shall direct such auditor the manner in which the accounts of the Government company are required to be audited.

- ❖ The auditor so appointed shall submit a copy of the audit report to CAG and include directions issued by CAG /action taken.

Section-143 (6) Supplementary audit

The Comptroller and Auditor-General of India shall within sixty days from the date of receipt of the audit report have a right to conduct a supplementary audit of the financial statement of the company by such person or persons as he may authorise in this behalf; and comment upon or supplement such audit report. **Provided that** any comments given by the CAG shall be sent by the company to every person entitled to copies of audited financial statements under **Section 136(1)**.

Section-143 (7) Test Audit

- ❖ The CAG may, in case of any company covered under **Section 139(5) or (7)**, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of the Comptroller and Auditor- **General's (Duties, Powers and Conditions of Service) Act, 1971**, shall apply.

Section-143 (8) Provisions relating to Branch Audit

- ❖ Qualification- Principle Auditor or any other person qualified u/s 139. If branch is o/s india, any other person duly qualified to act as an auditor may act as auditor of branch.
- ❖ The rights and duties of the branch auditor shall be same as statutory auditor with reference to the branch.
- ❖ The branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal it with his report and also report as per **Section 143(3)**.

Compliance with Standards of Auditing

Section-143 (9) : Every auditor shall comply with Standards of Auditing

Section 143 (10)

1. The Central Government may prescribe the standards of auditing as recommended by ICAI in consultation with NFRA.
2. Until any auditing standards are notified, standards issued by ICAI shall be followed.

Reporting of fraud by an Auditor (Section-143 (12) to (15) read with rule 13)

Reporting of fraud to CG -Section 143(12)

Frauds which involves or is expected to involve individually an amount of ₹1 crore or more shall be reported to CG. Other frauds involving lesser amount are to be reported to the Audit Committee or BOD and also must be included in Board Report immediately within 2 days and the report shall specify-

- ❖ Nature of Fraud with description
Approximate amount involved and
- ❖ Parties Involved

Rule-13

The auditor shall report the matter to the Central Government as under:-

- Report immediately to BOD/AC within 2 days.
- Seek reply within 45 days.
- On receipt of reply or observations, forward report to CG in ADT-4.
- Report shall be sent to secretary, MCA in sealed cover via registered post acknowledgment due or speed post followed by email.

Section-143 (14)

The provisions of this section shall mutatis mutandis apply to—

- ❖ the cost accountant in practice conducting cost audit under **section 148**; or
- ❖ the company secretary in practice conducting secretarial audit under **Section 204**

Section-143 (15)

Penalty imposed on auditor, cost accountant or company secretary in practice for non compliance of Section 143 (12)

- ❖ For Listed Company- ₹ 5,00,000
- ❖ For other Company- ₹ 1,00,000

Reporting Under CARO, 2020

CARO is notified by CG u/s 143(11) dated 25th February 2020.

1. APPLICABILITY OF COMPANIES (AUDITOR REPORT) ORDER, 2020

The CARO, 2020 is an additional reporting requirement. **The order applies to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013.** However, the Order specifically **exempts the following classes of companies:**

- ❖ a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);
- ❖ an insurance company as defined under the Insurance Act, 1938 (4 of 1938);
- ❖ a company licensed to operate u/s 8 of the Companies Act
- ❖ a One-Person Company as defined in Sec. 2(62) of the Companies Act
- ❖ a Small Company as defined in Sec. 2(85) of the Companies Act; and
- ❖ a private limited company, not being a subsidiary or holding of a public company,
 - having a Paid-up capital & Reserves & Surplus not **more than ₹1 Cr. as on the balance sheet date, and**
 - which does not have total borrowings **exceeding ₹1 Cr.** from any bank or financial institution **at any point of time during the financial year, and**
 - which does not have **a total revenue** as disclosed in Schedule III to the Companies Act, 2013 (including revenue from discontinuing operations) **exceeding ₹10 Cr. during the financial year** as per the financial statements.

Note :

- ❖ Section 2 (85) of the companies Act, 2013, "Small Company" means a company, other than a public company whose
 - (i) Paid-up share capital of does not exceed four crore rupees, and
 - (ii) Turnover as per profit and loss account for the immediately preceding financial year does not exceed forty crore rupees.

Provided that nothing in this clause shall apply to holding co or subsidiary co , Sec 8 co, company or body corporate under special act.

Important points to be remembered while studying applicability of CARO 2020

1. CARO is not applicable to Audit Report of Consolidated Financial Statement except clause xxi.
2. While computing Paid up Share Capital for the applicability of CARO, the following points must be kept in mind:

- To be exempt from applicability of CARO, a Private Limited Company should have Paid up Capital and Reserves & Surplus not more than 1 crore as on Balance Sheet Date.
 - Paid up share capital includes Equity Share Capital and Preference Share Capital.
 - Share application money is not considered part of capital.
 - While calculating Paid up Capital, amount of calls unpaid should be deducted therefrom, and amount originally Paid-up on Forfeited Shares should be added to the figure of Paid- Up Capital
3. While computing **Borrowings** for the applicability of CARO, the following points must be kept in mind:
- To be exempt from applicability of CARO, a Private Limited Company should have Borrowings not more than 1 crore at any point of time during the Financial Year.
 - All types of Borrowings from Banks and Financial Institution are to be considered. (**Short Term, Long Term, Overdraft facility, Cash Credit, Dues in respect of credit card etc.**)
 - The term "Banks" includes Private Banks and Foreign Banks also as per Banking Regulations Act, 1949.
 - The term "Financial Institution" used in CARO includes a Scheduled Bank and NBFC's.
4. **While computing Total Revenue for the applicability of CARO, the following points must be kept in mind:**
- To be exempt from applicability of CARO, a Private Limited Company should have Revenue as per Schedule 3 not more than 10 crores at any time during the Financial Year.
 - The term "Revenue" shall include not only Sale of goods and services but also include other incomes like sale of scrap, interest on investment etc.
 - All sales returns are to be deducted from Sales for the purpose of CARO and Tax Audit.

2. MATTERS TO BE INCLUDED IN THE AUDITOR'S REPORT

The auditor's report on the accounts of a company to which this Order applies shall include a statement on the following matters, namely:-

[Para 3(i)] Property, Plant and Equipment

- ❖ **Adequacy of Records**
 - (a) (A) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of **Property, Plant and Equipment**.
 - (B) whether the company is maintaining proper records showing full particulars of intangible assets;
- ❖ **Physical verification**
 - (b) whether these Property, Plant and Equipment have been physically verified by the management at **reasonable intervals**; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;
- ❖ **Title Deeds**
 - (c) whether the title deeds of all the immovable properties (other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) disclosed in the financial statements are held in the name of the company, if not, provide the details thereof in the format below:-

Description of property	Gross carrying value	Held in name of	Whether promoter, director or their relative or employee	Period held - indicate range, where appropriate	Reason for not being held in name of company*
-	-	-	-	-	*also indicate if in dispute

❖ **Revaluation of Property, Plant and Equipment**

- (d) whether the company has revalued its Property, Plant and Equipment (including Right of Use assets) or intangible assets or both during the year and, if so, whether the revaluation is based on the valuation by a Registered Valuer; specify the amount of change, if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment or intangible assets;

❖ **Proceedings, if any against the company for holding Benami Property**

- (e) whether any proceedings have been initiated or are pending against the company for holding any Benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and rules made thereunder, if so,

whether the company has appropriately disclosed the details in its financial statements;

[Para 3(ii)] Inventories

❖ **Physical Verification**

- (a) whether physical verification of inventory has been conducted at reasonable intervals by the management and whether, in the opinion of the auditor, the coverage and procedure of such verification by the management is appropriate; whether any **discrepancies of 10% or more in the aggregate for each class of inventory** were noticed and if so, whether they have been properly dealt with in the books of account.

❖ **Working Capital Limit**

- (b) **whether during any point of time of the year, the company has been sanctioned working capital limits in excess of ₹5 crore, in aggregate**, from banks or financial institutions on the basis of security of current assets; whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details.

[Para 3(iii)] Investments, Guarantee / Security, Loans or Advances

- (iii) whether during the year the company has made investments in, provided any guarantee or security or granted any loans or advances in the nature of loans, secured or unsecured to companies, firms, Limited Liability Partnerships or any other parties, if so,-

- (a) whether during the year the company has provided loans or provided advances in the nature of loans, or stood guarantee, or provided security to any other entity **[not applicable to companies whose principal business is to give loans]**, if so, indicate-

- A) the aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to **subsidiaries, joint ventures and associates**;
- B) the aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to parties **other than subsidiaries, joint ventures and associates**;

- (b) Whether the **investments made, guarantees provided, security given** and the terms and conditions of the grant of all loans and advances in the nature of loans and guarantees provided are not prejudicial to the company's interest;
- (c) in respect of loans and advances in the nature of loans, whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;
- (d) if the amount is overdue, state the total amount **overdue for more than ninety days**, and whether reasonable steps have been taken by the company for recovery of the principal and interest.
- (e) whether any loan or advance in the nature of loan granted which has fallen due during the year, has been renewed or extended or fresh loans granted to settle the overdues of existing loans given to the same parties, if so, specify the aggregate amount of such dues renewed or extended or settled by fresh loans and the percentage of the aggregate to the total loans or advances in the nature of loans granted during the year **[not applicable to companies whose principal business is to give loans]**;
- (f) whether the company has granted any loans or advances in the nature of loans either repayable on demand or without specifying any terms or period of repayment, if so, specify the aggregate amount, percentage thereof to the total loans granted, aggregate amount of loans granted to Promoters, related parties as defined in clause (76) of section 2 of the Companies Act, 2013.

Para 3(iv) Compliance of provisions of Sec. 185 & 186

- (iv) in respect of loans, investments, guarantees, and security, whether provisions of sections 185 and 186 of the Companies Act have been complied with, if not, provide the details thereof.

[Para 3(v)] Public Deposits

- (v) in respect of deposits accepted by the company or amounts which are **deemed to be deposits**, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act and the rules made thereunder, where applicable, have been complied with, if not, the nature of such contraventions be stated; if an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not;

[Para 3(vi)] Cost Records

Whether maintenance of cost records has been specified by the CG u/s 148(1) of the Companies Act, 2013 and whether such accounts and records have been so made and maintained.

[Para 3(vii)] Statutory Dues

- a) Whether the company is regular in depositing undisputed statutory dues including **Goods and Service Tax**, provident fund, employees' state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of **more than 6 months** from the date they became payable, shall be indicated.
- b) Where statutory dues referred above have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. **(A mere representation to the concerned Department shall not be treated as a dispute).**

Para 3(viii) Unrecorded Income

- (viii) whether any transactions not recorded in the books of account have been surrendered or disclosed as income during the year in the tax assessments under the Income Tax Act, 1961 (43 of 1961), if so, whether the previously unrecorded income has been properly recorded in the books of account during the year;

Para 3(ix) Repayment of Dues.

- (ix) (a) whether the company has defaulted in repayment of loans or other borrowings or in the payment of interest thereon to any lender, if yes, the period and the amount of default to be reported as per the format below:-

Nature of borrowing, including debt securities	Name of lender*	Amount	Whether	No. of	Remarks,
		not paid on due	principal or interest	days delay or	if any
		date		unpaid	
	*lender-wise details to be provided in case of defaults to banks, financial institutions and Government.				

- b) whether the company is a **declared wilful defaulter** by any bank or financial institution or other lender;
- c) whether term loans were applied for the purpose for which the loans were obtained; if not, the amount of loan so diverted and the purpose for which it is used may be reported;
- d) whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated;
- e) whether the company has taken any funds from any entity or person on account of or to meet the obligations of its subsidiaries, associates or joint ventures, if so, details thereof with nature of such transactions and the amount in each case;
- f) whether the company has raised **loans during the year on the pledge of securities held in its subsidiaries, joint ventures or associate companies**, if so, give details thereof and also report if the company has defaulted in repayment of such loans raised;

Para 3(x) Application of Money raised by public issue and preferential allotment

❖ Application of Money raised by public issue

- (x) (a) whether moneys raised by way of initial public offer or further public offer (including debt instruments) during the year were applied for the purposes for which those are raised, if not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported.

❖ Preferential allotment

- (b) whether the company has made any preferential allotment or private placement of shares or convertible debentures (fully, partially, or optionally convertible) during the year and if so, whether the requirements of section 42 and section 62 of the Companies Act, 2013 have been complied with and the funds raised have been used for the purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of non-compliance.

[Para 3(xi)] Fraud

- (xi) (a) whether any **fraud by the company or any fraud on the company** has been noticed or reported during the year, if yes, the nature and the amount involved is to be indicated.
- (b) whether any report under sub-section (12) of section 143 of the Companies Act has been filed by the auditors in **Form ADT-4** as prescribed under rule 13 of Companies (Audit and Auditors) Rules, 2014 with the Central Government.
- (c) whether the auditor has considered **whistle- blower complaints**, if any, received during the year by the company.

Para 3(xii) Nidhi Companies

- (xii) (a) whether the Nidhi Company has complied with the **Net Owned Funds to Deposits** in the ratio of 1:20 to meet out the liability.
- (b) whether the Nidhi Company is maintaining ten per cent. unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability.
- (c) **whether there has been any default in payment of interest on deposits or repayment thereof for any period and if so, the details thereof.**

Para 3(xiii) Transactions with related Parties

- (xiii) whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act where applicable and the details have been disclosed in the financial statements, etc., as required by the applicable accounting standards;

Para 3(xiv) Internal Audit System

- (xiv) (a) whether the company has an internal audit system commensurate with the size and nature of its business.
- (b) whether the reports of the Internal Auditors for the period under audit were considered by the statutory auditor;

Para 3(xv) Non cash transactions with directors

- (xv) whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act have been complied with.

Para 3(xvi) Registration. with RBI

- (xvi) (a) whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 (2 of 1934) and if so, whether the registration has been obtained.
- (b) whether the company has conducted any Non-Banking Financial or Housing Finance activities **without a valid Certificate of Registration (CoR)** from the Reserve Bank of India as per the Reserve Bank of India Act, 1934.
- (c) whether the company is a **Core Investment Company (CIC)** as defined in the regulations made by the Reserve Bank of India, if so, whether it continues to fulfil the criteria of a CIC, and in case the company is an exempted or unregistered CIC, whether it continues to fulfil such criteria.
- (d) whether the Group has more than one CIC as part of the Group, if yes, indicate the number of CICs which are part of the Group.

Para 3(xvii) Cash Losses

- (xvii) whether the company has incurred cash losses in the financial year and in the immediately preceding financial year, if so, state the amount of cash losses;

Para 3(xviii) Considerations of issues raised by outgoing auditor

- (xviii) whether there has been any resignation of the statutory auditors during the year, if so, whether the auditor has taken into consideration the issues, objections or concerns raised by the outgoing auditors;

Para 3(xix) Existence of Material uncertainty as to company ability to meet its liabilities

- (xix) on the basis of the financial ratios, ageing and expected dates of realisation of financial assets and payment of financial liabilities, other information accompanying the financial statements, the auditor's knowledge of the Board of Directors and management plans, whether the auditor is of the opinion that no material uncertainty exists as on the date of the audit report that company is capable of meeting its liabilities existing at the date of balance sheet as and when they fall due within a period of one year from the balance sheet date;

Para 3(xx) Transfer of unspent CSR amount

- (xx) (a) whether, in respect of other than ongoing projects, the company has transferred unspent amount to a Fund specified in Schedule VII to the Companies Act within a period of six months of the

expiry of the financial year in compliance with second proviso to sub-section (5) of section 135 of the said Act.

- (b) whether any amount remaining unspent under sub-section (5) of section 135 of the Companies Act, pursuant to any ongoing project, has been transferred to special account in compliance with the provision of sub-section (6) of section 135 of the said Act.

Para 3(xxi) Qualifications or adverse remarks in CARO Reports of group companies

- (xxi) whether there have been any qualifications or adverse remarks by the respective auditors in the Companies (Auditor's Report) Order (CARO) reports of the companies included in the consolidated financial statements, if yes, indicate the details of the companies and the paragraph numbers of the CARO report containing the qualifications or adverse remarks.

4. REASONS TO BE STATED FOR UNFAVOURABLE OR QUALIFIED ANSWERS-

- (a) Where, in the auditor's report, the answer to any of the questions referred to in paragraph 3 is **unfavourable or qualified**, the auditor's report shall also state the basis for such unfavourable or qualified answer, as the case may be.
- (b) Where the auditor is unable to express any opinion on any specified matter, his report shall indicate such fact together with the reasons as to why it is not possible for him to give his opinion on the same.

CHAPTER 01

PROFESSIONAL ETHICS

The Chartered Accountant Act, 1949

Part I

1. Introduction

- ❖ The term **"Ethics"** means moral principles which govern a person's behaviour or the conducting of an activity.

2. OVERVIEW OF THE CODE OF ETHICS (Given in Vol-I of Code of Ethics)2.1 The revised Code of Ethics

Part 1 — Complying with the Code, Fundamental Principles and Conceptual Framework.

Part 2 — Professional Accountants in Service, which sets out additional material that applies to professional accountants in service when performing professional activities.

Part 2 — is also applicable to individuals who are professional accountants in public practice when performing professional activities pursuant to their relationship with the firm as an employee.

Part 3 — Professional Accountants in Public Practice

Part 4A — Independence for Audit and Review Engagements, which applies when performing audit or review engagements.

Part 4B — Independence for Assurance Engagements Other than Audit and Review Engagements

Each section of Code is structured as **Introduction, Requirements and Application.**

3. Fundamental Principles to be followed by Professional Accountants**(a) Integrity - Subsection 111**

1. A professional accountant shall comply with the principle of integrity, **which requires an accountant to be straightforward and honest**. Integrity implies fair dealing and truthfulness.
2. A professional accountant **shall not knowingly be associated with** reports, returns, communications or other information where the accountant believes that the information:
 - (a) Contains a materially **false or misleading statement**.
 - (b) Contains statements or information provided **negligently**; or
 - (c) Omits or obscures required information where such omission or obscurity would be misleading.

However, a professional accountant **will not be considered** to be in breach of matters, if **the professional accountant provides a modified report**.

3. When a professional accountant becomes aware of having been associated with information described in paragraph 2, **the accountant shall take steps to be disassociated from that information**.

(b) Objectivity- Subsection 112

1. A professional accountant shall comply with the **principle of objectivity**, which requires an accountant not to compromise professional or business judgment because of bias, **conflict of interest or undue influence** of others.
2. A professional accountant shall not undertake a professional activity if a circumstance or relationship unduly influences the accountant's professional judgment regarding that activity.

(c) Professional Competence and Due Care - Subsection 113

1. A professional accountant shall comply with the **principle of professional competence and due care**, which requires an accountant to:
 - (a) Attain and maintain **professional knowledge** and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and
 - (b) act diligently in accordance with applicable technical and professional standards.
2. **Serving** clients and employing organizations **with professional competence** requires the exercise of **sound judgment** in applying **professional knowledge** and **skill** when undertaking professional activities.
3. **Maintaining professional competence** requires a **continuing awareness** and **an understanding** of relevant **technical, professional and business developments**.
4. **Diligence** encompasses the responsibility to act in accordance with the requirements of an assignment, **carefully, thoroughly** and on a **timely** basis.
5. In **complying** with the **principle of professional competence and due care**, a professional accountant shall take reasonable steps to ensure that those working in a professional capacity under the accountant's authority have appropriate training and supervision.

(d) Confidentiality- Subsection 114

1. A professional accountant shall comply with the principle of confidentiality, which requires an accountant to respect the confidentiality of information acquired as a result of professional and employment relationships. An accountant shall:
 - **Be alert** to the possibility of inadvertent disclosure, including in a social environment, and particularly to a close business associate or an immediate or a close family member;
 - Maintain **confidentiality** of information **within the firm** or employing organization;
 - Maintain **confidentiality** of information disclosed by **a prospective client** or employing organization;
 - **Not disclose** confidential information acquired as a result of professional and employment relationships outside the firm or employing organization without proper and specific authority, unless there is a legal or professional duty or right to disclose;
 - **Not use** confidential information acquired as a result of professional and employment relationships for the personal advantage of the accountant or for the advantage of a third party;
 - Not use or disclose any confidential information, either acquired or received as a result of a professional or employment relationship, **after that relationship has ended**; and
 - Take reasonable steps to ensure that personnel under the accountant's control, and individuals from whom advice and assistance are obtained, **respect the accountant's duty of confidentiality**.
2. **Circumstances where disclosure is appropriate -**

- (a) **Disclosure is required by law, For Example : Sec. 143(12)**
- (b) Disclosure is **permitted by law and is authorized by the client** or the employing organization, **For Example :** Statutory Filing on behalf of client.
- (c) There is a **professional duty or right to disclose**, when not prohibited by law, **For Example :** During Peer Review or Quality Review or Investigation.

3. Considerations before disclosing information

In deciding whether to disclose confidential information, professional accountants should consider the following points:

- a) Whether the **interests of any party**, including third parties whose interests might be affected, could be harmed if the client or employing organization consents to the disclosure of information by the professional accountant;
- b) Whether all the relevant information is **known and substantiated**, to the extent it is practicable; and
- c) The proposed **type of communication**, and to whom it is addressed;
- d) Whether the parties to whom the communication is addressed are appropriate recipients.

Points to remember –

- ❖ A professional accountant shall continue to comply with the principle of confidentiality **even after the end of the relationship** between the accountant and a client or employing organization.
- ❖ When changing employment or acquiring a new client, **the accountant is entitled to use prior experience** but shall not use or disclose any confidential information acquired or received as a result of a professional or employment relationship.

(e) Professional Behaviour- Subsection 115

1. A professional accountant shall comply with the principle of professional behaviour, which requires an accountant **to comply with relevant laws and regulations**.
2. When promoting himself and his work, a professional accountant shall **not bring the profession into disrepute**. A professional Accountant is required to conduct his affairs in a manner that he remains outside the boundaries of professional and other misconduct. A professional accountant shall be honest and truthful and **should not make:**
 - (a) **Exaggerated claims** for the services they are able to offer, the qualifications they possess, or experience they have gained; or
 - (b) **Disparaging references** or unsubstantiated comparisons to the work of others.
 - (c) Any direct or indirect measures to advertise any professional/other facts which are in violation of Advertisement Guidelines issued by the Council of the Institute from time to time.

4. Threats, Evaluation of Threats and Safeguards

The conceptual framework specifies an approach for a professional accountant to:

- (i) **Identify** threats to compliance with the fundamental principles;
- (ii) **Evaluate** the threats identified; and

(iii) **Address** the threats by eliminating or reducing them to an acceptable level.

4.1 Threats

Threats to compliance with the fundamental principles fall into one or more of the following categories:

- ❖ **Self-interest threat-** the threat that a financial or other interest will inappropriately influence a professional accountant's judgment or behaviour;
- ❖ **Self-review threat-** the threat that a professional accountant will not appropriately evaluate the results of a previous judgment made; or an activity performed by the accountant or by another individual within the accountant's firm or employing organization, on which the accountant will rely when forming a judgment as part of performing a current activity;
- ❖ **Advocacy Threat-** the threat that a professional accountant will promote a client's or employing organization's position to the point that the accountant's objectivity is compromised;
- ❖ **Familiarity threat-** the threat that due to a long or close relationship with a client, or employing organization, a professional accountant will be too sympathetic to their interests or too accepting of their work; and
- ❖ **Intimidation threat-** the threat that a professional accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the accountant.

A. The following are examples of facts and circumstances within each of those categories of threats that might create threats for a professional accountant when undertaking a professional service (CA in Practice) :

Example : Self-interest Threats

- ❖ A professional accountant having a **direct financial interest** in a client.
- ❖ A professional accountant quoting a **low fee** to obtain a new engagement and the fee is so low that it might be difficult to perform the professional service in accordance with applicable technical and professional standards for that price.
- ❖ A professional accountant having a **close business relationship** with a client.
- ❖ A professional accountant having **access to confidential information** that might be used for personal gain.
- ❖ A professional accountant discovering a **significant error** when evaluating the results of a previous professional service performed by a member of the accountant's firm.

Example : Self-review Threats

- ❖ A professional accountant issuing an assurance report on the **effectiveness** of the operation of financial systems after implementing the systems.
- ❖ A professional accountant having prepared the original data used to generate records that are the subject matter of the assurance engagement.

Example : Advocacy Threats

- ❖ A professional accountant **promoting the interests of, or shares in, a client.**
- ❖ A professional accountant **acting as an advocate** on behalf of a client in litigation or disputes with third parties.
- ❖ A professional accountant **lobbying in favour of legislation** on behalf of a client.

Example : Familiarity Threats

- ❖ A professional accountant having a **close or immediate** family member who is a director or officer of the client.
- ❖ A director or officer of the client, or an employee in a position to **exert significant influence** over the subject matter of the engagement, having recently served as the engagement partner.
- ❖ An audit team member having a **long association** with the audit client.

Example : Intimidation Threats

- ❖ A professional accountant being threatened with **dismissal from a client engagement** or the firm because of a disagreement about a professional matter.
- ❖ A professional accountant **feeling pressured** to agree with the judgment of a client because the client has more expertise on the matter in question.
- ❖ A professional accountant being informed that a **planned promotion** will not occur unless the accountant agrees with an inappropriate accounting treatment.
- ❖ A professional accountant having accepted a **significant gift** from a client and being threatened that acceptance of this gift will be made public."

B. The following are examples of facts and circumstances within each of those categories that might create threats for a professional accountant when undertaking a professional activity (CA in Service) :

Example : Self-interest Threats

- ❖ A professional accountant holding a **financial interest** in, or receiving a loan or guarantee from, the employing organization.
- ❖ A professional accountant participating in **incentive compensation arrangements** offered by the employing organization.
- ❖ A professional accountant having access to corporate assets for **personal use**.
- ❖ A professional accountant being offered a gift or special treatment from a supplier of the employing organization.

Example : Self-review Threats

- ❖ A professional accountant determining the **appropriate accounting treatment** for a business combination after performing the feasibility study supporting the purchase decision.

Example : Advocacy Threats

- ❖ A professional accountant having the opportunity to **manipulate information** in a prospectus in order to obtain favourable financing.

Example : Familiarity Threats

- ❖ A professional accountant being responsible for the **financial reporting** of the employing organization when an immediate or close family member employed by the organization makes decisions that affect the financial reporting of the organization.
- ❖ A professional accountant having a **long association** with individuals influencing business decisions.

Example : Intimidation Threats

- ❖ A professional accountant or immediate or close family member facing the **threat of dismissal** or replacement over a disagreement about:
 - The application of an accounting principle.
 - The way in which financial information is to be reported.

- ❖ An individual attempting to influence the **decision-making process** of the professional accountant, for example with regard to the awarding of contracts or the application of an accounting principle.

Note: Tax Services to Audit Clients [Subsection 604]

1. Providing tax services to an audit client might create a self- review or advocacy threat.
In case of Assistance in the resolution of Tax disputes, the term "Court" is explained as under:

"For the purpose of this subsection, "Court" does not include a Tribunal"

4.2 Evaluation of Threats:

The conditions, policies and procedures described above might impact the evaluation of whether a threat to compliance with the fundamental principles is at an acceptable level.

- (i) **Acceptable level:** An acceptable level is a level at which a professional accountant using the reasonable and informed **third party test** would likely conclude that the accountant complies with the fundamental principles.
- (ii) **Reasonable and Informed Third Party (RITP Test):**
 - The reasonable and informed third party test is a consideration by the professional accountant about whether the same conclusions would likely be reached by another party.
 - The reasonable and informed third party does **not need to be an accountant** but would possess the relevant knowledge and experience to understand and evaluate the appropriateness of the accountant's conclusions in an impartial manner.

4.3 Addressing Threats

The accountant shall do so by:

- (i) **Eliminating the circumstances**, including interests or relationships, that are creating the threats;
- (ii) **Applying safeguards**, where available and capable of being applied, to reduce the threats to an acceptable level; or
- (iii) **Declining or ending** the specific professional activity.

Actions to Eliminate Threats :

- Depending on the facts and circumstances, a threat might be addressed by eliminating the circumstance creating the threat. However, there are some situations in which threats can only be addressed by declining or ending the specific professional activity.
- This is because the circumstances that created the threats cannot be eliminated and safeguards are not capable of being applied to reduce the threat to an acceptable level.

4.4 Safeguards:

Safeguards are actions individually or in combination that the accountant takes that effectively reduce threats to an acceptable level. Safeguards vary depending on the facts and circumstances. **Examples of actions that in certain circumstances might be safeguards to address threats include:**

- a) **Assigning additional time and qualified personnel** to required tasks when an engagement has been accepted might address a self-interest threat.
- b) **Having an appropriate reviewer**, who was not a member of the team, review the work performed or advise as necessary might address a self-review threat.
- c) **Using different partners and engagement teams** with separate reporting lines for the provision of non- assurance services to an assurance client might address self- review, advocacy or familiarity threats.
- d) **Involving another firm** to perform or re-perform part of the engagement might address self-interest, self-review, advocacy, familiarity or intimidation threats.

- e) **Separating teams** when dealing with matters of a confidential nature might address a self-interest threat.

5. Non-Compliance with Laws and Regulations (NOCLAR)

In the course of providing a professional service to a client or carrying out professional activities for an employer, a Professional accountant may come across an instance of non-compliance with laws and regulations (NOCLAR).

Non-compliance with laws and regulations ("non-compliance") comprises of **acts of omission or commission, intentional or unintentional, which are contrary to the prevailing laws or regulations committed by:**

- ❖ a client/professional accountant's employing organisation;
- ❖ those charged with governance of a client or employing organisation;
- ❖ management of a client/ employing organisation; or
- ❖ other individuals working for or under the direction of a client/ employing organisation.

However, NOCLAR under Revised Code of Ethics **does not address the personal misconduct unrelated to the business activities** of the client/ employing organisation and non-compliance by parties other than listed out in the definition of NOCLAR.

5.1 Examples of NOCLAR

As per the International Ethics Standards Board for Accountants (IESBA), **following examples would be covered in NOCLAR.** Fraud, corruption and bribery, Money laundering, terrorist financing and proceeds of crime, Securities markets and trading, Banking and other financial products and services, Data protection, Environmental protection, Public health and safety, Tax and pension liabilities and payments.

5.2 Some important facts about NOCLAR are given below:

- i. **During Course of Providing a Service:** NOCLAR will be applicable if a professional accountant encounters, or is made aware of, non-compliance or suspected non-compliance in the course of providing a professional service to a client. He is not required to investigate, nor responsible for ensuring complete compliance.
- ii. **Expertise of Laws not Required:** A professional accountant is expected to apply knowledge and expertise, and exercise professional judgment.
- iii. **Certain Matters Expressly out of Purview:** Matters that are clearly inconsequential, or relating to personal misconduct pertaining to business activities of the client not covered.
- iv. **Disclosure, which is Contrary to Law not Required:** As per IESBA Code, disclosure of the matter to an appropriate authority would be precluded if doing so would be contrary to law or regulation.

5.3 NOCLAR vs. SA 250

1. **SA 250** is applicable only on Audit, and not on other Assurance engagements. However, **NOCLAR is applicable on professional accountants in service, and in practice.**
2. **SA 250** talks of auditor's responsibilities for laws having direct effect on the determination of material amounts and disclosures in the financial statements (such as tax and labour laws); and other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business. **NOCLAR**, while being alike to SA 250 till this point, is further ahead of it in that **it takes into account non-compliance** that causes substantial harm resulting in serious consequences in financial or non-financial terms.
3. **SA 250** does not define stakeholders. NOCLAR is related to effect of non-compliance on investors, creditors, employees as also the general public.
4. **As per NOCLAR**, in exceptional circumstances, the professional accountant might become aware of an imminent breach of a law or regulation that would cause substantial harm to investors, creditors, employees or the general public. This provision is not existent in SA 250.

5.4 Applicability of NOCLAR in India

1. **Responding to Non-Compliance with Laws and Regulations (NOCLAR) applicable to Professional Accountants in service (Section 260):** Applicable to Senior Professional Accountants in service, being employees of listed entities.

Senior professional accountants in service ("senior professional accountants") are directors, officers or senior employees able to exert significant influence over, and make decisions regarding, the acquisition, deployment and control of the employing organization's human, financial, technological, physical and intangible resources.

It is further explained that the senior professional accountants refer to key managerial personnel.

2. **Responding to Non-Compliance with Laws and Regulations (NOCLAR) applicable to Professional Accountants in public practice (Section 360) :** Applicable to Audit engagements of entities the shares of which are listed on recognized stock exchange(s) in India and have net worth of 250 crores of rupees or more.

5.5. Steps to Responding to NOCLAR

- Obtaining understanding of matter
- Addressing matter
- Seeking advice
- Determining if further action is needed.
- Documentation
- Imminent Breach
- Determining whether to disclose matter to appropriate authority.

Documentation Requirements in NOCLAR :

Revised Code over and above require the professional accountant to follow the additional documents requirements as under:

- ❖ How management / those charged with governance have responded to the matter.
- ❖ The course of action the accountant considered, the judgments made and the decisions that were taken, having regard to the reasonable and informed third party test.
- ❖ How the accountant is satisfied that the responsibility of public interest has been fulfilled.

Part II

6. Relevant Provisions of CA ACT, 1949

PART A-Provisions Related to Membership

Section 19- Register of Member

On acceptance of application by the Council, the applicant's name shall be entered in the Register and a certificate of membership in the appropriate Form shall be issued to the applicant.

Particulars of the Registers- Full name, date of birth, domicile, residential and professional address; Date of entry of name in the Register; Qualifications; Whether the member holds a COP; and Any other prescribed particulars.

Section 5- ACA and FCA

Once the CA becomes the member of ICAI, he can use the letter ACA. Upon completion of 5 years with continuous practice, letters FCA can be used by informing and obtaining the approval of the council.

Section 8 –Disabilities for purpose of membership

Under any of the following six circumstances a person is debarred from having his name entered in the register of members :

- ❖ If he has **not attained the age of 21 years** at the time of his application for the entry of his name in the Register.
- ❖ If he is of **unsound mind** as adjudged by a competent court.
- ❖ If he being a **discharged insolvent**, has not obtained from the court a certificate stating that his insolvency was caused by misfortune without any misconduct on his part.
- ❖ If he has been **convicted by a competent court** of an offence involving moral turpitude.
- ❖ If he has been **removed from membership** of the Institute for being guilty of professional or other misconduct.

Note: A person who has been removed from membership for a specified period, shall not be entitled to have his name entered in the register until the expiry of such period.

Section 20 – Removal of Name from the Register of Member

As per Section 20 of the Act, the name of the member can be removed in the following cases:

- (i) who is **dead**; or
- (ii) from whom a **request** has been received to that effect; or
- (iii) who has not paid any **prescribed fee** required to be paid by him; or
- (iv) who is found to have been subject at the time when his name was entered in the Register, or who at any time thereafter has become subject, to any of the disabilities mentioned in Section 8, or who for any other reason has ceased to be entitled to have his name borne on the Register.

Regulation 19 – Restoration of Membership

Effective date of restoration in the given situations

- (A) If application for restoration and requisite fees are made within the same year of removal- Restoration shall be with effect from the date on which it was removed from the register.
- (B) If application for restoration and requisite fees are not made within the same year of removal- Restoration shall be with effect from the date on which the fee was received.
- (C) Removal of name in accordance with the order of Board of Discipline or the Disciplinary Committee or the Appellate Authority or the High Court- Removal shall be in accordance with such orders.

Section 24- Falsely representing to be a Member

Any person who not being a member of the Institute represents that he is a member of the Institute or uses the designation Chartered Accountant being a member of the Institute, but not having a certificate of practice, represents that he is in practice or practices as a Chartered accountant, shall be punishable.

- ❖ On 1st conviction with fine which may extend to **₹ 1000/-**.
- ❖ On any **subsequent conviction** with imprisonment which may extend to **6 months or with fine which may extend to ₹ 5000/- or with both.**
- ❖ Failure to pay fine-rigorous imprisonment for 3 months.

Section 2(2) - Members deemed to be in Practice

A member of the Institute shall be deemed **"to be in practice"** when individually, or in partnership with Chartered Accountants in practice, he, in consideration of remuneration received or to be received:

1. **Engages** himself in the practice of accountancy.
2. Offers to **perform or performs service** involving the auditing or verification of financial transactions, books, accounts or records, or the preparation, verification or certification of financial accounting and related statements or holds himself out to the public as an accountant; or
3. Renders **professional services or assistance** in or about matters of principle or detail relating to accounting procedure or the recordings, presentation or certification of financial facts or data; or
4. Renders **such other services** as, in the opinion of the council, are or may be rendered by a Chartered Accountant in practice.

Explanation

An associate or a fellow of the Institute who is a **salaried employee of a Chartered Accountant** in practice or a firm of such Chartered Accountants or firm consisting of one or more chartered accountants and members of any other professional body having prescribed qualifications shall, notwithstanding such employment, **be deemed to be in practice for the limited purpose of the training of Articled Assistants**".

Pursuant to Section 2(2)(iv) above, the Council has passed a resolution permitting a Chartered Accountant in practice to render entire range of **"Management Consultancy and other Services"**.

"Management Consultancy and other Services"

The expression "Management Consultancy and other Services" **shall not include** the function of statutory or periodical audit, tax (both direct taxes and indirect taxes) representation or advice concerning tax matters or acting as liquidator, trustee, executor, administrator, arbitrator or receiver, **but shall include the following-**

- (i) Financial management planning and financial policy determination.
- (ii) Capital structure planning and advice regarding raising finance.
- (iii) Working capital management.
- (iv) Preparing project reports and feasibility studies.
- (v) **Preparing cash budget**, cash flow statements, profitability statements, statements of sources and application of funds etc.
- (vi) Budgeting including capital budgets and revenue budgets.
- (vii) **Inventory management**, material handling and storage.
- (viii) Market research and demand studies.
- (ix) **Price-fixation** and other management decision making.
- (x) Management accounting systems, cost control and value analysis.
- (xi) Control methods and management information and reporting.
- (xii) **Personnel recruitment and selection**.
- (xiii) Setting up **executive incentive plans**, wage incentive plans etc.
- (xiv) Management and operational audits.
- (xv) Acting as **Registered Valuer** under Section 247 of Companies Act, 2013

- (xvi) Business Policy, corporate planning, organisation development, growth and diversification.
- (xvii) Organisation structure and behaviour, development of human resources including design and conduct of training programmes, work study, job-description, job evaluation and evaluation of workloads.
- (xviii) Professional services relating to **Electronic Data Processing**.
- (xix) **Acting as advisor or consultant to an issue, including such matters as:**
 - (a) Drafting of **prospectus and memorandum**, listing agreement
 - (b) Preparation of **publicity budget**, selection of bankers, brokers and underwriters
 - (c) Advice regarding selection of various agencies connected with issue, namely Registrars to Issue, printers and advertising agencies.
 - (d) Advice on the post issue activities.
- (xx) **Investment counselling** in respect of shares and securities.
- (xxi) Acting as **registrar to an issue** and for transfer of shares/other securities. (In doing so, the relevant provisions of the Code of Ethics must be kept in mind).
- (xxii) Quality Audit.
- (xxiii) Environment Audit.
- (xxiv) Energy Audit.
- (xxv) Acting as **Recovery Consultant** in the Banking Sector.
- (xxvi) Insurance Financial Advisory Services under the Insurance Regulatory & Development Authority Act, 1999, including Insurance Brokerage.
- (xxvii) Acting as **Insolvency Professional** in terms of Insolvency and Bankruptcy Code, 2016
- (xxviii) **Administrative services** requiring little to no professional judgement.{ example- word processing services and services which normally a GST practitioner performs}.

Prohibited services for a CA in Practice:

- ❖ Broking activities, Underwriting activities, Portfolio Management Activities (section 2 (2)(iv) of CA Act, 1949, NRI fund management, Cash collection services and Insurance agency services. If a CA in practice provides the prohibited management consultancy services given above, he shall be guilty under **clause 11 of part 1 of First Schedule**.

Correlation of Section 144

Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor. An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but **which shall not include any of the following services** (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely

- (i) Accounting and book- keeping services;
- (ii) Internal audit;
- (iii) Design and implementation of any financial information system;
- (iv) Actuarial services;
- (v) Investment advisory services;
- (vi) Investment banking services;
- (vii) Rendering of outsourced financial services;

- (viii) Management services and
- (ix) Other Prescribed Services.

Section 6 -Significance of COP

1. No member of the institute can practice (whether in India or elsewhere) until and unless he has obtained a COP. A member who is not in practice cannot accept assignments to render services normally prescribed for a Chartered Accountant.
2. A member of the Institute **having COP can also hold COP's of other institutes simultaneously** subject to permission of other institutes. However, he can practise only in the capacity of a Chartered Accountant. The provisions of the CA Act shall apply to the member **even in the period of suspension**, when he has been removed temporarily by the institute due to professional or other misconduct.
3. A member of ICAI can have **no other capacity** in which he can take up such practice separable from his capacity to practice as a member of the institute.

Regulation 10 - Cancellation of Certificate of Practice

- (i) Name of holder of certificate is removed from the register.
- (ii) The Council is satisfied after giving an opportunity of being heard to the person concerned that such certificate was issued on the basis of incorrect, misleading or false information.
- (iii) A member has ceased to practice.
- (iv) A member has not paid annual fees till **30th Sept** of the relevant year.

Where COP is cancelled, the holder shall surrender the same to the secretary.

Regulation 11 - Restoration of Certificate of Practice

Regulation 11 on restoration of COP states that, on an application made in the approved Form and on payment of such fee, the Council may restore the COP with effect from the date on which it was cancelled, to a member whose certificate has been cancelled due to non-payment of the annual fee for the COP and whose application, complete in all respects, together with the fee, is received by the Secretary before the expiry of the relevant year.

Section 27 -Maintenance of branch offices

Office : A place where a name - board is fixed or where such place is mentioned in the letter - head or any other documents as a place of business:

1. If a CA in practice or a firm of CA has more than one office in India. Each one of such offices should be in the separate In-charge of a member of the Institute, who may be either **partner/employee**.
2. Such a member should also reside at the place where the office is situated for a period of **not less than 182 days** in a year or attend the said office for a period of not less than 182 days in a year.
3. Exemption has been given to members practicing in hilly areas subject to certain conditions which are:
 - a) Such members / firm be allowed to open temporary offices in a city in the plains for a limited period of **not more than 3 months in a year**.
 - b) Name board of the firm in the **temporary office** should be not displayed at times other than the period such offers is permitted to function.
 - c) Regular office need not be closed during above period.
 - d) Temporary office should not be mentioned as a **place of business** of the member / firm on letterheads or visiting cards or any other documents.
 - e) Before commencement of every winter it shall be obligatory on the member / firm to inform the Institute that he / it is opening the temporary office from a particular date.
 - f) Intimation to that effect should also be sent to the office of the institute by registered post.

4. Exemption has been given to a member or a firm of CAs in practice to have a 2nd office without such 2nd office being under the separate charge of a member of the Institute, provided:
 - The 2nd office is located in the **same premises** in which the 1st office is located or
 - The 2nd office is located in the **same city** in which the 1st office is located
 - The 2nd office is located within a **distance of 50 km from the municipal limits** of a city in which the 1st office is located

Note :

1. **The use of the name-board:** No bar to be putting up of a name - board in the place of residence of a member with the designation of Chartered Accountant, provided it is a name - plate or a name - board of an individual member and not of the firm.
2. **Regulation 189** requires that a CA in practice or a firm of such CAs shall inform the Council within one month of the opening or closing of a branch office.

PART C-Other Provisions

Section 7 - Member in practice is prohibited from using a designation other than a Chartered Accountant**Under section 7 of the CA Act 1949, a member in practice cannot**

1. Use any designation other than that of a Chartered Accountant
2. Use any other description, whether in addition thereto or in substitution.

Permissible:

- ❖ Members are entitled to indicate membership of Accountancy Bodies which has been approved by the Council or of bodies other than Accountancy Institutes as long as such use does not imply adoption of a designation and/or does not amount to advertisement or publicity.

Example: Though the members of the institute are now permitted to use the word 'CA.' as prefix before their name irrespective of the fact they are in practise or not.

- ❖ Committee on ethical standards, allowed the use of 'Dr' with the designation 'CA'. It is left to the discretion of member, whether to use 'CA' first, or 'Dr. first, or use 'Dr' only before the name of the member.

Important points to be remembered:

- 1) A member cannot designate himself as a cost Accountant, he can use the letters A.C.M.A (Associate) or F.C.M.A (Follow) after his name, when he is a member of that Institute.
- 2) It is improper for a CA to state in his professional documents that he is an Income Tax Consultant, Company Secretary, Cost Consultant or Management Consultant or **Corporate Lawyer or Cyber Security Expert**.
- 3) A member in practice is **not permitted** to use the designation corporate lawyer.
- 4) The members are not permitted to use the initials CPA on their visiting cards.
- 5) The members may apply for and obtain registration as **category IV Merchant Banker/Advisor to an issue under the SEBI's** rules and regulations and act as Advisor or Consultant to an issue. In client Companies' offer documents and advertisements regarding capital issue, name and address of the Chartered Accountant or firm of Chartered Accountants acting as Advisor or Consultant to the Issue could be indicated under the caption "Advisor/Consultant to the Issue". **However, the name and**

address of such Chartered Accountant/firm of Chartered Accountants should not appear prominently. Also cannot mention in his visiting card.

- 6) Members are **permitted** to mention **membership of a foreign institute** of accountancy subject to Memorandum of understanding / Mutual Recognition Agreement.

Section 25 - Companies not to engage in Accountancy

Section 25 of the Chartered Accountants Act, 1949 provides that :

- ❖ **No company**, whether incorporated in India or elsewhere, shall practise as chartered accountants
- ❖ If any company contravenes this provision- every director, manager, secretary and any other officer thereof who is knowingly a party to such contravention shall be punishable with fine which may extend on first conviction to **₹ 1,000 and on any subsequent conviction to ₹ 5,000.**
- ❖ Note-LLP **not having any company as its partner**, can be engaged into practicing and thus take audit assignments

Section 26- Unqualified Persons not to sign documents

- ❖ No person other than a member of the Institute shall sign any document on behalf of a CA in practice or a firm of such CA's in his or its professional capacity.

Penalty for Contravention-

- ❖ **First Conviction** - Upto **₹ 1000**
- ❖ **Subsequent Conviction**- Upto **₹ 5000 or 6 months** imprisonment or both.

Section 21 - Disciplinary Procedure-

Matter to be placed before Board of Discipline	Matter to be placed before Disciplinary Committee.
❖ If a member is guilty of any professional or other misconduct mentioned in First Schedule, the Disciplinary Directorate shall place the matter between BOD. ❖ Powers of BOD if CA found guilty of misconduct a) Reprimand the member; b) Remove the name of the member from the register for a period of three months; c) Impose fine up to ₹ 1 lakh.	❖ If a member is guilty of any professional or other misconduct mentioned in Second Schedule, the Disciplinary Directorate shall place the matter between DC. ❖ Powers of DD if CA found guilty of misconduct a) Reprimand the member; b) Remove the name of the member permanently or for such period, as it thinks fit; c) Impose fine up to ₹ 5 lakhs.

Section 28A - Quality Review Board

Composition	Functions
❖ Chairperson ❖ Ten other members ❖ Chairperson and members of Board shall be appointed from amongst the persons of eminence having experience in the field of	❖ To make recommendations to the Council with regard to quality of services provided by the members of institute; ❖ To review the quality of services provided by the members of the institute including audit services; and

law, economics, business, finance or accountancy. ❖ 5 members to be nominated by Council. 5 members to be nominated by CG.	❖ To guide the members of the Institute to improve the quality of services and adherence to various statutory and other regulatory requirements.
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7. Schedules to the Act

First Schedule Part I – Professional Misconduct in relation to member in practice

Clause 1 – A CA in practice is deemed to be guilty of professional misconduct if "**he allows any person to practice in his name as a CA**", unless such person is also a CA in practice and in partnership with or employed by him".

Analysis of the clause:

- ❖ A CA in practice can allow another person to practice in his name only if he is a CA in practice and his partner/employee.

Clause 2 – A CA in practice is deemed to be guilty of professional misconduct if he

- i. **Pays / allows / agrees to pay or allow**, directly or indirectly, **any share, commission or brokerage in fees or profits** of his professional business to any person other than
 - a. A member, or
 - b. Partner, or
 - c. Retired partner, or
 - d. Legal representative of deceased partner, or
 - e. Member of any other professional bodies, or
 - f. With such persons having prescribed qualification

for the purpose of rendering such professional services from time to time in or outside India.

Points to remember

1. In case of partnership firm, when there are 2 or more partners and one of them dies, the widow of the deceased partner can continue to receive a share of the firm, only if partnership agreement provides such provision.
2. In case of proprietorship, **Goodwill of a proprietary firm** of Chartered Accountant can be sold or transferred to another eligible member of the institute, after the death of the proprietor concerned.

Transfer of goodwill of the firm of Chartered Accountants are permitted subject to fulfilment of the following procedure:

 - An application in writing should be forwarded by a member, holding COP, intimating his intention to purchase goodwill.
 - The application should be made within 1 year from the death of the member.
 - The name of the firm shall be **kept in abeyance for 1 year** from the death of proprietor/settlement of dispute if any.
3. The professional bodies and persons with prescribed qualification given in Regulation 53 A of CA Regulations, 1988.

Clause 3 – A CA in practice is deemed to be guilty of profession misconduct if he “**Accepts / Agrees to accept any part of the profits of the professional work of a person who is not a member of the Institute**”.

However, such a restriction does not apply in respect of following:

1. Member of any other professional bodies, or
2. With such other persons having prescribed qualification as referred to in clause 2.

Just as a member cannot share his profits with a non-member, he is also not permitted to receive and share the fees of others except from members and professional bodies and persons specified in Regulation 53 A. The object of the clause is to ensure that a CA in practice don't work as commission agent. However, referral fees amongst members in practice for referring a client is allowed.

Clause 4 – A CA in practice is deemed to be guilty of professional misconduct if he “**Enters into partnership in or outside India** with any persons other than the following.

1. C.A in practice; or
2. Member of any other professional body having prescribed qualifications; or
3. A person resident without India who but for his residence abroad would be entitled to be registered as a member; or
4. A person whose qualification are recognized by central Govt. or council of the purpose of permitting such partner ships.”

Analysis of the clause:

- ❖ A CA can enter into partnership with CA in Practice, CS, CWA, LLB, Actuary, Architect, and Engineer.

Notes on clause 4

- a. A CA in practice can enter into partnership with:
 1. A CA in practice or,
 2. A member of any other professional body having prescribed qualifications (Regulation 53 A and 53 B)
- b. Taking into consideration Regulation 53 A, B and other prescribed qualification, a CA can enter into partnership with



Note:

Sharing in clause 2 and 3 can be done with a member not in practice but **partnership can be entered only with a CA in practice.**

- a. A CA cannot enter into partnership with a foreign professional.
- b. A CA residing outside India can enter into partnership with a foreign professional as provisions of CA Act are not applicable on him.

(Newly Inserted)

- c. **Members cannot form multi-disciplinary partnership**, till other professional regulators permit and also guidelines of council are issued in this regard. (The implication is that CA in practice will not be able to enter into partnership with an advocate even though permitted as per regulation 53 B until the Bar council also permits it).

- d. Members in practice cannot become a partner / designated partner (non-working and without remuneration) in LLP not carrying out professional work.

Clause 5 – A CA in practice is deemed to be guilty of professional misconduct if he **“Secures any professional business through the services of a person who is not an employee or not his partner or by means which are not open to a CA”**.

Clause 6 – A CA in practice is deemed to be guilty of professional misconduct if he solicits clients or professional work either directly or indirectly, by circular, advertisement, personal communication or interview or by any other means.

Provided that nothing herein contained shall be construed as preventing or prohibiting - (1) Any CA from applying, requesting for or inviting or securing professional work from another Chartered Accountant in practice, or (2) A member from responding to tenders or enquiries issued by various users of professional services or organisations from time to time and secure professional work as a consequence.

Some forms of soliciting work which the council has prohibited as discussed below: -

A. Advertisement and note in press

- Members should not advertise for soliciting work.

Exceptions to above rule

- Changes in partnerships, or
- Of any change in address of practice and telephone numbers

However, such announcements should be limited to a bare statement of facts and consideration given to the opportunities of the area of distribution of the newspaper or magazine and number of insertions

- A member is also permitted to issue a classified advertisement in the journal / newsletter of the Institute which is
 - Intended to give information for sharing professional work on assignment basis, or
 - For seeking partnership or salaried employment of an accountancy nature, provided it only contains the accountant's name, address or telephone number, fax number, e - mail address **and address of social networking sites of members**.
- Mere factual position of experience and area of specialization relevant to seek response of advertisement are permissible.

B. Empanelment of allotment of audit / professional work

- The Governments departments Government companies / corporations and other similar Institutions prepare panels of chartered Accountant for allotment of audit and other professional work.
- Where the existence of such a panel is within the knowledge of a member, he is free to write to the concerned organizations with a request to place his name on the panel.
- Roving enquiries for existence of such panel is not permitted.
- It is permissible to quote fees on enquires being received from such bodies, which maintain such panel.
- Printed or xerox copies of scale of fees in reply to such enquires is not permitted.

C. Publications in telephone / other directories

The council has held that it would be permissible for a Chartered Accountant to have entries in telephone directory either by making a special request or by means of an additional payment. It has decided to permit such entries subject to the following restrictions:

- The entry should appear in the section/category of “Chartered Accountant”.

2. The member / firm should belong to the town/city in respect of which the directory is being published.
3. The entry should be in **normal type of letters**. Entry in bolder type or abnormal type of letters or in a box is not permissible.
4. The order of the entries should be alphabetical and logical.
5. The entry should **not appear** in a manner giving the impression of publicity / Advertisement.
6. The payment, if any for the entry should not be unreasonable.
7. The entries should be open to all the CA's / firms of CA's in a particular city / town.

D. Responding to Tenders, Advertisements and Circulars :

- ❖ It is not prohibited to the members to respond to tenders and requests made by users of professional work. This is however subject to conditions that may be issued by the Council from time to time.
- ❖ A member of the Institute in practice shall **not respond to any tender** issued by an organization or user of professional services in areas of services which are exclusively reserved for Chartered Accountants, such as audit and attestation services. However, such restriction shall not be applicable where **minimum fee** of the assignment is prescribed in the tender document itself or where the areas are open to other professionals along with the Chartered Accountants.
- ❖ The "minimum fee" for this purpose should be such that it commensurate with size, value, volume, manpower requirement and nature of work.
- ❖ **EMD/Security Deposit** : Permitted but A cost sheet be maintained by members of the Institute responding to tenders, incorporating details of the costs being incurred therein having regard to number of persons involved, hours to be spent, etc, so that the same may be called for by the Institute for perusal.

E. Website (212th meeting and 242nd meeting of the council)

- No standard format prescribed, No colour restriction.
- Individual members would also be permitted to have their web pages in their **trade name or individual name**.
- Websites are permitted to run on a **"pull" model and not a "push" model** of the technology to ensure that only a person who wishes to locate the CAs or CAs' firms would have access to the information.
- The CAs would be permitted to mention the websites address on their **professional stationary only**.
- **Websites may contain** : Member /trade / firm name, year of establishment, Member / firm's address (both head office and branches), Tel. no (s), Fax No (s), E - mail ID (s), Nature of service rendered (to be displayable only on **specific "pull" request**), Partners - partner name, year of qualification (s) tell. no, direct, res, mobile, e-mail, address, area of experience, (to be displayable only on specific "pull" request), Details of employee - name, designation, area of experience (to be displayable only on specific "pull" request), **Job vacancies for the Chartered Accountant** / firm of Chartered Accounts (including article ship), **No. of articled clerks** (to be displayable only on specific "pull" request), Nature of assignments handled (to be displayable only on "pull" request), Name of clients and fee charged cannot be given, Usage of approval logo of ICAI on website. Any other logo should not be used and educational videos on topic of professional relevance are permissible.
- No photographs of any sort are permitted. Display of **passport size photographs is permitted**
- The **chat rooms** can be provided which permit chatting amongst members of the ICAI and between the Firms and its clients. The confidentiality protocol would have to be observed. 10. CAs can provide only advice to their clients who specifically requests for the Advice whether free of charge or on payment.

- **Listing on suitable search engine should be permitted.** However, the field of search should be restricted only to the field of "Chartered Accountants" or "CA" or "Indian CA". "Indian CPA" "Indian Chartered Accountant" or any permutation or combination related there to.
- The detail in the website should be so designed that it does not amount the soliciting client or professional work or advertisement of professional attainments or services.
- **The website may provide a link to** website of ICAI, Regional Council and Branches. Govt websites, Regulatory authorities, other professional bodies etc.

F. Roving Enquiries

- ❖ It is not permissible for a member to address letters or circulars to persons who are likely to require services of a CA since it would tantamount to advertisement.

G. Publication of books and articles

- ❖ It is not permissible for a member to maintain in a book or an article published by him, or a presentation made by him, any professional attainment(s), whether of the member or the firm of Chartered Accountants, with which he is associated.
- ❖ However, he may indicate in a book, article or presentation the designation "Chartered Accountant" as well as the name of the firm.

H. Issue of greeting Cards

- ❖ The Council does not approve of the issue of greeting cards or personal invitations by members indicating their professional designation, status and qualifications etc. However, the Council is of the view that the designation "**Chartered Accountant**" as well as the name of the firm may be used in greeting cards, invitations for marriages and religious ceremonies and any invitations for opening or inauguration of office of the members, change in office premises and change in telephone numbers, provided that such greeting cards or invitations etc. are sent only to clients, relatives and friends of the members concerned.

Points to Remember :

- ❖ Indicating their professional designation, status and qualification etc. are prohibited
- ❖ Issuing the same to clients and relatives of the partner shall amount to professional misconduct.

I. seeking work from professional colleagues

- ❖ issue of an advertisement or a circular by a CA seeking work from professional colleagues is not permitted. Only classified advertisement in newsletter/journal is permissible in this regard.

J. scope of representation u/s 140(4) of companies Act 2013

- ❖ Representation should not be used to secure needless publicity and soliciting for his continuance as an auditor.

K. acceptance of work, emanating from a client introduced by other CA

- ❖ The council has decided that a member should not accept the original professional work emanating from a client introduced to him by another member.

L. Public interview

- ❖ While giving any interview, the member should ensure that it should not result in publicity and due care must be given to ensure that professional attainments are not highlighted.

M. Advertisement for Silver, Golden, Platinum or Centenary celebrations :

- ❖ It is **not permitted to advertise the events organized by a Firm** of Chartered Accountants. However, considering the need of interpersonal socialization/relationship of the members ,it may be published in newspaper or newsletter.

N. Sponsoring Activities

- A member in practice or a Firm of Chartered Accountants is **not permitted to sponsor an event**. However, such member or Firm may sponsor an event conducted by a Programme Organizing Unit (PoU) of the ICAI, provided such event has the prior approval of Continuing Professional Education (CPE) Directorate of the ICAI.
- Members sponsoring activities relating to **Corporate Social Responsibility** may mention their individual name with the prefix "CA". However, the mention of **Firm name or CA Logo is not permitted**.

O. Advertisement of Teaching/Coaching activities by members:

- ❖ Members are advised to abstain from advertising their association with Coaching /teaching activities through hoardings, posters, banners and by any other means, failing which they may be liable for disciplinary action. Such members may put, outside their Coaching/ teaching premises, sign board mentioning the name of Coaching/teaching Institute, contact details and subjects taught therein only. As regards the size and type of sign board, the Council Guidelines as applicable to Firms of Chartered Accountants would apply.

P. Educational Videos:

- ❖ While the videos of educational nature may be uploaded on the internet by members, **no reference should be made to the Chartered Accountants Firm** wherein the member is a partner/ proprietor. Further, it should not contain any contact details or website address.

Q. Sharing Firm profile with prospective client:

- ❖ It is not permitted to share Firm profile with a prospective client unless it is in response to a proposed client's specific query, and otherwise not prohibited to be used by the client.

R. Television or movie credit:

- ❖ **Firm name is allowed** but exhibition of name should not be made differently as compared to others.

S. Giving Public Interviews

While giving any interview or otherwise furnishing details about themselves or their firms in public interviews or to the press or at any forum, the members should ensure that, it should **not result in publicity**. Due care should be taken to ensure that such interviews or details about the members or their firms are not given in a manner highlighting their professional attainments.

Clause 7- A CA in practice is deemed to be guilty of professional misconduct if he: "**Advertise his professional attainments or services**, or uses any designation or expressions other than CA on professional documents, visiting cards, letter heads or sign boards."

However, a recognised degree of university or title indicating membership of ICAI or any other institution that has been recognised by Central government or council may be used.

Provided that a member in practice may advertise through a write up, setting out the service provided by him or his firm and particulars of his firm's subject to such guidelines as may be issued by the council.

Points to remember

- A member empanelled as Insolvency Professional or Registered Valuer can mention the designation Insolvency Professional or Registered Valuer respectively on his visiting card and letterhead.

- b. Income tax consultant, cost consultant or management consultant on professional documents - NOT ALLOWED.
- c. Designation such as **"Member of Parliament", Municipal Council** or in addition to designation Chartered Accountant - **NOT ALLOWED**.
- d. Chartered Accountant in practice who is otherwise eligible may practice as an Advocate SUBJECT TO THE PERMISSION of the Bar Council, but in such case, he should NOT use designation 'Chartered Accountant' in respect of matters involving the practice as an Advocate. In respect of other matters, they should use the designation 'Chartered Accountant' but they should not use the designation 'Chartered Accountant' and 'Advocate' simultaneously.
- e. Members of the Institute in practice who are otherwise eligible may practice as advocates subject to the permission of the Bar Council in such case, they should not use designation 'Chartered Accountant' In respect of the matters involving the practice as an advocate.
- f. In respect of other matters, they should use the designation 'Chartered Accountant' but they should not use the designation 'Chartered Accountant' and 'advocate' simultaneously.
- g. Name, description and address of member (firm) may appear in any directory or list of members of a particular body, (alphabetically). He may provide appropriate directorship held and reasonable personal details (outside Interest) but not name of clients and services offered his firm.
- h. Publication of photographs and brief particulars of member in magazines is permissible provided that no payment should be made for the same and there is no advertisement of professional attainments.
- i. **Advertisement in Press-Not Allowed**
Exception-
 - Advertisement for recruiting staff in the members own office
 - Advertisements inserted on behalf of clients requiring staff or wishing to acquire or dispose of business or property
 - Advertisement for the sale of a business or property by a member acting in a professional capacity as trustee, liquidator or receiver
- j. **Please note: - on success of candidate in exams**
 - Name, address, local background and success details of the candidate can be mentioned.
 - The name of the firm can be mentioned but there should no undesirable publicity of article / principal / firm.
- k. Appearance in T.V films / radio etc. - ALLOWED, but no reference should be made, in the case of practising member to the name and addresses or services of his firm.
- l. Use the glow signed board / light or large size board - NOT ALLOWED, he may have a name board to himself at residence but not of a firm.
- m. Inclusion of the name of a member of the Institute in the prospectus or public announcements or other public communication issued by the companies in which the member in a director - ALLOWED.
- n. **Use of logo - NOT ALLOWED only common logo permitted by ICAI is allowed.**
- o. Printing photograph on the visiting card is not permissible. However, Quick Response Code may be printed on visiting card provided that the Code does not contain information that is not otherwise permissible to be printed in visiting card.
- p. It is not permissible for CA Firm to print its vision and values behind the visiting cards, as it would result in solicitation and therefore would be violative of the provisions of Clause (6) Of Part-I of First Schedule to the Chartered Accountants Act, 1949.
- q. **Members are permitted to mention a title on their visiting cards to indicate membership of a foreign institute of Accountancy, which has been recognised by council.**
Example: CPA, ICAEW

- r. **Network firm and networking guidelines:** The council has permitted network amongst the firm registered with the institute. A member of the network may advertise to the extent permitted by the advertisement guidelines issued by the institute.
- t. **Appearance of Chartered Accountants on Electronic Media (including Internet):** Members may appear on television, films and Internet and agree to broadcast in the Radio or give lectures at forums and may give their names and describe themselves as Chartered Accountants. Firm name may also be mentioned, however, any **exaggerated claim or any kind of comparison is not permissible.**
- u. **Organising Training Courses, Seminars etc. for his staff:** A Chartered Accountant in practice holding training courses, seminars etc. for his staff may also invite the staff of other Chartered Accountants and clients to attend the same. However, undue prominence should not be given to the name of the Chartered Accountant in any booklet or document issued in connection therewith.
- v. **Writing Articles or Letters to the Press:** Members writing articles or letters to the Press on subjects connected with the profession may give their names and use the description Chartered Accountants
- x. **Public Announcements with details of Directors:** The prospectus or public announcements issued by these Companies often publish descriptions about the Chartered Accountant's expertise, specialisation and knowledge in any particular field or add appellations or adjectives to their names. Attention of the members in this context is invited to the provisions of Clause (6) and (7) of Part I of the First Schedule to the Chartered Accountants Act so that such prospectus or public announcements or public communications do not directly or indirectly amount to solicitation of clients for professional work by the member.

Clause 8 – A CA in practice is deemed to be guilty of professional misconduct if **"he accepts a position as auditor previously held by another Chartered Accountant or certified auditor who has been issued certificate under the Restricted Certificate Rules 1932, without first communicating with him in writing."**

Important points

1. **The professional reasons for not accepting an audit could be:**
 - A. **Non-compliance** of the provisions of section 139 & 140 of Companies Act, 2013.
 - B. **Non - payment of undisputed audit fees** by auditees other than in case of sick units (sick unit shall mean a unit registered for **not less than 5 years**, which has at the end of any F.Y. accumulated losses equal to or exceeding its entire net worth).
 - C. Issuance of a qualified report

In the first two cases, an auditor who accepts the audit would be guilty of professional misconduct. In the last case, however, he may accept the audit if he satisfied that the attitude of the retiring auditor was not proper and justified.
2. Communication should be by way of RPAD (**Registered Post Acknowledgment Due**), Courier with proof of delivery, by hand delivery against an acknowledgment in writing, e-mail through e-mail id registered with ICAI of last known official e-mail id, (UDIN) generated on UDIN portal (subject to separate guidelines issued by the council). **Certificate of Posting not a conclusive proof of communication**, mere posting of a letter under Certificate of Posting is not sufficient to establish communication.
3. It is duty of outgoing auditor to reply as early as possible, if outgoing auditor does not reply, the incoming auditor may act after waiting for reasonable time. Apply to all audit assignment including internal concurrent tax audit, however not applicable for special Audits, But as per healthy practice for special audit **u/s 142(2A) of IT Act** also.

4. Duty of communication is **absolute and required in every case**, even when appointment is made by government or when if previous auditor knows about the appointment. The **mandatory communication** with the previous auditor being a Chartered Accountant is required even in case where the previous auditor happens to be an auditor for a year other than the immediately preceding year.
5. **Communication required for all kinds of audit:** The requirement for communicating with the previous auditor being a Chartered Accountant in practice would apply to all types of Audit viz., Statutory Audit, Tax Audit, GST Audit, Internal Audit, Concurrent Audit or any other kind of audit.
6. **Premises found locked:** The communication received back by the incoming auditor with "office found locked" written only Acknowledgement due shall be deemed as having being delivered to the retiring auditor.
7. **Firm not found at the given registered address:** If the communication send by the incoming auditor is received back with remarks "no such office exists at this address" and the address of communication is the same as registered with institute on the date of dispatch, the letter will be deemed to be delivered, unless the retiring auditor proves that it was not really served and that he was not responsible for such non-service.
8. **Communication in case of Assignments done by other professionals:** Not mandatory but a healthy practise to communicate.
9. **Lack of time in acceptance of Government Audits :**
 - In case the time schedule given for the assignment is such that there is no time to wait for the reply from the outgoing auditor, the incoming auditor may give a conditional acceptance of the appointment and commence the work which needs to be attended to immediately after he has sent the communication to the previous auditor in accordance with this clause.
 - In his acceptance letter, he should make clear to the client that his acceptance of appointment is subject to professional objections, if any, from the previous auditors and that he will decide about his final acceptance after taking into account the information received from the previous auditor.

Clause 9 – A CA in practice is deemed to be guilty of professional misconduct if he **"Accepts an appointment as auditor of a company without ascertaining whether requirements of sec 225 of companies Act, 1956 (Section 139, 140 read with 141), in respect of such appointment have been duly complied with."**

Clause 10 – A CA in practice is deemed to be guilty of professional misconduct if he **"Charges or offers to charge, accepts or offers to accept in respect of any professional employment, fee which is based on a percentage of profits or which are contingent upon findings, or results of such employment, except as permitted under regulations."**

Points to remember

- a) **Fees will not be treated contingent if fixed by a court or other public authority.**
- b) **Regulation 192 (Exemption to clause 10).**
 - In the case of a **receiver or a liquidator**, the fees may be based on a percentage of the realisation or disbursement of the assets
 - In the case of an **auditor of a co - operative society**, the fee may be based on a percentage of the paid-up capital or the working capital or the gross or net income or profits.
 - In the case of a **valuer** for the purposes of direct taxes and duties, the fee may be based on a percentage of the value of property valued

- in the case of certain **fund-raising services**, the fees may be based on a percentage of the fund raised
- in the case of **debt recovery services**, the fees may be based on a percentage of the debt recovered
- in the case of **services related to cost optimisation**, the fees may be based on a percentage of the benefit derived; and
- any other service or audit as may be decided by the Council (Following activities have been decided by the Council under "h" above :- (i) Acting as Insolvency Professional; (ii) Non-Assurance Services to Non-Audit Clients).

Clause 11 - A CA in practice is deemed to be guilty of professional misconduct if he **"Engages in any business or occupation other than profession of CA unless permitted by council so to engage.** However, a member may become director (not being M. D or whole-time director) in a company provided he or any of his partners is not interested in such company as an auditor."

Regulation - 190 A

- ❖ The Council, on a very careful consideration of the matter, has formulated Regulation, 190A and 191 which are reproduced below, specifying the activities with which a member in practice can associate himself with or without the permission of the Council.
- ❖ The Council has passed a Resolution under **Regulation 190A granting general permission** (for private tutorship, and part-time tutorship under Coaching organization of the Institute) and **specific permission** (for part-time or full-time tutorship under any educational institution other than Coaching organization of the Institute). Such general and specific permission granted is subject to the condition that the direct teaching hours devoted to such activities taken together **should not exceed 25 hours a week** in order to be able to undertake attest functions.

General Permission

Permission granted generally - Members of the Institute in practice be generally permitted to engage in the following categories of occupations, for which **no specific permission** from the Council would be necessary in individual cases:

- (1) **Employment** under Chartered Accountants in practice or firms of such chartered accountants.
- (2) **Private tutorship.**
- (3) Authorship of books and articles.
- (4) Holding of **Life Insurance Agency License** for the limited purpose of getting renewal commission.
- (5) Attending classes and appearing for any examination.
- (6) Holding of public elective offices such as **M.P., M.L.A. and M.L.C.**
- (7) Honorary office leadership of charitable-educational or other non-commercial organisations.
- (8) Acting as **Notary Public, Justice of the Peace, Special Executive Magistrate** and the like.
- (9) **Part-time tutorship** under the coaching organisation of the Institute.
- (10) Valuation of papers, acting as **paper-setter, head-examiner or a moderator**, for any examination.
- (11) **Editorship** of professional journals.
- (12) Acting as **Surveyor and Loss Assessor** under the Insurance Act, 1938 provided they are otherwise eligible.
- (13) Acting as **recovery consultant** in the banking sector

(14) Owning **agricultural land and carrying out agricultural activity** (w.e.f. August 9th, 2008).

Specific Permission -

Members of the Institute in practice may engage in the following categories of business or occupations, after obtaining the specific and prior approval of the Council in each case:

- (1) Full-time or part-time employment in **business concerns** provided that the member and/or his relatives do not hold "substantial interest" in such concerns.
- (2) Full-time or part-time employment in **non-business concern**.
- (3) Office of managing director or a whole-time director of a body corporate within the meaning of the Companies Act, 1956 (now Companies Act, 2013) provided **that the member and/or any of his relatives do not hold substantial interest in such concern**.
- (4) **Interest in family business concerns** (including such interest devolving on the members as a result of inheritance / succession / partition of the family business) or concerns in which interest has been acquired as a result of relationships and in the management of which no active part is taken.
- (5) Interest in an educational institution.
- (6) Part-time or full-time lectureship for courses other than those relating to the Institute's examinations conducted under the auspices of the Institute or the Regional councils or their branches.
- (7) Part-time or full-time tutorship under any educational institution other than the coaching organization of the Institute.
- (8) Editorship of journals other than professional journals.
- (9) Any other business or occupation for which the Executive Committee considers that permission may be granted.

However, it is open to the Council to refuse permission in individual cases though covered under any of the above categories. For the purpose of the above resolution:

Regulation 191

A CA in practice can accept the appointment [provided it is **not on salary - cum - full time basis**]

1. As a liquidator, trustee, executor, administrator, arbitrator, receiver, advisor or
2. As representative for costing, financial or taxation matters or
3. Any appointment made by central or state Government or court of Law or any other legal authority
4. As a secretary.

Clarifications by the Council :

1. **Directors of the Company**
 - a. The expression "**Director Simplicitor**" means an ordinary / simple Director who is not a Managing Director or Whole time Director and is required only in the Board Meetings of the company and not paid any remuneration except for attending such meetings.
 - b. A member in practice is permitted generally to be a Director Simplicitor in any Company including a board-managed Company and as such he is not required to obtain any specific permission of the Council in this behalf unless he or any of his partners is interested in such Company as an auditor, irrespective of whether he and/or his relatives hold substantial interest in that Company
2. **Promoter/Promoter Director -** There is no bar for a member to be a promoter / signatory to the Memorandum and Articles of Association of any company. There is also no bar for such a promoter /

signatory to be a Director Simplicitor of that company irrespective of whether the object of the company include areas which fall within the scope of the profession of Chartered Accountants. Therefore, members are not required to obtain specific permission of the Council in such cases.

3. **Member in practice in a HUF doing business** - "A member of the Institute can acquire interest in family business in any of the following manner:

- (i) as a proprietary firm
- (ii) as a partnership firm
- (iii) in the name and style of Hindu Undivided Family as its Karta or a member.

It would be necessary for the members to provide evidence that interest in the family business concern devolved on him as a result of inheritance / succession / partition of the family business. It is also necessary for the member to show that he was not actively engaged in carrying on the said business and that the family business concern in question was not created by himself.

To establish his case, the member should furnish a declaration in the prescribed format and the documents evidencing above for consideration to the concerned Decentralized Office."

A member in practice engaged as Karta of a HUF doing family business, will be within the limit prescribed by Council if he makes investments from the funds pertaining to HUF only, provided, he is not actively engaged in the management of the said business

Clause 12 : A CA in practice is deemed to be guilty of professional misconduct if he **"Allows a person not being a member of ICAI in practice or a member not being in partner to sign on his behalf or his firm, any Balance sheet, Profit and loss account, report or financial statements"**.

For example: If CA in practice allows his audit assistants, who are not members, to sign the bills for audit fees on behalf of firm of CA then it shall not be deemed to be professional misconduct.

Additional Reference: -

The Council has clarified that the power to sign routine documents on which a **professional opinion or authentication is not required** to be expressed may be delegated in the following instances and such **delegation will not attract provisions of this clause:**

- (i) **Issue of audit queries** during the course of audit.
- (ii) **Asking for information** or issue of questionnaire.
- (iii) **Letter forwarding** draft observations/financial statements.
- (iv) **Initiating and stamping** of vouchers and of schedules prepared for the purpose of audit.
- (v) Acknowledging and carrying on **routine correspondence with clients**.
- (vi) Issue of **memorandum** of cash verification and other physical verification or recording the results thereof in the books of the clients.
- (vii) Issuing **acknowledgements** for records produced.
- (viii) **Raising of bills** and issuing acknowledgements for money receipts.
- (ix) Attending to **routine matters** in tax practice, subject to provisions of Section 288 of Income Tax Act.
- (x) Any other matter incidental to the **office administration** and routine work involved in practice of accountancy.

A member of the Institute (other than member in practice) is deemed to be guilty of professional misconduct if he

Clause 1 – “Pays or allows or agrees to pay directly or indirectly to any person any share in the emoluments of the employment undertaken by him”.

This clause does not restrict such sharing or commitments among relatives, dependents, friends etc. If there is no relationship in procuring or retaining the job and payment is not a consideration for job procurements or retainership.

Clause 2 – “Accepts or agrees to accept any part of fees, profits or gains from a lawyer, a Chartered Accountant or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification”

Chartered Accountant in service must maintain high level of ethics and should not accept any other amount from any one for which he is not entitled from employer under contractual agreement of service

First Schedule Part III– Professional Misconduct in relation to members generally

A Member of the Institute, whether in practice or not is deemed to be guilty of professional misconduct if he

Clause 1 – A CA in general is deemed to be guilty of professional misconduct if he “Not being a fellow of the Institute, but acts as a fellow of the Institute”.

Clause 2 – A CA in general is deemed to be guilty of professional misconduct if he “Does not supply the information called for, or does not comply with the requirements asked for by the Institute council or any of its committees, Director (Discipline), Board of Discipline, Disciplinary committee, Quality Review Board of the appellate authority”

Clause 3 – A CA in general is deemed to be guilty of professional misconduct if he: “While inviting professional work from another Chartered Accountant or while responding to tenders or enquiries or while advertising through a write up or anything as provided for in clauses (6) and (7) of Part I of this schedule, gives information knowing it to be false”.

Example: – A CA firm disclosed Mr. Ram as their partner even though Mr. Ram is not a partner to another organization to procure work.

First Schedule Part IV– Other Misconduct in relation to members generally

A Member of the Institute, whether in Practice or not, shall be deemed to be guilty of other misconduct if he

1. Is held guilty of any civil or criminal court for an offence which is punishable with imprisonment for a term not exceeding six months.
2. In the option of the council brings disrepute to the profession or the Institute as a result of his action whether or not related to his professional work.

Second Schedule Part I “Professional Misconduct in relation to Members in Practice”

Clause 1 – A chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he “Discloses the information acquired in the course of his professional engagement to any person other than his client so engaging him without the consent of his client or otherwise than as required by any law of the time being in force.”

Important Points :

1. The accountant's duty not to disclose continues **even after the completion of his assignment**.
2. An auditor is not required to provide the client or other auditors of the same enterprise or its related enterprise such as a parent or a subsidiary, **access to his audit working papers**. However, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge.

Clause 2 - A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he "**Certifies or submits in his name or in the name of his firm**, a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee in his firm or by another CA in practice."

Clause 3 - A chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he "**Permits his name or the name of his firm to be used in connection with an estimate of earnings contingent** upon future transactions in manner which may lead to the belief that he vouches for the accuracy of the forecast."

Important Points:

As per SAE 3400, A CA in practice can associate his name with the forecasts. He can participate in preparation of profits or final forecasts and can review them subject to the following conditions:

1. Source of information is mentioned.
2. The basis of forecasts is mentioned.
3. He gives in the report the major assumptions made in arriving at the forecasts.
4. He does not vouch for accuracy of forecasts.

Clause 4 - A chartered Accountant in practice shall be deemed to be guilty of his professional misconduct, if he "**Expresses his opinion on financial statements** of any business or enterprise in which he, his firm or a partner in his firm has a **substantial interest**."

Important Points

- (i) A member of the Institute shall not express his opinion on financial statements of any business or enterprise in which one or more persons, who are his **"relatives"** within the meaning of AS 18 related party disclosures, have either by themselves or in conjunction with such members a substantial interest in the said business or enterprise.
- (ii) It is not permissible for a member to undertake the assignment of certification, wherein the client is relative of the member. The "relative" for this purpose would refer to the definition mentioned in Accounting Standard (AS)-18. The meaning of term **"relative"** is taken as per AS 18 and covers person such as father, mother, son, daughter, brother, sister, spouse. Apart from above holding company, subsidiary company, key management personnel, relatives of director and KMP, associate and Joint Venture.
- (iii) The words **"financial statements"** used in this clause would **cover both reports and certificates**.

(iv) In this connection, the Council has decided not to permit a Chartered Accountant in employment to certify the financial statements of the concern in which he is employed, or of a concern under the same management as the concern in which he is employed, even though he holds certificate of practice and that such certification can be done by any Chartered Accountant in practice. This restriction would not however apply where the certification is permitted by any law. The Council has also decided that a Chartered Accountant should not by himself or in his firm name: -

1. accept the Auditorship of a college, if he is working as a part-time lecturer in the college.
2. accept the Auditorship of a Trust where his partner is either an employee or a trustee of the Trust.

(v) The Council has, in this connection, issued the following guidelines:

Requirements of Clause applicable to all Attest Functions

Many new areas of professional work have been added, e.g., Tax Audit, GST Audit, Concurrent Audit of Banks, Concurrent Audit of Borrowers of Financial institutions, Audit of non-corporate borrowers of Banks and Financial Institutions, Audit of Stock Exchange, Brokers, etc. The Council wishes to emphasize that the aforesaid requirement of Clause (4) are equally applicable while performing all types of attest functions by the members.

vi) Public conscience is expected to be ahead of the law. Members, therefore, are expected to interpret the requirement as regards independence much more strictly than what the law requires.

vii) Member must take care to see that they do not land themselves in situations where there could be conflict of interest and duty.

For example, where a Chartered Accountant is appointed the Liquidator of a Company, he should not qua a Chartered Accountant himself, audit the Statement of Accounts to be filed under Section 348(1) of the Companies Act, 2013. The audit in such circumstances should be done by a Chartered Accountant other than the one who is the Liquidator of the Company.

viii) An accountant is expected to be **not independent in the discharge of his duties as a tax consultant or a financial advisor than as auditor**.

(ix) Members are not permitted to write the books of accounts of their auditee clients.

(x) Statutory auditor should not be appointed as the internal auditor simultaneously of the same entity.

(xi) An internal auditor cannot be appointed as tax auditor of same entity.

(xii) The internal auditor cannot undertake GST Audit of the same entity.

(xiii) Cooling off period after completion of tenure as Director: A member shall not accept the assignment of audit of a Company for a period of two years from the date of completion of his tenure as Director, or resignation as Director of the said Company.

(xiv) Members to satisfy whether appointment is as per the statute: A member should satisfy himself before accepting an appointment as an auditor of an entity that his appointment is in accordance with the statute governing the entity.

(xv) In case the appointment is to be authorised by the regulatory authorities such as in the case of co-operative societies, trusts etc. then the member must satisfy whether such **regulatory authorities have authorised** the managing committee of the society/trust for appointment of the auditors.

(xvi) Section 288 of Income Tax Act, 1961 describe the disqualifications for the purpose of Tax Audit.

(xvii) Substantial interest means having 20 % voting power.

Clause 5 - A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he **"Fails to disclose a material fact known to him which is not disclosed in a financial statements**, but disclosure of which is necessary in making such financial statement not misleading where he is concerned with that financial statement in a professional capacity".

Note- The word **"financial statements"** used in this clause would cover both reports and certificate. The definition of materiality is given in SA 320.

Clause 6 - A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he **"Fails to report a material misstatement** known to him to appear in a financial statement with which he is concerned in a professional capacity".

Clause 7 - A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he **"Does not exercise due diligence, or is grossly negligent of the conduct of his professional duties."**

Important Points

Examples of Gross Negligence

- Failure to check the bank balances** with the passbooks of the banks and to obtain certificates of balances from the bankers.
- Issuing clean report on the balance sheets** whereas the reports on the special audit conducted subsequently revealed **few irregularities**.
- Accepting arbitrary valuation** of stock without its physical verification.
- Issuing **wrong consumption certificate** in respect of raw materials and components without examining stock register.
- Not completing his work in due course of time**, delaying it unnecessarily.

Clause 8 - A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he **"Fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion"**.

Important Points :

- A CA should express his opinion about the truth and fairness of statement of accounts only after obtaining required data and information.
- He has to determine extent to which information is required.
- In case of inadequacy of information or data, he should clearly express his disclaimer in no uncertain terms.

For example, if the auditor has not seen any evidence of the existence and/or valuation of the investment which constitute the only asset of a company, he should not say that:

"Subject to the verification of the existence and value of the investments the balance sheet shows a true and fair view"

Clause 9 – A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he “Fails to invite attention to any material departure from the generally accepted procedure of audit applicable. ”

Few examples

- ❖ Audit of Listed Companies shall be done by only those auditors who have subjected themselves to the Peer Review process of the Institute, and hold a valid certificate issued by the Peer Review Board of the ICAI.
- ❖ **FRN and Membership No.:** The members are required to mention the Membership number and Firm registration number to all reports issued pursuant to any attestation engagements, including certificates, issued by them as proprietor or/ partner in the said firm.
- ❖ A member of the Institute in practice shall generate Unique Document Identification Number (UDIN) for all kinds of the certification, GST and Tax Audit Reports and other Audit, Assurance and Attestation functions undertaken/signed by him.

Clause 10 – A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he “Fails to keep money of his client other than fees or remuneration or money meant to be expended in a separate banking account or to use such moneys for purposes for which they are intended within a reasonable time.”

Important Points

1. The aforesaid money received by the auditor should be deposited into a separate bank account.
2. It is the duty of CA to use the money as per client's instructions or for the purpose instructed by the client.
3. An advance received by a CA against the services to be rendered does not fall under these clauses.
4. Money received for expenses to be incurred which are not intended to be spent within reasonably short time, should be put in a separate bank account immediately.
5. Money received by a Chartered Accountant, in his capacity as trustee, executor, liquidator, etc. must be put in a separate bank account immediately.

Second Schedule - Part II “Professional Misconduct in relation to Members of Institute Generally”

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he

Clause 1 – Contravenes any of the provisions of this Act or the regulations made there under or any guidelines issued by the council.

Clause (2) being an employee of any company, firm or person, **discloses confidential information** acquired in the course of his employment except as and when required by any law for the time being in force or except as permitted by the employer.

Clause (3) Includes in any information, statement, return or form to be submitted to the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline. Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars **knowing them to be false.**

Clause (4) **Defalcates or embezzles money** received in his professional capacity.

Defalcation and embezzlement of moneys received in professional capacity amounts to fraud (Covered in SA-240) and such member will be deemed to be guilty of professional misconduct under this clause.

Second schedule- Part III "Other Misconduct in relation to Members of Institute Generally"

Clause 1 - A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he is held guilty by any civil or criminal court for an offence which is punishable with **imprisonment for a term exceeding six months.**

Imprisonment awarded for a term exceeding six months in any civil/criminal matter treated as a major offence under 'other misconduct' is included in this Schedule.

8. Council General Guidelines, 2008**Chapter I - Preliminary****Chapter II - Conduct of a Member being an employee**

A member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

Chapter III- Appointment of a Member as Cost Auditor-Omitted**Chapter IV - Opinion on financial statements when there is substantial interest- Omitted****Chapter V- Maintenance of books of account**

A member of the Institute in practice or the firm of Chartered Accountants of which he is a partner, shall maintain and keep in respect of his / its professional practice, proper books of account including the following-

- (i) a Cash Book;
- (ii) a Ledger.

Chapter VI - Tax Audit assignments under Section 44 AB of the Income-tax Act, 1961

- ❖ A member of the institute in practice shall not accept, in a financial year, **more than 60 tax audit assignments under Section 44 AB of the Income Tax Act, 1961** whether in respect of corporate or non- corporate assesses.
- ❖ According to a clarification on Tax Audit Assignments by Committee on Ethical Standards Board) of the Institute, even 1 partner can sign all tax audit reports on behalf of other partners.
- ❖ The audit of the head office and branch offices of a concern shall be regarded as one tax audit assignment. The audit of one or more branches of the same concern by one Chartered Accountant in practice shall be construed as only one tax audit assignment.

Chapter VII - Appointment of an Auditor in Case of non-payment of undisputed fees

A member of the Institute in practice shall not accept the appointment as auditor of an entity in case the undisputed audit fee of another Chartered Accountant for carrying out the statutory audit under the Companies Act, 2013 or various other statutes has not been paid: Provided that in the case of sick unit, the above prohibition of acceptance shall not apply.

For this purpose, "sick unit" shall mean a unit registered for **not less than five years**, which has at the end of any financial year accumulated losses equal to or exceeding its entire net worth.

Chapter VIII - Specified numbers of Audit Assignments

A member of the Institute in practice shall **not hold at any time appointment of more than 30 audit assignments** whether in respect of private Companies or other Companies, with the exception of one person Companies and dormant companies. {In case of firm, it will be considered 30 per partner}.

However, under **Section 141 (3) (g)**, a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than 20 companies other than one

person companies, dormant companies, small companies and private companies having paid-up share capital **less than one hundred crore rupees**. No of partners on date of acceptance to be considered.

Chapter IX - Appointment as Statutory Auditors

a member of the Institute in practice shall not accept the appointment as a statutory auditor of a PSUs'/Govt company(ies)/Listed company(ies) and other public company(ies) having a turnover of ₹ 50 crores or more in a year and where he accepts any other work(s) or assignment(s) or service(s) in regard to same undertaking(s) on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the same undertaking.

For this purpose, the other work/services include Management Consultancy and all other professional services permitted by Council excluding audit under any other statute, Certification work required to be done by the statutory auditor and any representation before an authority.

Author's note- Applicability of these guidelines seems to be redundant in case of companies as section 144 prohibits the auditor from rendering such services including management services directly /indirectly to company or its holding company or its subsidiary company.

Chapter X - Appointment of an Auditor when he is indebted to a concern

A member of the Institute in practice or a partner of a firm in practice or a firm or a relative of such member or partner shall not accept appointment as auditor of a concern while indebted to the concern or given any guarantee or provided any security in connection with the indebtedness of any third person to the concern, for limits fixed in the statute and in other cases for amount exceeding 1,00,000/-.

Points to Remember :

1. Recovery of fees on progressive basis doesn't mean indebtedness.
2. As per Section 141(3) of companies act, 2013, the limits of indebtedness is ₹ 5 lakh and for guarantee or security is ₹ 1 lakh .

Chapter XI - Directions in case of unjustified removal of auditors

A member of the Institute in practice shall follow the direction given, by the Council or an appropriate Committee or on behalf of any of them, to him being the incoming auditor(s) not to accept the appointment as auditor(s), in the case of unjustified removal of the earlier auditor(s).

Chapter XIII - Guidelines on Tenders- covered in clause vii.

Chapter XIV - Unique Document Identification Number (UDIN) Guidelines

A member of the Institute in practice shall generate Unique Document Identification Number (UDIN) for all kinds of the certification, GST and Tax Audit Reports and other Audit, Assurance and Attestation functions: -

- ❖ For all Certificates w.e.f. 1st February, 2019.
- ❖ For all GST and Tax Audit Reports w.e.f. 1st April, 2019.
- ❖ For all other Audit, Assurance and Attestation functions w.e.f. 1st July, 2019.

Chapter XV - Guidelines for Networking Note: Covered separately.

Chapter XVI - Logo Guidelines

- ❖ The logo consists of letter 'CA' with a tick mark inside a rounded rectangle with **white background**.
- ❖ The letters CA have been put in **blue, the corporate colour** which not only stands out on the background but also denotes creativity, innovativeness, knowledge, integrity, trust, truth, stability and depth.

- ❖ The upside-down tick mark typically used by Chartered Accountants, has been used to symbolize **the wisdom and value of the professional**.
- ❖ The green colour in the tick mark signifies growth, prosperity, harmony and freshness.
- ❖ Members are encouraged to use the new logo, as published here as it is. **Do not change the design and colours, including the white background. Refrain from rotating or tilting the logo.**

Chapter XVII - Guidelines for Corporate Form of Practice

- ❖ The Council decided to allow members in practice to hold the office of Managing Director, Whole-time Director or Manager of a body corporate within the meaning of the Companies Act provided that **the body corporate is engaged exclusively in rendering Management Consultancy and Other Services permitted by the Council in pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949.**
- ❖ The members can retain **full time Certificate of Practice besides being the Managing Director, Whole-time Director or Manager of such Management Consultancy Company.**
- ❖ There will be no restriction on the quantum of the equity holding of the members, either individually and/ or along with the relatives, in such Company. Such members shall be regarded as being in **full-time practice** and therefore can continue to do attest function either in individual capacity or in Proprietorship/Partnership firm in which capacity they practice and wherein they are also entitled to train articled/audit assistants.

9. Council Guidelines For Advertisement, 2008

1. Advertisement through write-up

The write-up shall comply with the following conditions: -

- A. It shall be honest and truthful.
- B. There shall be no exaggerated claims for the services offered by the member or the Firm, or the qualifications or experience of the member or any of the partners or any other person associated with the Firm.
- C. It must not make any disparaging references or unsubstantiated comparisons to the work of others.
- D. It should not be of a nature that may bring the profession into disrepute.
- E. It should not contain testimonials or endorsements concerning Member(s) or names of clients (both the past and present) or the fees charged.
- F. It should not contain any information about achievements /awards (except the awards given by the Central or State Governments or Regulatory bodies) or any other position held , or accreditation(s) granted by any organisation.
- G. Monogram of any kind or use of any kind of catch words is not permissible.
- H. The Membership No./FRN (as may be applicable) is mandatory to be mentioned in the write- up.
- I. It should not be of font size exceeding 14.
- J. It must not be violative of any provisions of Chartered Accountants Act, 1949, Chartered Accountants Regulations, 1988, Code of Ethics, 2020 or any Guideline of the Council.

The Institute of Chartered Accountants of India may issue a reasoned directive for removal or withdrawal of the whole write-up or of any part(s) thereof.

2. Guidelines for website

Already covered under Clause 6 of Part 1 of First Schedule.

3. **Online Third-Party Platforms**

A number of non-Chartered Accountants' firms, corporates including banks, finance Companies and newspapers have **set up their own Websites providing advisory services on taxation and other areas** where **Chartered Accountants are rendering professional service**. Some of such Websites may request Chartered Accountants or Chartered Accountants' firms to provide consultation and advice through their Websites.

No other service, besides consultancy and advice can be rendered through such websites. The name of Chartered Accountants' firm with suffix "Chartered Accountants" would not be permitted.

4. **Publication of Name or Firm Name by Chartered Accountants in the Telephone or other Directories published by Telephone Authorities or Private Bodies**

Already covered in clause 6.

5. **Application based Service provider Aggregators**

It is not permissible for members to list themselves with **online Application based service provider Aggregators**, wherein other categories like businessmen, technicians, maintenance workers, event organizers etc. are also listed.

10. Council Guidelines on Network and Network Firm

What constitutes a network/Common attribute that must exist for a firm to be called a Network? It's a large structure aimed at: -

- (a) **Co-operation**
- (b) **Profit or cost sharing or shares common ownership, control or management-** Where the larger structure is aimed at cooperation and the entities within the structure share common ownership, control or management, it is deemed to be a network. This could be achieved by contract or other means.
- (c) **Common quality control policies and procedures-** Where the larger structure is aimed at co-operation and the entities within the structure share common quality control policies and procedures, it is deemed to be a network.
- (d) **Common business strategy-** Where the larger structure is aimed at co-operation and the entities within the structure share a common business strategy, it is deemed to be a network.
- (e) **The use of a common brand name-**
 - Where the larger structure is aimed at co-operation and the entities within the structure share the use of a common brand name, it is deemed to be a network. A common brand name includes common initials or a common name.
 - A firm is deemed to be using a common brand name if it includes, for example, the common brand name as part of, or along with, its firm name, when a partner of the firm signs an audit report.
 - Even though a firm does not belong to a network and does not use a common brand name as part of its firm name, it may give the appearance that it belongs to a network if it makes reference in its stationery or promotional materials to being a member of an association of firms.

Clarifications on What will not constitute a Network

1. Whether these larger structures create a network depends on the particular facts and circumstances and does not depend on whether the firms and entities are legally separate and distinct. For example,

a larger structure may be aimed only at facilitating the referral of work, which in itself does not meet the criteria necessary to constitute a network.

2. **The sharing of immaterial costs does not in itself create a network.** In addition, if the sharing of costs is limited only to those costs related to the development of audit methodologies, manuals, or training courses, this would not in itself create a network.
3. An association between a firm and an otherwise unrelated entity to jointly provide a service or develop a product does not in itself create a network.
4. An entity is not deemed to be a network firm merely because it co-operates with another entity solely to respond jointly to a request for a proposal for the provision.
5. Where the shared resources are limited to common audit methodology or audit manuals, with no exchange of personnel or client or market information, it is unlikely that the shared resources would be significant and hence such an association would not constitute a network.

Forms of the Network

1. A network can be constituted as a **mutual entity** which will act as a facilitator for the constituents of the Network. In such a case the Network itself will not carry out any professional practice.
2. A network can be constituted as a **partnership firm** subject to the condition that the total number of partners does not exceed twenty.
3. A network can be constituted as a **Limited Liability Partnership** subject to the provision of the Chartered Accountant Act and Rules and such other laws as may be applicable.
4. A network can be constituted as **company** subject to the guidelines prescribed by Institute for corporate form of practice and formation of management consultancy services company.
5. Network Firms shall consist of **sole Practitioner/proprietor, partnership** or any such entity of professional accountants as may be permitted by the Act
6. **A firm is allowed to join only one network.**
7. **Firms having common partners shall join only one Network.**

Approval of Name of Network amongst firms registered with Institute:

1. The Network may have distinct name which should be approved by the Institute. To distinguish a "Network" from a "firm" of Chartered Accountants, the words "& Affiliates" shall be used after the name of the network and the words "& Co." / "& Associates" shall not be used. The prescribed format of application for approval of Name for Network is at Form 'A' (enclosed). Illustrative examples of names of Network: -
 - (a) If the Network is a Mutual Entity or Partnership Firm: AB & Affiliates
 - (b) If the Network is a LLP: AB Affiliates LLP
 - (c) If the Network is a Limited Company: AB Affiliates P. Ltd/Limited
2. The Institute shall approve or reject the name of the Network and intimate the same to the Network at its address mentioned in Form 'A' within a period **which shall not be later than 30 days from the date of receipt of the said Form.**
3. Mere approval of the name of the Network shall not entitle the Network to carry on practice in its own name.

Registration of Network with entities in India

1. After the name of a Network is approved as per provision under Guideline 5, the Institute same shall **reserve such name for a period of three (3) months** from the date of approval.

2. The Network shall get itself registered with the Institute by applying in Form B within the **period of 3 months**, failing which the name assigned shall stand cancelled on the expiry of the said period.
3. Registration of Network with Institute is **mandatory**.
4. If different Indian firms are networked with a common Multinational Accounting Firm, they shall be considered as a part of network.

Listing of Network with entities outside India

1. The duly authorized representative(s) of the Indian Member firm (s)/Member constituting the Network with entities outside India shall file a declaration with the Institute in **Form 'D'** for Listing of such Network **within 30 days** from the date of entering into the Network arrangement.
2. Proprietary/individual members, partnership firms as well as members in LLP or any such other entity of members as may be permitted by the Act, shall be permitted to join such network with entities outside India provided that the proprietary/individual members, partnership firms as well as members in LLP or any such other entity of members are allowed to join only one network and firms having common partners shall join only one such network.

Change in constitution of registered Network:

In case of change in the constitution of registered Network on account of any entry into or exit from the Network, the network shall communicate the same to the Institute by filing **Form 'C' within a period of thirty (30) days** from the date of change in the constitution.

Ethical Compliance:

Once the relationship of network arises, it will be necessary for such a network to comply with all applicable ethical requirements prescribed by the Institute from time to time in general and the following requirements in particular: -

1. If one firm of the network is the statutory auditor of an entity then the associate [including the networked firm(s)] or the said firm directly/indirectly shall not accept the internal audit or book-keeping or such other professional assignments which are prohibited for the statutory auditor firm.
2. The guidelines of ceiling on **non-audit fees** is applicable in relation to a Network as follows: -
 - i) For a Network firm who is doing statutory audit (including its associate concern and/or firm(s) having common partnership), it shall be the same as mentioned in the said notification; and
 - ii) For other firms of the same Network collectively, it shall be **3 times of the fee payable** for carrying out the statutory audit of the same undertaking/ company.
3. In those cases where rotation of firms is prescribed by any regulatory authority, no member firm of the network can accept appointment as an auditor in place of any member firm of the network which is retiring.
4. The Network may advertise the Network to the extent permitted by the Advertisement Guidelines issued by Institute. The firms constituting the network are permitted to use the words **"Network Firms"** on their professional stationery.

Consent of Client:

The effect of registration of network with Institute will be deemed to be a public notice of the network and therefore consent of client will be deemed to be obtained.

Framework of Internal Byelaws of Network:

To streamline the networking, a network shall formulate operational bye-laws. **Bye-laws** may contain the following clauses on which the affiliates of the network may enter into a written agreement among themselves:

- (i) **Appointment of a Managing Committee**, from among the managing partners of the member firms of the network and the terms and conditions under which it should function. The minimum and maximum number of members of the Managing Committee shall also be agreed upon.
- (ii) **Administration** of the network
- (iii) Contribution of **membership fees** to meet the cost of the administration of the network.
- (iv) Identifying a partner of any of the member firms of the network to be responsible for the assignment (engagement partner)
- (v) **Dispute settlement** procedures through arbitration and conciliation
- (vi) Development of **training materials** for members of the network
- (vii) Issue of News-letters for staff and clients
- (viii) Development of software for different **types** of assignments
- (ix) Development and maintenance of data bases relevant for different types of assignments
- (x) Library
- (xi) Appointment of a **technical director** to whom references can be made
- (xii) Determining the **methodology for drawing resources** from each member firm
- (xiii) Determining **compensation** to member firms for resources to be drawn from them
- (xiv) **Peer review** of the member firms

Part III

11. Recent Decisions of Ethical Standards Board

1. May engage himself as **Registration Authority** for obtaining Digital Signature Certificate for client.
2. CA can act as **mediator in Court** (Regulation 11).
3. It is Permissible for a CA in P to be **settlor of a trust** (provides property to beneficiary).
4. CA/CA firm can act as **internal auditor of company and statutory auditor** of its Employees Provident Fund but cannot act as stat auditor of company and internal auditor of its **EPF**.
5. Internal auditor of a PF trust of Govt co cannot be appointed as its Stat auditor.
6. CA may be **Equity research adviser** but can't publish **retail report** as it will be business or occupation.
7. CA in employment can appear as **Tax Representative** before tax authorities on behalf of employer but not for other employees of that employer.
8. Member of trust cannot be appointed as its auditor.
9. Can hold **credit card of bank** even if auditor of same bank but o/s balance **shouldn't exceed 1L** beyond prescribed credit period limit.
10. Stat auditor of bank can't do stock audit of such bank.
11. A CA in P Cant accept audit of bank if has taken loan against FD held by him in that bank.
12. CA in practice **can't become Financial Advisors** & receive fees/ commission from Financial Institutions such as Mutual Funds, Insurance cos, NBFCs.
13. A CA **Can't exercise lien over client docs** for non-payment of fees.
14. Not permissible to print vision or values behind visiting cards as it'd result in solicitation & thus violative of Clause 6 of First Schedule of CA Act 1949.

15. Not permissible for CA in P to take agencies of UTI, GIC & NSDL.
16. A CA in P Can't hold customs broker license under sec 146 of Custom Act, 1962.
17. Not permissible to print vision or values behind visiting cards as it'd result in solicitation & thus violative of Clause 6 of First Schedule of CA Act 1949.
18. Not permissible for CA in P to take agencies of UTI, GIC & NSDL.
19. Can act as authorised representative of Foreign Co if not the statutory auditor of Co.
20. **Not permissible** for a member to use **messaging apps to send messages** to people aware about his practice, and mentioning services provided.
21. **Cannot act as trademark or patent attorney.**
22. Stat auditor/tax auditor cannot be valuer of unquoted equity shares of same entity.(but permissible if not prohibited under any other law).
23. Not permissible for a member who has been a director of co, upon resignation to be appointed as auditor of same do for **2 years.**
24. A concurrent auditor of bank 'X ' cannot be appointed as stat auditor of bank ' Y' which is sponsored by 'X.'

12. Mandatory KYC Norms for a CA in Practice

1. Where Client is an Individual/ Proprietor

A. General Information

- Name of the Individual
- PAN No. or Aadhar Card No. of the Individual
- Business Description
- Copy of last Audited Financial Statement

B. Engagement Information

- Type of Engagement

2. Where Client is a Corporate Entity

A. General Information

- Name and Address of the Entity
- Business Description
- Name of the Parent Company in case of Subsidiary
- Copy of last Audited Financial Statement

B. Engagement Information

- Type of Engagement

C. Regulatory Information

- Company PAN No.
- Company Identification No.
- Directors' Names & Addresses
- Directors' Identification No.

3. Where Client is a Non-Corporate Entity

A. General Information

- Name and Address of the Entity Copy of PAN No.
- Business Description
- Partner's Names & Addresses (with their PAN/Aadhar Card/DIN No.)
- Copy of last Audited Financial Statement

B. Engagement Information

- Type of Engagement

13. RECOMMENDED SELF-REGULATORY MEASURES BY COUNCIL OF ICAI

The more important of these recommendations are as under:

13.1 Branch Audits

The branch audits of a company should not be conducted by its statutory auditors consisting of **ten or more members**, but should be conducted by the local firms of auditors consisting of less than ten members. This restriction may not apply in the following cases.

- (i) where the accounting records of the branches are maintained at the head office of the respective companies, and
- (ii) where significant operations of an undertaking or a company are carried out at its branch office.

13.2 Joint Audit

In the case of large companies, the practice of associating a practicing firm with **less than five members** as Joint auditors should be encouraged. Where a client desires to appoint such a firm as joint auditor, the senior firm should not object to the same.

13.3 Ratio Between Qualified and Unqualified Staff

In the Council's view, a practicing firm of Chartered Accountants engaged in audit work should have **at least one member for every five non-qualified members of the staff**, excluding articled and audit assistants, typists, peons and other persons not engaged directly in such professional work.

13.4 Disclosure of Interest by Auditors in other Firms

The Council has decided that as a good and healthy practice, auditors should make a disclosure of the payments received by them for other services through the medium of a different firm or firms in which the said auditor may be either a partner or proprietor.

13.5 Recommended Minimum Scale of Fees

The Institute has issued revised Minimum scale of Fees for the professional assignments of the members of ICAI. The recommended scale of Fees is to be charged as per the work performed for various professional assignments. The Fees has been recommended separately for Class-A, B and C cities.

13.5.1 Fees - Relative Size:

Differentiated disclosure requirements for non-public interest entities and public interest entities are following: -

1. **For Non-Public Interest Entities (PIE)**-Disclosure is required where for **two consecutive years**, the gross annual professional fees from an audit client represent **more than 40% of the total fees of the firm**.
2. **For public interest entities-** Disclosure is required where for **two consecutive years**, the gross annual professional fees from an audit client represent **more than 20% of the total fees of the firm**.

Exemption from applicability of the above provision will be in case where total Fees received by Firm does not exceed 20 lacs of rupees.

In addition, **exemption from applicability** of the above provision is also given in the case of audit of government Companies, public undertakings, nationalised banks, public financial institutions, regulators or where appointments of auditors are made by the Government.

CHAPTER 02

AUDIT PLANNING, STRATEGY AND EXECUTION

1. AUDIT PLANNING

General Requirements w.r.t Audit Planning:-

- ❖ The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business".
- ❖ Plans should be further developed and revised as necessary during the course of the audit.
- ❖ **SA-300, "Planning an Audit of Financial Statements"** further expounds this principle. According to it, **planning** is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. 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.

1.1 Benefit of Planning in an Audit of Financial Statements

- ❖ Helping the auditor to **devote appropriate attention** to important areas of the audit.
- ❖ Helping the auditor **identify and resolve potential problems** on a timely basis.
- ❖ Helping the auditor **properly organize and manage the audit engagement** so that it is performed in an effective and efficient manner.
- ❖ **Assisting in the selection of engagement team members** with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
- ❖ Facilitating the **direction and supervision of engagement team** members and the review of their work.
- ❖ Assisting, where applicable, in coordination of work done by auditors of components and experts.

1.2 Knowledge of Client's Business

As per **SA-315, "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment"**, the auditor shall obtain an understanding of the following:-

- a) **Relevant industry, regulatory and other external factors** including the applicable financial reporting framework.
- b) The **nature of the entity**, including operations, ownership structure, types of investments, mode of financing etc.
- c) The entity's **selection and application of accounting policies**, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are

appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

- d) The entity's **objectives and strategies**, and those related business risks that may result in risks of material misstatement.
- e) The **measurement and review of the entity's financial performance**. Example; Reviewing analyst report, credit rating agencies report.

1.3 Audit Planning - A Continuous Process

Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as:

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

1.4 Development of an Overall Plan:-

- ❖ The terms of his engagement and statutory responsibilities.
- ❖ Nature and timing of reports.
- ❖ Applicable legal or statutory requirements.
- ❖ Accounting policies adopted by the client.
- ❖ Effect of new accounting or auditing pronouncements on the audit.
- ❖ Identification of significant audit areas.
- ❖ Setting of materiality levels for audit purposes.
- ❖ The degree of reliance on accounting system and internal control.
- ❖ Possible rotation of emphasis on specific audit areas.
- ❖ The nature and extent of audit evidence to be obtained.
- ❖ The work of internal auditors and the extent of their involvement.
- ❖ The involvement of other auditors.
- ❖ The involvement of experts.
- ❖ The allocation of work between joint auditors'.
- ❖ Establishing and coordinating staffing requirements.

1.5 Description of Audit Plan

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

- a) The nature, timing and extent of planned risk assessment procedures, as determined under **SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment"**.
- b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under **SA 330 "The Auditor's Responses to Assessed Risks"**.
- c) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops.

1.6 Direction, Supervision and Review

The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including.

1. The size and complexity of the entity.
2. The area of the audit.
3. The assessed risks of material misstatement.
4. The capabilities and competence of the individual team members performing the audit work.

1.7 Discussion with Engagement team

- ❖ The engagement partner and other key members of the engagement team shall be involved in planning the audit including planning and participating in the discussion among engagement team members.
- ❖ The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement.

1.8 Planning Process

The elements of planning can be categorized as under: -

- (I) Preliminary engagement activities
- (II) Planning activities

1.9 Can Audit planning be revised ?

Audit planning is a continuous process, the auditor may change the audit plan or strategy during the performance of an audit engagement as a result of

- ❖ Unexpected events;
- ❖ Change in conditions; or

- ❖ The audit evidence obtained from the result of audit procedures.

1.10 Factors effecting Nature and Extent of Planning

- ❖ **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.

2. AUDIT STRATEGY

Overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan.

The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as:-

- ❖ The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters.
- ❖ The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas.
- ❖ When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates; and
- ❖ How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

2.1 Establishment of Overall Audit Strategy

In establishing the overall audit strategy, the auditor shall

- Identify the characteristics of the engagement that define its scope.**

Some of characteristics are as under: -

- Applicable financial reporting framework applicable to the entity
- Nature of business segments to be audited including the need for specialized knowledge
- Industry specific reporting requirements required by industry regulators
- Expected use of audit evidence obtained in previous audits

- The ascertaining of reporting objectives of engagement helps the auditor to plan timing of different audit procedures and also nature of communications. Some of the instances are given under: -**

- The **entity's timetable for reporting**.
- **Organization of meetings** to discuss of nature, timing and extent of audit work with management.
- Discussion with management regarding the **expected type and timing of reports** to be issued including the auditor's report.
- Discussion with management regarding the **expected communications** on the status of audit work throughout the engagement.
- Expected **nature and timing of communications among engagement team members**, including the nature and timing of team meetings and timing of the review of work performed.

c) **Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts.**

The auditor needs to direct efforts of engagement team towards matters that in his professional judgment are significant. Preliminary identification of material classes of transactions, account balances and disclosures help auditor in establishing overall audit strategy. More energies need to be devoted to significant matters to obtain desired outcomes.

Few examples are listed as under: -

- **Volume of transactions** which may determine whether it is more efficient for the auditor to rely on internal control.
- **Significant industry developments** such as changes in industry regulations and new reporting requirements.
- **Significant changes in the financial reporting framework**, such as changes in accounting standards.
- Other significant relevant developments, such as **changes in the legal environment** affecting the entity.

(d) **Considering results of preliminary engagement activities and knowledge gained from similar engagements goes a long way in establishing sound audit strategy. Examples are listed as under: -**

- Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified deficiencies and action taken to address them.
- The manner in which the auditor emphasizes to engagement team members the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence.

e) **Ascertain the nature, timing and extent of resources necessary to perform the engagement.**

Selection of engagement team and assignment of audit work to team members is a significant factor in establishing overall audit strategy. Experienced team members may be assigned in areas where there is higher risk of material misstatement. Similarly, engagement budgeting

and devotion of more time to areas of higher risk of material misstatement are to be kept in mind.

2.2 Relationship between Overall Audit Strategy and Audit Plan

- a. **The audit strategy provides the guidelines for developing the audit plan.** It establishes the scope and conduct of the audit procedures and thereby works as basis for developing a detailed audit plan.
- b. Detailed audit plan would include **the nature, timing and extent of the audit procedures** to obtain sufficient appropriate audit evidence.
- c. **The audit strategy is prepared before the audit plan.**
- d. The **audit plan contains more details** than the overall audit strategy.
- e. **Audit strategy and audit plan are inter-related** because change in one would result into change in the other.

The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit:

- i. Terms of his engagement and any statutory responsibilities.
- ii. Nature and timing of reports or other communications.
- iii. Applicable Legal or Statutory requirements.
- iv. Accounting policies adopted by the clients and changes, if any, in those policies.
- v. The effects of new accounting and auditing pronouncement on the audit.
- vi. Identification of significant audit areas.
- vii. Setting of materiality levels for the audit purpose.
- viii. Degree of reliance to be placed on the accounting system and internal control.
- ix. Possible rotation of emphasis on specific audit areas.
- x. Nature and extent of audit evidence to be obtained.

3. PRELIMINARY ENGAGEMENT ACTIVITIES

- ❖ Evaluating compliance with ethical requirements, including independence, as required by SA 220;
- ❖ Understanding of Terms of the Engagements as required by SA 210;
- ❖ Perform 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.

4. ADDITIONAL CONSIDERATIONS FOR INITIAL AUDIT ENGAGEMENT

For an Initial Audit Engagement, auditor may need to expand the planning activities as he does not have any prior experience with the entity. In case of Initial audit engagement, auditor should consider the following additional aspects:

- ❖ Unless prohibited by law or regulation, **arrangements to be made with the predecessor auditor**, for example, to review his working papers.
- ❖ Any major issues (including the application of accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the

communication of these matters to TCWG and how these matters affect the overall audit strategy and audit plan.

- ❖ The **audit procedures necessary to obtain SAAE** regarding opening balances as prescribed by SA 510.
- ❖ Other procedures required by the firm's system of quality control for initial audit engagements.

5. AUDIT PROGRAMME

An audit programme is commonly prepared to allocate work to team members which may include the list of audit procedures and instructions to be followed by the member. It also estimates the duration for completing an audit task.

5.1 Formulating an Audit Programme

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 means to control the proper execution of work.

The important matters which need to be considered in this regard are:

1. **Nature of business in which the organization is engaged-** Auditor should draw up the audit programme after considering the technical, financial and accounting set-up of the company.
2. **Overall Plan-** Audit programme should be drawn up to ensure a systematic approach to the work.
3. **System of internal control and accounting procedures-** The study and evaluation of internal control helps the auditor to establish the reliance he can place on the internal controls determining the nature, timing and extent of his substantive auditing procedures. The auditor's examination of the system of internal control should have three features - review and preliminary evaluation, testing of compliance and evaluation.
4. **Size of the organisation and structure of its management-** An increase in the size of the organisation enhances the complexity of the examination of its accounting records specially when it has a number of branches, deals in several products or has a very large turnover.
5. **Information as regards organization of the business-** To plan audit programme, it is necessary that the auditor should obtain from his client information as regards the client's history and business, purpose and nature of engagement and time schedule for the completion of audit.
6. **Accounting and Management Policies-** Review the financial statements of the past several years, audited by his predecessors and ascertain accounting and management policies followed in the past and whether this have been employed consistently.

5.2 Drawing up the Audit Programme

After the auditor has collected the aforementioned information, he will be in a position to draw up the programme of audit. He can now decide the areas to be covered by audit, also those to be covered in detail and those which should be covered by the applications of the test checks. He will also be able to decide the specific audit procedures which should be applied in each case.

The audit programme should be developed in three stages stated below

- (i) To begin with, a broad outline of the audit programme should be drawn up.
- (ii) After the internal and accounting procedures have been reviewed, the details should be filled up on a consideration of the deficiencies in the system of internal control.
- (iii) After the detailed checking procedure is over, the extent to which the special procedures (first time/ opening balance audit procedures) that are required to be applied should be determined, e.g.,

independent verification of balances of debtors and creditors, physical inspection of fixed assets, personal inspection of various items of stock included in closing inventories and testing their values. At times, special procedures may have to be applied on a consideration of the nature of business e.g. verification of provision for tax liability in case of a shipping company regarding freight booked in different countries or for making a provision for unexpired liability in case of an insurance company, etc.

5.3 Circumstances on which Audit Programme would have to be suitably altered

- i. If the audit procedures were designed for a certain volume of turnover and subsequently the volume have substantially increased.
- ii. Where during the course of an audit, it has been discovered that internal control procedures were not as effective as assumed at the time the audit programme was framed.
- iii. Where there has been **an extraordinary increase** in the amount of book debts or that in the value of stocks as compared to that in the previous year.
- iv. When a **suspicion has aroused** during the course of audit or information has been received that assets of the company have been misappropriated.

6. AUDIT EXECUTION

Key phases in the audit execution stage are Execution Planning, Risk and Control Evaluation, Testing and Reporting.

6.1 Execution Planning

- ❖ 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.
- ❖ A preliminary survey would help in gathering the required information and plan the audit more effectively.

6.2 Risk and Control Evaluation

- ❖ For each segment of audit, the auditors should conduct a detailed risk and control assessment
- ❖ While bearing risk assessment, it is necessary to bear in mind the Materiality levels.

6.3 Testing

- ❖ 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.

6.4 Reporting

- ❖ **SA 700, "Forming an Opinion and Reporting on Financial Statements"** establishes standards on the form and content of the auditor's report issued as a result of an audit performed by an auditor of the financial statements of an entity.
- ❖ The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements.

CHAPTER 03

MATERIALITY, RISK ASSESSMENT AND INTERNAL CONTROL

1. MATERIALITY AND RISK ASSESSMENT

1.1 Identification of Risks

- ❖ Audit risk is the risk of expressing an inappropriate audit opinion on financial statements that are materially misstated.
- ❖ Audit Risk has two components: Risk of material misstatement (the risk that the financial statements contain a material misstatement Prior to Audit) and detection risk (the risk that the auditor will not be able to detect such misstatement).

Audit Risk = Risk of Material Misstatement X Detection Risk

Risk of material Misstatement: - Risk of material misstatement is anticipated risk that a material misstatement may exist in financial statement before start of the audit. It has two components inherent risk and control risk. The relationship can be defined as
Risk of material Misstatement = Inherent risk X Control risk.

Detection risk: It is a risk that a material misstatement remained undetected even if all audit procedures applied.

It should be noted that the combined level of Inherent Risk and Control Risk is inversely related with Detection Risk, and Audit Materiality is also inversely related with Audit Risk.

1.2 Audit Risk Components

Nature	Description	Commentary
Inherent Risk	Susceptibility of an assertion to a misstatement that could be material, individually or when aggregated with other misstatements, assuming that there are no related controls. Inherent risk is addressed at both the financial statement level and at the assertion level. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement.	These are the business and other risks that arise from the entity's objectives, nature of operations and industry, the regulatory environment in which it operates and its size and complexity. The risks of material misstatement will vary based on the nature of the account balance or class of transaction. Risks of particular concern to the auditor might include - ❖ Complex calculations which could be misstated; ❖ High value inventory; ❖ Accounting estimates that are subject to significant measurement uncertainty;

		❖ Lack of sufficient working capital to continue operations; ❖ A declining or volatile industry with many business failures; and ❖ Technological developments that might make a particular product obsolete.
Control Risk	Risk that the entity's internal control system will not prevent, or detect and correct on a timely basis , a misstatement that could be material, individually or when aggregated with other misstatements.	Some control risk will always exist because of the inherent limitations of any internal control system. The auditor is required to understand the entity's internal control and perform procedures to assess the risks of material misstatement at the assertion level.
Detection Risk	This is the risk that the auditor will not detect a misstatement that exists in an assertion that could be material , either individually or when aggregated with other misstatements. The acceptable level of detection risk for a given level of audit risk bears an inverse relationship to the risks of material misstatement at the assertion level.	The auditor identifies assertions where there are risks of material misstatement and concentrates audit procedures on those areas. In designing and evaluating the results of performing procedures, the auditor should consider the possibility of: ❖ Selecting an inappropriate audit procedure; ❖ Misapplying an appropriate audit procedure; or ❖ Misinterpreting the results from an audit procedure.

Types of Assertions

SA 315, "**Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment**" categorises the types of assertions used by the auditor to consider the different types of potential misstatements that may occur, as follows:

A. Assertions about classes of transactions and events for the period under Audit

- (i) **Occurrence** - transactions and events that have been recorded have occurred and pertain to the entity.
- (ii) **Completeness** - all transactions and events that should have been recorded have been recorded.
- (iii) **Accuracy** - amounts and other data relating to recorded transactions and events have been recorded appropriately.

- (iv) **Cut-off-** transactions and events have been recorded in the correct accounting period.
- (v) **Classification** - transactions and events have been recorded in the proper accounts.

B. Assertions about account balances at the period end-

- (i) **Existence** - assets, liabilities and equity interest exist.
- (ii) **Rights and obligations** - the entity holds or controls the right to assets, and liabilities are the obligations of the entity.
- (iii) **Completeness** - all assets. Liabilities and equity interests that should have been included have been included.
- (iv) **Valuation and allocation** - assets. Liabilities and equity interests are included in the FS at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

C. Assertions about presentation and disclosure:

- (i) **Occurrence and rights and obligations** - disclosed events, transactions and other matters have occurred and pertain to the entity.
- (ii) **Completeness** - all disclosures that should have been included in the FS have been included.
- (iii) **Classification and understandability** - financial information is appropriately presented and described, and disclosures are clearly expressly.
- (iv) **Accuracy and Valuation** - financial and other information are disclosed fairly and at appropriate amounts.

1.3 Steps for Risk Identification

1. **Assess the significance** of the assessed risk, impact of its occurrence and also revise the materiality accordingly for the specific account balance.
2. **Determine the likelihood** for assessed risk to occur and its impact on auditing procedures.
3. **Document the assertions** that are effected.
4. Consider **the impact of the risk** on each of the assertions. (completeness, existence, accuracy, validity, valuation and presentation) relevant to the account balance, class of transactions, or disclosure.
5. **Identify the degree of significant risks** that would require separate attention and response by the auditor. Planned audit procedures should directly address these risks.
6. Enquire and document the management's response.
7. Consider the **nature of the internal control system** in place and its possible effectiveness in mitigating the risks involved.
8. Consider the **unique characteristics** of the risk.
9. Consider the existence of any particular characteristics (inherent risks) in the class of transactions, account balance or disclosure that need to be addressed in designing further audit procedures.

Potential Misstatement Indicators -

Completeness

- ❖ Transactions not identified.
- ❖ Source documents not prepared.
- ❖ Source documents not captured.
- ❖ Rejected source documents not represented.

Existence

- ❖ Fictitious or unauthorised transactions entered on source documents.
- ❖ Source documents overstated.
- ❖ Transactions duplicated on source documents.
- ❖ Capture of source documents duplicated.
- ❖ Invalid source documents captured on subsidiary ledgers.

Recording

- ❖ Source documents captured inaccurately.
- ❖ Processing of transactions is inaccurate.
- ❖ Inaccurate adjustments made in subsidiary ledgers.

Cut-Off Procedures

- ❖ Transactions that occur in one period are recorded in another period.

2. RISK BASED AUDIT

- ❖ Audit should be **risk-based** or focused on areas of greatest risk to the achievement of the audited entity's objectives. **Risk-based audit (RBA)** is an approach to audit that analyzes audit risks, sets materiality thresholds based on audit risk analysis and develops audit programmes that allocate a larger portion of audit resources to high-risk areas.
- ❖ **Risk Based Audit is an essential element of financial audit**-both in the attest audit of the financial statements and in the audit of financial systems and transactions including evaluation of internal controls.

2.1 Audit Risk Analysis

- ❖ The auditor should perform an analysis of the audit risks that impact on the auditee before undertaking specific audit procedures. **Risk assessment is a subjective process.** It is part of the professional judgment of the auditor and of the particular circumstances. It is the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated. Audit risks are brought about by error and fraud.

2.2 General steps in the conduct of Risk Based Audit

The auditor's objective in a risk-based audit is to obtain reasonable assurance that no material misstatements whether caused by fraud or errors exist in the financial statements.

The Risk -based audit process is presented in three distinct phases :

A. Risk Assessment

The risk assessment phase of the audit involves the following steps:

- **Performing client acceptance** or continuance procedures;
- **Planning** the overall engagement;
- **Performing risk assessment procedures** (RAP) to understand the business and identify inherent and control risks;
- **Identifying relevant internal control procedures** and assessing their design and implementation (those controls that would prevent material misstatements from occurring or detect and correct misstatements after they have occurred);
- **Assessing the risks of material misstatement** (ROMM) in the financial statements;
- **Identifying the significant risks** that require special audit consideration and those risks for which substantive procedures alone are not sufficient;
- **Communicating any material weaknesses** in the design and implementation of internal control to management and those charged with governance; and
- Making an **informed assessment of the risks** of material misstatement at the financial statement level and at the assertion level.

B. **Risk Response**

Some of the matters the auditor should consider when planning the audit procedures include:

- Assertions **that cannot be addressed by substantive procedures alone**. This can occur where there is highly automated processing of transactions with little or no manual intervention.
- **Existence of internal control** that, if tested, could reduce the need/scope for other substantive procedures.
- The **potential for substantive analytical procedures (SAP)** that would reduce the need/scope for other types of procedures.
- The need to incorporate an element of **unpredictability** in procedures performed.
- The need to perform **further audit procedures (FAP)** to address the potential for management override of controls or other fraud scenarios.
- The need to perform specific procedures to address **"significant risks"** that have been Identified.

C. **Reporting**

The final phase of the audit is to assess the audit evidence obtained and determine whether it is sufficient and appropriate to reduce the risks of material misstatement in the financial statements to an acceptably low level.

It is important at this stage to determine:

- If there had been a change in the assessed level of risk;
- Whether conclusions drawn from work performed are appropriate; and
- If any suspicious circumstances have been encountered.

Any additional risks should be appropriately assessed, and further audit procedures performed as required.

When all procedures have been performed and conclusions reached:

- Audit findings should be reported to management and those charged with governance; and

- An audit opinion should be formed, and a decision made on the appropriate wording for the auditor's report.

3. INTERNAL CONTROL SYSTEM-NATURE, SCOPE, OBJECTIVE AND STRUCTURE

When obtaining audit evidence about the effective operation of internal controls, the auditor considers :

- ❖ How they were applied;
- ❖ The consistency with which they were applied during the period; and
- ❖ By whom they were applied.

3.1 Nature of Internal Control

A set of internally generated policies and procedures adopted by the management of an enterprise is a prerequisite for an organisations efficient and effective performance. It is thus, a primary responsibility of every management to create and maintain an adequate system of internal control appropriate to the size and nature of the business entity.

3.2 Scope of Internal Control

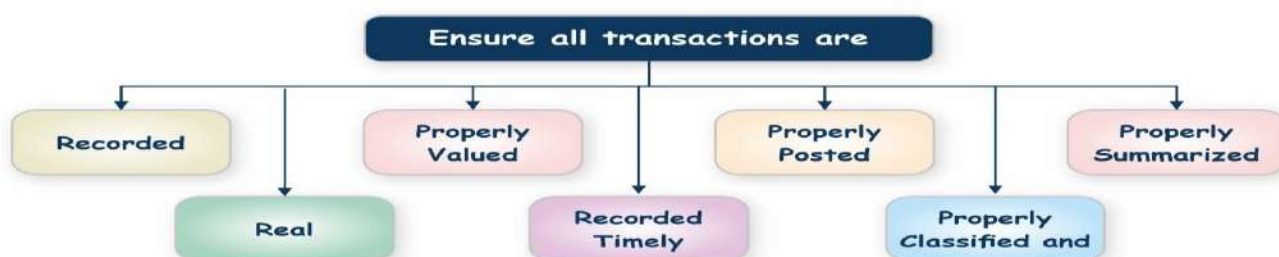
The scope of internal controls extends beyond mere accounting controls and includes all administrative controls concerned with the decision - making process leading to managements authorization of transaction, such controls include, production method, time and motion study, pricing policies, quality control, work standard, budgetary control, policy appraisal, quantitative controls etc.

3.3 Objectives of Internal Control

The objectives of internal controls relating to the accounting system are:

- | | |
|-------|---|
| (i) | Transactions are executed through general or specific management authorization. |
| (ii) | All transactions are promptly recorded in an appropriate manner to permit the preparation of financial information and to maintain accountability of assets. |
| (iii) | Assets and records are safeguarded from unauthorized access, use or disposition. |
| (iv) | Assets are verified at reasonable intervals and appropriate action is taken with regard to the discrepancies. |

The basic accounting control objectives which are sought to be achieved by any accounting control system are:



3.3.1 Limitations of Internal Control

Internal control, no matter how effective, can provide an entity with only reasonable assurance and not absolute assurance about achieving the entity's operational, financial reporting and compliance objectives.

Internal control systems are subject to certain inherent limitations, such as:

Management's consideration that the **cost of an internal control** does not exceed the expected benefits to be derived.

The fact that most **internal controls do not tend to be directed** at transactions of unusual nature. The potential for human error, such as, due to carelessness, distraction, mistakes of judgement and misunderstanding of instructions.

The **possibility of circumvention of internal controls** through collusion with employees or with parties outside the entity.

The possibility that a person responsible for exercising an internal control could **abuse** that responsibility, for example, a member of management overriding an internal control.

Manipulations by management with respect to transactions or estimates and judgements required in the preparation of financial statements.

3.4 Structure of Internal Control

In order to achieve the objectives of internal controls, it is necessary to establish adequate control policies and procedures. Most of these policies and procedures cover:

1. **Segregation of Duties-** Transaction processing are allocated to different persons in such a manner that no one person can carry through the completion of a transaction from start to finish or the work of one person is made complimentary to the work of another person. The purpose is to **minimize the occurrence of fraud and errors** and to detect them on a timely basis, when they take place.
2. **Authorization of Transactions-** of authority to different levels and to particular persons are required to establish by the management for controlling the execution of transaction in accordance with prescribed conditions.

Authorization may be general or it may be specific with reference to a single transaction

3. **Adequacy of records and documents-** Accounting controls should ensure that -

- | | |
|-------|--|
| (i) | Transactions are executed in accordance with management's general or specific authorization. |
| (ii) | Transactions and other events are promptly recorded at correct amounts. |
| (iii) | Transactions should be classified in appropriate accounts and in the appropriate period to which it relates. |
| (iv) | Transaction should be recorded in a manner so as to facilitate preparation of financial statements in accordance with applicable accounting standards, other accounting policies and practices and relevant statutory requirements. |
| (v) | Recording of transaction should facilitate maintaining accountability for assets. |
| (vi) | Assets and records are required to be protected from unauthorized access , use or disposition. |
| (vii) | Records of assets such as sufficient description of the assets (to facilitate identification) its location should also be maintained so that the assets could be physically verified periodically. |

4. **Accountability and Safeguard of Assets-** The process of accountability of assets commences from acquisitions of assets its use and final disposal. Safeguarding of assets requires appropriate maintenance of records, their periodic reconciliation with the related assets. Assets like cash, inventories, investment scrips require frequent physical verification with book records. Assets which are considered sensitive or susceptible to error need to be reconcile more frequently than others.
5. **Independent checks-** Independent verification of the control systems, designed and implemented by the management, involves periodic or regular review by independent persons to ascertain whether the control procedures are operating effectively or not.

4. COMPONENTS OF INTERNAL CONTROL

4.1 Control Environment

The control environment encompasses the following elements:

- (a) **Communication and enforcement of ethical values** - The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts.
- (b) **Commitment to Competence** - Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job.
- (c) **Participation by TCWG** - An entity's control consciousness is influenced significantly by those charged with governance. Responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures and the process for reviewing the effectiveness of the entity's internal control.
- (d) **Management's philosophy and operating style** - Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions toward financial reporting.
- (e) **Organisational structure** - Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The appropriateness of an entity's organisational structure depends, in part, on its size and the nature of its activities.
- (f) **Assignment of authority and responsibility** - The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties.
- (g) **Human resource policies and practices** - Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity. For example, standards for recruiting the most qualified individuals - with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behaviour - demonstrate an entity's commitment to competent and trustworthy people.

4.2 Entity's Risk Assessment Process

For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof.

Risks can arise or change due to circumstances such as the following:

- | | |
|-----|--|
| (a) | <u>Changes in operating environment</u> - Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks. |
| (b) | <u>New personnel</u> - New personnel may have a different focus on or understanding of internal control. |
| (c) | <u>New or revamped information systems</u> - Significant and rapid changes in information systems can change the risk relating to internal control. |
| (d) | <u>Rapid growth</u> - Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls. |
| (e) | <u>New technology</u> - Incorporating new technologies into production processes or information systems may change the risk associated with internal control. |
| (f) | <u>New business models, products, or activities</u> - Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control. |
| (g) | <u>Corporate restructurings</u> - Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control. |
| (h) | <u>Expanded foreign operations</u> - The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions. |
| (i) | <u>New accounting pronouncements</u> - Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements. |

4.3 Control Activities

Generally, control activities that may be relevant to an audit may be categorised as policies and procedures that pertain to the following:

- (a) **Performance reviews:** These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data - operating or financial - to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.
- (b) **Information processing:** The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT-controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems.
- (c) **Physical Controls-** Controls that encompass:
 - The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
 - The authorisation for access to computer programs and data files.
 - The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting records).
- (d) **Segregation of Duties-** Assigning different people the responsibilities of authorising transactions, recording transactions, and maintaining custody of assets.

4.4 Information System, Including the Related Business Process, Relevant to Financial Reporting, and Communication

The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods and records that:

- (a) **Identify and record** all valid transactions.
- (b) **Describe** on a **timely basis** the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- (c) **Measure the value of transactions** in a manner that permits recording their proper monetary value in the financial statements.
- (d) **Determine the time period** in which transactions occurred to permit recording of transactions in the proper accounting period.
- (e) **Present properly** the transactions and related disclosures in the financial statements.

4.5 Monitoring of Controls

Monitoring of controls may include activities such as, management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies.

5. INTERNAL CHECK SYSTEM

The system provides existence of checks on the day-to-day transactions which operate continuously as part of the routine system whereby the work of each person is either proved independently or is made complimentary to the work of another.

The following are the objectives of internal check system

- i. To **detect errors and frauds** with ease.
- ii. To **avoid and minimize the possibility** of commission of errors and fraud by any staff.
- iii. To **increase the efficiency of the staff** working within the organization.
- iv. To **locate the responsibility area** or the stages where actual fraud and error occurs.
- v. To **protect the integrity of the business** by ensuring that accounts are always subject to proper scrutiny and check.
- vi. To **prevent and avoid the misappropriation or embezzlement of cash** and falsification of accounts.

The effectiveness of an Internal Check system depends on the following considerations :

- (i) **Clarity of Responsibility** - The responsibility of different persons engaged in various operations of business transactions should be properly identified.
- (ii) **Division of Work** - The segregation of work should be made in such a manner that the free flow of work is not interrupted and also helps to determine that the work of one person is complementary to the other.
- (iii) **Standardization** - The entire process of accounting should be standardized by creating suitable policies commensurate with the nature of the business, so as to strengthen the system of internal check.

- (iv) **Appraisal** - Periodic review should be made of the chain of operations and workflow. Such process may be carried out by preparing an audit flow chart.

General considerations pertaining of Internal Check System

- (i) **No single person** should have complete control over any important aspect of the business operation. Every employee's action should come under the review of another person.
- (ii) **Staff duties should be rotated** from time to time so that members do not perform the same function for a considerable length of time.
- (iii) Every member of the staff should be encouraged to **go on leave at least once a year**.
- (iv) Persons having **physical custody of assets must not be permitted** to have access to the books of accounts.
- (v) There should exist **an accounting control** in respect of each class of assets, in addition, there should be periodical inspection so as to establish their physical condition.
- (vi) **Mechanical devices** should be used, where ever practicable to prevent loss or misappropriation of cash.
- (vii) **Budgetary control** should be exercised and wide deviations observed should be reconciled.

6. REVIEW OF THE SYSTEM OF INTERNAL CONTROL

- ❖ The control environment **sets the tone of an organization**, influencing the control consciousness of its people. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity.
- ❖ Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. The review of the internal control system enables the auditor
 - (i) **To formulate his opinion** as to the reliance he may place on the system itself i.e. whether the system is such as would enable the management to produce a true and fair set of financial statements; and
 - (ii) **To locate the areas of weakness** in the system so that the audit programme and the nature, timing and extent of substantive and compliance audit procedures can be adjusted to meet the situation

7. INTERNAL CONTROL ASSESSMENT AND EVALUATION

Following are some of the key components to assess & evaluate the controls environment :

Standard Operating Procedures (SOPs): A well defined set of SOPs helps define role, responsibilities, process & controls & thus helps clearly communicate the operating controls to all touch points of a process. The controls are likely to be clearly understood & consistently applied even during employee turnover.

1. **Enterprise Risk Management:** An organization which has robust process to identify & mitigate risks across the enterprise & its periodical review will assist in early identification of gaps & taking effective control measures. In such organizations, surprises of failures in controls is likely to be few.
2. **Segregation of Job Responsibilities:** Segregation of duties is an important element of control such that no two commercial activities should be conducted by the same person.
3. **Job Rotation in Sensitive Areas:** Any job carried out by the same person over a long period of time is likely to lead to complacency & possible misuse in sensitive areas.

4. **Delegation of Financial Powers Document:** As the organization grows, it needs to delegate the financial & other powers to their employees. A clearly defined document on delegation of powers allows controls to be clearly operated without being dependent on individuals.
5. **Information Technology based Controls:** With the advent of computers & enterprise resource planning (ERP) systems, it is much easier to embed controls through the system instead of being human dependent.

7.1 Techniques of evaluation of Internal Control

The following are the techniques of evaluation of internal control:

7.1.1 Questionnaire

- ❖ A questionnaire is a **set of questions framed in an organised manner**, about each functional area, which has as purpose the evaluation of the effectiveness of control and detection of its weakness if any.
- ❖ A questionnaire usually consists of **several separate sections** devoted to areas such as purchases, sales, trade receivables, trade payables, wages, etc.
- ❖ The questionnaire is intended to be **filled by the company executives** who are in charge of the various areas.
- ❖ Questions are so framed as generally to dispense with the requirement of a detailed answer to each question. For this purpose, often one general question is broken down into a number of questions and sub-questions to enable the executive to provide a just 'Yes', 'No' or 'Not applicable' form of reply.
- ❖ Questions are also framed in such a manner that generally a **"No" answer will reflect weakness in the control system.**
- ❖ Questions may be framed also when a **'Yes' answer would indicate weakness.** The only thing that should be borne in mind is that the scheme of questions should be consistent, sequential, logical, and if possible corroborative.

7.1.2 Checklist

- It is a **series of instructions or questions on internal control** which the auditor must follow or answer. When a particular instruction is carried out, the auditor initials the space opposite the instruction.
- If it is in the form of a question, the answer generally **'Yes', 'No' or 'Not Applicable'** is entered opposite the question. **A check list is more in the nature of a reminder to the auditor about the matters to be checked for testing the internal control system.**

The basic distinction between internal control questionnaire and check list are as under:

- | | |
|----|--|
| 1. | The ICQ incorporates a large number of detailed questions but the check list generally contains questions relating to the main control objective with the area under review. |
| 2. | In ICQ, questions are usually answered by company executives . However, in a check list, the same are required to be answered by auditor/auditor staff. |
| 3. | The significance of 'No' in an ICQ does indicate a weakness but the significance of that weakness is not revealed automatically. However, in the check list, a specific statement is required where an apparent weakness may prove to be material in relation to the accounts as a whole. |

7.1.3 Flow Chart

- ❖ It is a **graphic presentation of internal controls** in the organisation and is normally drawn up to show the controls in each section or sub-section.

- ❖ It provides the **most concise and comprehensive way** for reviewing the internal controls and the evaluator's findings.
- ❖ **Essentially a flow chart is a diagram full with lines and symbols** and, if judicious use of them can be made, it is probably the most effective way of presenting the state of internal controls in the client's organisation.
- ❖ A properly drawn up flow chart can provide a neat visual picture of the whole activities of the section or department involving flow of documents and activities. More specifically, it can show-
 - At what point a document is raised internally or received from external sources;
 - The number of copies in which a document is raised or received;
 - The intermediate stages set sequentially through which the document and the activity pass;
 - Distribution of the documents to various sections, department or operations;
 - Checking authorisation and matching at relevant stages;
 - Filing of the documents; and
 - Final disposal by sending out or destruction.

8. REPORTING TO CLIENTS ON INTERNAL CONTROL WEAKNESS

- ❖ During the course of audit work, the audit may notice material weaknesses in the internal control system. Material weaknesses are defined as absence of adequate controls on flow of transactions that increases the possibility of errors and frauds in the financial statements of the entity.
- ❖ The auditor should communicate such material weaknesses to the management or the audit committee, if any, on a timely basis. This communication should be, preferably, in writing through a letter of weakness or management letter.

Important points with regard to such a letter are as follows:

- (a) The letter lists down **the area of weaknesses** in the system and offers suggestions for improvement.
- (b) It should clearly indicate that it discusses **only weaknesses** which have come to the attention of the auditor as a result of his audit and that his examination has not been designed to determine the adequacy of internal control for management.
- (c) This letter serves as a **valuable reference** document for management for the purpose of revising the system and insisting on its strict implementation.
- (d) The letter may also serve to **minimize legal liability** in the event of a major defalcation or other loss resulting from a weakness in internal control.

9. INTERNATIONAL INTERNAL CONTROL FRAMEWORKS

- A. **Internal Control - Integrated Framework issued by Committee of the Sponsoring Organisations of the Treadway Commission (COSO Framework)**
 - COSO's Internal Control - Integrated Framework was introduced in 1992 as guidance on how to establish better controls so companies can achieve their objectives.
 - The framework includes more than 17 basic principles representing the fundamental concepts associated with its five components: Control environment, Risk assessment, Control activities, Information and Communication, and Monitoring.

Objectives of COSO Framework

Operations Objectives - related to the effectiveness and efficiency of the entity's operations, including operational and financial performance goals, and safeguarding assets against loss.

- **Reporting Objectives** - related to internal and external financial and non-financial reporting to stakeholders, which would encompass reliability, timeliness, transparency, or other terms as established by regulators, standard setters, or the entity's policies.
- **Compliance objectives** - In the Framework, the compliance objective was described as "relating to the entity's compliance with applicable laws and regulations."

B. Guidance on Assessing Control published by the Canadian Institute of Chartered Accountants (CoCo)

- CoCo was introduced with the objective of **improving organizational performance and decision - making** with better controls, risk management, and corporate governance.
- **The Criteria of Control (CoCo)** framework was developed by the Canadian Institute of Chartered Accountants with the objective of improving organisational performance and decision making with better controls, risk management, and corporate governance.

C. Control Objectives for Information and Related Technology (COBIT)

- COBIT stands for Control Objectives for Information and Related Technology.
- It is a framework created by the ISACA (Information Systems Audit and Control Association) for IT governance and management.
- COBIT has 34 high-level processes that cover 210 control objectives categorized in four domains: planning and organization, acquisition and implementation, delivery and support, and monitoring and evaluation.

D. Internal Control: Guidance for Directors on the Combined Code, published by the Institute of Chartered Accountants in England & Wales (known as the Turnbull Report)

The key principles of the Code are enunciated as below:

- The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.
- The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management.
- Companies which do not have an internal audit function should from time to time review the need for one.

E. Sarbanes - Oxley Section 404

- Section 404 of Sarbanes-Oxley Act (Sarbanes-Oxley Act Section 404) of United States of America **mandates that all publicly-traded companies must establish internal controls**
- The purpose of SOX is to **reduce the possibilities of corporate fraud** by increasing the stringency of procedures and requirements for financial reporting. The Sarbanes Oxley Act, has revamped federal regulations pertaining to publicly traded companies' corporate governance and reporting obligations. It was followed up with constitution of **PCAOB (Public Company Accounting Oversight Board)**.

CHAPTER 04

DIGITAL AUDITING AND ASSURANCE

1. DIGITAL AUDIT

1.1 What is a Digital Audit?

Digital Audit is placing assurance on the effectiveness of the IT systems implemented in an organization. Technology is becoming an integral part of day-to-day business operations.

1.2 Key Features of a Digital Audit

Digital audit encourages the auditee to **embrace the latest technological advancements** and provides confidence to auditee to stay updated in a constantly evolving environment. A digital audit improves **the quality of opinion**. This consequently leads to a more reliable audit report. Digital Audit leads to **savings in time, cost and human effort** which can be utilized towards more productive tasks.

1.3 Advantages of Digital Audit

- (i) **Enhanced Effectiveness & Efficiency:** Increased efficiency is one of the key benefits of digital audit. With the use of tools and automation techniques, auditee can standardize the processes and routine tasks can be automated.
- (ii) **Better Audit Quality:** Technology can correctly evaluate massive volumes of data quickly. This can assist auditors in determining the areas that require more testing, lowering the chance that serious misstatements or other problems would go unnoticed.
- (iii) **Lower Costs:** By automating processes that were previously done manually, technology can assist with the cost of auditing.
- (iv) **Better Analytics:** Improved analytics capabilities can aid management and auditors in seeing trends and patterns that may be challenging to spot manually.
- (v) **Improved Risk Assessment:** Creating a number of automations to assist with the audit process and streamlined testing improves the risk assessment procedure. Management and auditors put their testing efforts on sites with a higher risk of material misstatement and make informed decisions.

1.4 Consideration and Challenges of Digital Audit

Some considerations that organization should keep in mind while using digital techniques & automation:

Know what business benefits the organization wants to achieve with automation`

Think people first and do not underestimate change is difficult

Target the right processes – this is a key for successful automation.

Automation is not a stand-alone solution and should be part of a broader digitalization strategy.

Ensure the process works and it is standardised before automating. Bots do not easily adapt to process change

Automation introduces new challenges for organization. Don't forget about governance and data security in the risk framework.

Areas of focus could include understanding of the following:

- ❖ **New activities or changes** to existing processes due to new technology (e.g., new revenue streams, changes in the roles and responsibilities of entity personnel, automation of manual tasks, changes in staffing levels that affect an entity's internal control environment)
- ❖ Changes in the way the entity's systems are **developed and maintained** and whether these changes introduce new risks and require new controls to respond to those risks
- ❖ The **impact of the new technology** as how the organization obtains or generates and uses relevant, quality information to support the functioning of internal control.

2. AUDITING DIGITALLY

2.1 What is the concept of auditing digitally?

Auditing Digitally is using advancements in technology for conducting an effective and efficient audit. With a rapidly growing IT environment it is essential to adapt technology in auditing practices.

It is time to digitize the way an audit is delivered through automation and innovation. There are new technologies to **help capture data, automate procedures, analyse information and focus on the real risks of the client**. The opportunity is in **understanding** how technology can help and then applying it to the auditing challenges.

2.2 Key Features or Advantages of Auditing Digitally:

Following are key features or advantages of Auditing Digitally:

- (i) **Improved Quality of Audits:** The impact on quality is evident, through automation, data analytics techniques, we can easily move from **sample auditing to full population** of transactions being reviewed or re-performed
- (ii) **Decreasing human dependency:** Using technology **minimizes the manual intervention** which ultimately results in reducing the risk of manual errors. Technology helps in streamlining the process of testing for auditors which decreases the errors which occur from the judgement of different individuals.
- (iii) **Increases Transparency:** With the technological advancement, **transparency** has been increased. New ERPs and tools have audit trail feature available to trace the transaction end to end.
- (iv) **Automation and Ease:** Automating tasks like recording work in repositories, extracting data and sampling have improved the **quality of audit** and reduced the manual error. Using dashboards (e.g., Power BI) for reporting helps in understanding the position and helps the auditor to form his opinion.
- (v) **Improved Efficiency:** What used to take weeks to learn and programme using deep experts, is now easily available to auditors after some **simple training and digital upskilling**. The result may be increased efficiency and fewer errors, but the benefits are wider reaching and personal. This also results in improved retention of talent and confidence.
- (vi) **Better Risk Assessment:** With usage of automation and technology in audit, auditor may focus on the real challenges and assess the potential risk precisely. **Dashboards, visual presentations** and other tools helps in understanding where the risk lies and what all areas need more attention.

2.3 Considerations in Auditing Digitally

There are few questions it is important to ask and answer – at all stages of tech journey:

2.3.1 What problems are you trying to solve?

- ❖ Continuously evaluate the emerging technologies and latest tools to see what can benefit the audit.

- ❖ Think about what would make your audit easier or better and how you will measure return on your investment.

2.3.2 Which technology can help you?

- ❖ There are a number of tools available and many vendors and start-ups using data acquisition, manipulation and visualization tools. Consider how comfortably these solutions will integrate into your current processes and flag any potential implementation issues early on.

2.3.3 How will you upskill your people to make best use of the technology available?

- ❖ Technology is only as good as the people using it. Training and development are critical to ensure teams understand how and why they are using the technology. Reluctance to change is obvious, however continuous training help them to get better.

2.3.4 Range of automated solutions:

- ❖ There is a range of automation solutions, from low to high sophistication, which helps to standardize the repeatable tasks and optimize the efforts resulting in doing better. Some of the techniques are using robotics and automation for data gathering activities, use of data analytics for planning and budgeting and reporting by dashboards.

3. UNDERSTAND THE IT ENVIRONMENT

3.1 Key Areas for an Auditor to Understand IT Environment

Key Areas for an Auditor to Understand IT Environment are as follows:

1. Understand the flow of transaction: The auditor's understanding of the IT environment may focus on **identifying and understanding** the nature and number of the specific IT applications and other aspects of the IT environment that are relevant to the flows of transactions and processing of information in the information system
2. Identification of Significant Systems: The auditor may identify the IT applications and supporting IT infrastructure concurrently with the auditor's understanding of how information relating to **significant classes of transactions, account balances and disclosures** flows into, through and out the entity's information system.
3. Identification of Manual and Automated Controls: An entity's system of internal control contains manual elements and automated elements. These are relevant to **the auditor's identification and assessment of the risks of material misstatement.**
4. Identification of the technologies used : The need to understand the emerging technologies implemented and the role they play in the entity's information processing or other financial reporting activities and consider whether there are risks arising from their use.

Some examples of emerging technologies are:

- **Block chain**, including crypto currency businesses (e.g., token issuers, custodial services, exchanges, miners, investors), **Robotics, Artificial Intelligence, Internet of Things, Biometrics, Drone**
- 5. Assessing the complexity of the IT environment: Not all applications of the IT environment have the same level of complexity. The level of complexity for individual characteristics differs across applications.

Complexity is based on the following factors

- Automation used in the organization,
- Entity's reliance on system generated reports,

- Customization in IT applications,
- Business model of the entity,
- Any significant changes done during the year and implementation of emerging technologies.

4. IDENTIFYING THE RISKS ARISING FROM USAGE OF IT

4.1 How to identify the IT Risks?

In identifying the risks arising from the use of IT, the auditor may consider

- ❖ the **nature of the identified IT application**.
- ❖ Applicable risks arising from the use of IT may also be identified related to **cyber security**.
- ❖ It is more likely that there will be more risks arising from the use of IT **when the volume or complexity of automated application controls is higher**, and management is placing greater reliance on those controls for effective processing of transactions.

4.2 Risks arising from use of IT

- ❖ **Unauthorized access to data** that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- ❖ **Unauthorized changes to IT** applications or other aspects of the IT environment.
- ❖ **Failure to make necessary update** to IT applications or other aspects of the IT environment.
- ❖ **Inappropriate manual intervention**.
- ❖ **Data loss or data corruption** is a major risk which arises from use of IT. If appropriate cyber security controls and protocols not followed it may lead to loss of sensitive data, hackers might encrypt your system or illegally break into your system.

4.3 Know how to identify the IT dependencies impacting the Audit?

4.3.1 Why is it important to identify IT dependencies?

- ❖ Identifying and documenting the entity's IT dependencies in a consistent, clear manner helps to identify **the entity's reliance upon IT**
- ❖ Understand how **IT is integrated into the entity's business model**,
- ❖ Identify **potential risks** arising from the use of IT,
- ❖ Identify related **IT General Controls** and enables us to develop an effective and efficient audit approach.

4.3.2 How IT dependencies arise and types of IT dependencies.

IT Dependencies are created **when IT is used to initiate, authorize, record, process, or report** transactions or other financial data for inclusion in financial statements.

There are five types of IT dependencies as described below:

Type	Description
Automated Controls	Automated controls are designed into the IT environment to enforce business rules. For example, Purchase order approval via workflow or format checks (e.g., only a particular date format is accepted), existence checks (e.g., Duplicate customer number cannot exist), and/or reasonableness checks (e.g., maximum payment amount) when a transaction is entered.

Reports	System generated reports are information generated by IT systems. These reports are often used in an entity's execution of a manual control, including business performance reviews, or may be the source of entity information used by us when selecting items for testing, performing substantive tests of details or performing a substantive analytical procedure. E.g. (Vendor master report, customer ageing report)
Calculations	Calculations are accounting procedures that are performed by an IT system instead of a person. For example, the system will apply the 'straight-line' depreciation formula to calculate depreciation of an asset (i.e., cost of the asset, less the residual value of the asset at the end of its useful life divided by the useful life of the asset) or the system will calculate the value of the amount invoiced to a customer by multiplying the item price times the quantity shipped.
Security	Security including segregation of duties is enabled by the IT environment to restrict access to information and to determine the separation of roles and responsibilities that could allow an employee to perpetrate and conceal errors or fraud, or to process errors that go undetected.
Interfaces	Interfaces are programmed logic that transfer data from one IT system to another . For example, an interface may be programmed to transfer data from a payroll sub- ledger to the general ledger.

4.3.3 Understanding and responding to risks arising from IT dependencies

When auditors identify IT dependencies that are relevant to the entity's flow of transactions and processing of financial information, they need to understand how management responds to the associated risks that may arise from them.

Management may implement **information technology general controls (ITGCs)** to address risks related to IT dependencies.

4.3.4 The illustration below is an overview of the Control Objectives and controls for each area of General IT Controls:

1. Access Security

Objective: To ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives.

Activities:

- **Access requests to** the application are properly reviewed and authorized by management
- **Access of terminated user** is removed on a timely basis
- **Access rights to applications** are **periodically monitored** for appropriateness
- Transactions of **administrative and sensitive generic IDs** are monitored
- **Security policies** and procedures are maintained
- Access to operating system and database is **restricted**.

2. Program Change

Objective:

To ensure modified systems continue to meet financial reporting objectives

Activities:

- **Change Management policy** and procedures are maintained.

- **Development, testing and production environments** are segregated for changes to application configurations
- Changes are **adequately tracked and recorded**.
- Changes to application configurations are **adequately tested and approved** before being migrated into production
- **Emergency changes** are approved.
- **Segregation of duties** is maintained between developer and implementor.

3. Data Centre and network operations

Objective : To ensure production systems are appropriately backed up to meet financial reporting objectives

Activities:

- Policies and procedures for **data backup and recovery** is maintained.
- Data is appropriately **backed up and recoverable**
- **Restoration testing** is performed
- **Monitoring and compliance** of service level agreements.
- **Batch job** scheduled are monitored for failures and **access is restricted**.

5. ASSESSING CYBER RISKS (INCLUDING REMOTE AUDIT)

5.1 What is Cyber Risk:

A cyber-attack is **an attempt to gain unauthorized access to a computing system** or network with the intent to cause damage, steal, expose, alter, disable, or destroy data.

Most common types of cyber- attacks are:

1. **Malware:** Malware or malicious software is any program or code that is created with the intent to do harm to a computer, network or server. Malware is the most common type of cyberattack, its subsets are ransomware, fileless Malware trojans, viruses etc.

Type	Description
Ransomware	In a ransomware attack, an adversary encrypts a victim's data and offers to provide a decryption key in exchange for a payment. Ransomware attacks are usually launched through malicious links delivered via phishing emails, but unpatched vulnerabilities and policy misconfigurations are used as well.
Fileless Malware	Fileless malware is a type of malicious activity that uses native, legitimate tools built into a system to execute a cyber-attack. Unlike traditional malware, fileless malware does not require an attacker to install any code on a target's system, making it hard to detect.
Trojan	A trojan is malware that appears to be legitimate software disguised as native operating system programs or harmless files like free downloads. Trojans are installed through social engineering techniques such as phishing or bait websites.
Mobile Malware	Mobile malware is any type of malware designed to target mobile devices . Mobile malware is delivered through malicious downloads, operating system vulnerabilities, phishing, smishing, and the use of unsecured Wi-Fi.

2. **Denial-of Service (DoS) Attacks:** A Denial-of-Service (DoS) attack is a malicious, targeted attack that **floods a network with false requests** in order to disrupt business operations.

In a DoS attack, users are unable to perform routine and necessary tasks, such as accessing email, websites, online accounts or other resources that are operated by a compromised computer or network. While most DoS attacks **do not result in lost data** and are typically resolved without paying a ransom, they cost the organization time, money and other resources in order to restore critical business operations.

3. **Phishing:** Phishing is a type of cyber attack that uses **email, SMS, phone, social media, and social engineering techniques to entice a victim to share sensitive information** — such as passwords or account numbers — or to download a malicious file that will install viruses on their computer or phone.

Type	Description
Spear Phishing	Spear-phishing is a type of phishing attack that targets specific individuals or organizations typically through malicious emails. The goal of spear phishing is to steal sensitive information such as login credentials or infect the targets' device with malware.
Whaling	A whaling attack is a type of social engineering attack specifically targeting senior or C-level executive employees with the purpose of stealing money or information or gaining access to the person's computer in order to execute further cyber attacks.
Smishing	Smishing is a type of fraudulent practice of sending text messages purporting to be from reputable companies in order to induce individuals to reveal personal information, such as passwords or credit card numbers.
Vishing	Vishing, a voice phishing attack , is the fraudulent use of phone calls and voice messages pretending to be from a reputable organization to convince individuals to reveal private information such as bank details and passwords.

4. **Spoofing:** Spoofing is a technique through which a **cybercriminal disguises themselves as a known or trusted source**. In so doing, the adversary is able to engage with the target and access their systems or devices with the ultimate goal of stealing information, extorting money or installing malware or other harmful software on the device.

Type	Description
Domain Spoofing	Domain spoofing is a form of phishing where an attacker impersonates a known business or person with fake website or email domain to fool people into the trusting them. Typically, the domain appears to be legitimate at first glance , but a closer look will reveal subtle differences.
Email Spoofing	Email spoofing is a type of cyberattack that targets the businesses by using emails with forged sender addresses . Because the recipient trusts the alleged sender, they are more likely to open the email and interact with its contents, such as a malicious link or attachment.

5. **Identity-Based Attacks:** When a **valid user's credentials have been compromised** and an adversary is pretend to be that user. For e.g., people often use the same user ID and password across multiple accounts. Therefore, possessing the credentials for one account may be able to grant access to other, unrelated account.
6. **Insider Threats:** **When current or former employees that pose danger** to an organization because they have direct access to the company network, sensitive data, and intellectual property (IP), as well

as knowledge of business processes, company policies or other information that would help carry out such an attack.

7. **DNS Tunnelling:** DNS Tunnelling is a type of cyber attack that **leverages domain name system** (DNS) queries and responses to bypass traditional security measures and transmit data and code within the network. This tunnel gives the hacker a route to unleash malware and/or to extract data, IP or other sensitive information by encoding it bit by bit in a series of DNS responses.
8. **IoT-Based Attacks:** An IoT attack is any cyber attack that **targets an Internet of Things (IoT) device or network**. Once compromised, the hacker can assume control of the device, steal data, or join a group of infected devices

5.2 Stages of Cyber Risk:

Following are 3 Stage of cyber risk

1. **Stage 1 - Assessing the cyber risk:** No organization is completely immune to a cyber risk. Every organization should consider at least the common threats-
 - **Ransomware** disabling their organization (including their plants and manufacturing facilities)
 - **Common criminals** using email phishing and hacks for fraud and theft.
 - **Insiders** committing malicious activities or accidental activities resulting in unintended disclosure of information theft and frauds.
2. **Stage 2 - Impact of cyber risk:** Cyber-attack can impact one, two or more types of risks. The impact of the attack would vary from organization to organization and most importantly from an attack to attack. Some of the indicative areas can be -
 - **Regulatory costs**
 - **Business interruptions** causing an operational challenge for an organization.
 - **Data loss**, reputational loss and litigation.
 - **Ransomware** - more common these days where entire systems are encrypted
 - **Intellectual property theft** which may not only take the competitive advantage, but we may also result in any impairment/impediment charge because of the loss of IP.
 - **Incident response cost** which could be for investigations & remediation
 - **Breach of Privacy**, if personal data of a consumer is hacked it could have a significant impact on the organization.
 - **Fines and penalties**
3. **Stage 3- Managing the cyber risk:** A strategic approach to cyber risk management can help an organization to:
 - Gain a **understanding of the cyber risks**, threats facing their organization and other financial institutions
 - **Assess existing IT and cyber security program** and capabilities against the relevant regulatory requirements
 - **Align cyber security and IT transformation** initiatives with strategic objectives and critical risks
 - Understand **accepted risks** & documented **compensating controls**

5.3 Cyber Security Framework

Cyber security framework includes how management is identifying the risk, protecting and safeguarding its assets (including electronic assets) from the risk. Management preparedness to detect the attacks, anomalies and responsiveness to the adverse event.

5.3.1 Identify the risk:

Auditor has to determine whether the entity's risk assessment process considers cyber security risks.

- ❖ Entity should conduct a **periodic risk assessment & develop a management strategy** which identifies cyber security risks around IT system.
- ❖ The entity should **maintain and periodically reviews an inventory** of their information assets- i.e., **Asset Management** (e.g., intellectual property, patents, copyrighted material, trade secrets and other intangibles).
- ❖ **From the governance perspective**, management should review how cyber security risks affect internal controls over financial reporting. In case of adverse attack how management is going to assess the impact on the recoverability of financial data and impact on revenue recognition.
- ❖ To determine **overall responsibility for cyber security in the business environment**, entity should establish roles and responsibilities over cyber security (CISO, CIO).

5.3.2 Protect the risk

- ❖ Obtained an understanding of the entity's processes for **safeguarding of assets** subject to cyber security.
- ❖ Entity monitors whether there has been **unauthorized access** to electronic assets and any related impact on financial reporting.
- ❖ **Formal training** should be conducted to make the teams aware of the risk associated with cyber-attacks.
- ❖ Entity should **implement effective controls for data security**.
- ❖ Entity should have a process & procedures in place for identifying material digital/electronic assets on the balance sheet subject to cyber security risk (e.g., intellectual property, patents, copyrighted material, trade secrets) and prioritizing their protection based on criticality.

5.3.3 Detect The risk

- ❖ Entity should have **controls and procedures** that enable it to **identify cyber security risks** and incidents and to **assess and analyses their impact on the entity's business**.
- ❖ Evaluate the significance associated with such risks and incidents, and **consider timely disclosures**.

5.3.4 Respond to the risk

- ❖ In case of material cyber security or data breach has been identified management should **capture the details of nature of incident**.
- ❖ Management should assess **Litigation costs, Regulatory investigation costs and Remediation** costs as a part of mitigation process and improvement.
- ❖ Management should assess the **future action plans** that needs to be taken to safeguard the organisation from such attacks.

5.3.5 Recover from risk

- ❖ Once the impact evaluated and communicated with the regulators, **the recovery plan** needs to be implemented to overcome the impact.

- ❖ **Necessary improvements** - like patch upgrades, better controls, improved technology in terms of firewall, anti-virus, tools etc. needs to be implemented to safeguard the entity.

5.4 Control considerations for Cyber Risks:

1) Controls around vendor setup and modifications:

Certain cyber schemes exist in which changes to bank account or other critical vendor information are requested through email phishing scams by individuals purporting to be authorized vendor personnel.

- Who is **responsible for making changes to vendor master data**? Is the process centralized or decentralized?
- Are other **communication channels**, such as email, used to request changes to vendor master data? (If yes, consider if multi-factor authentication is enabled for email).
- What **systems and technologies are used** to initiate, authorize and process requests related to changes to vendor master data?
- Are **authentication protocols** defined to verify modifications to vendor master data (e.g., call back procedures, multi-factor authentication)?

2) Controls around electronic transfer of funds:

- Are **personnel responsible for wire transfers educated** on the relevant threats and information related to common phishing scams associated with fraudulent requests for wire transfers?
- Are **authentication protocols** defined to verify wire transfer requests (e.g., call back procedures, dual-authentication procedures)?
- What **systems and technologies** are used to facilitate the request/initiation, authorization and release of wire transfers?

3) Controls around patch management:

Cyber and ransomware attacks exploit known security vulnerabilities resulting in the manipulation or the destruction of data. Exploitations of known security vulnerabilities are often caused by unapplied patches or upgrades.

- Does the entity have a **patch management program**?
- Does the entity **run periodic vulnerability scans** to identify missing/unapplied patches?
- How is the entity **notified of patches** by external vendors (e.g., Microsoft for Windows patches)?

5.5 Remote Audit

Remote audit or virtual audit is when the **auditor uses the online or electronic means to conduct the audit**. It could be partially or completely virtual, auditor engages using technology to obtain the audit evidence or to perform documentation review with the participation of the auditee.

The COVID-19 pandemic has changed the entire business landscape and processes have been adjusted to this new situation, where remote audit is appreciated by clients as well.

5.5.1 Considerations for remote audit:

Auditors must develop tailored strategies to ensure the remote audit meets the requirements and deliver results equivalent to traditional onsite audits.

1. Feasibility and Planning

- Planning should involve **agreeing on audit timelines, meeting platform** (Zoom calls/ Microsoft Teams/Google Meet) to be used for audit sessions, data exchange mechanisms, any access authorization requests.

- Ensure feasibility is determining **what technology may be used**, if auditors and auditees have competencies and that resources are available.
- The execution phases of a remote audit involve **video/tele conferencing with auditees**.
- The documentation for audit evidence should be transferred through a **document sharing platform**.

2. Confidentiality, Security and Data Protection

- To ensure data security and confidentiality, **access to document sharing platform should be sufficiently restricted** and secured by encrypting the data that is sent across the network.
- The information, once reviewed and documented by auditor, is removed from the platform, and stored according to applicable **archiving standards and data protection requirements**.
- **Consider legislation and regulations**, which may require additional agreements from both sides (e.g., there will be no recording of sound and images, or authorizations to using people's images).
- **Auditors should not take screenshots of auditees as audit evidence**. Any screenshots of documents or records or other kind of evidence should be previously authorized by the audited organization.
- **In case of accessing the auditee's IT system auditor should use VPN (Virtual private network)**. VPN is a service which creates safe and encrypted online connection. It prevents unauthorized users to enter into network and allows the users to perform work remotely.

3. Risk assessment

The assessment if remote audit would be sufficient to achieve the audit objectives should be done and documented for each audit involving all members of the audit team and the audited organization representative.

5.5.2 Advantages and Disadvantages of remote audit:

ADVANTAGES	DISADVANTAGES
Cost and time effective: No travel time and travel costs involved.	Due to network issues , interviews and meetings can be interrupted.
Comfort and flexibility to the audit team as they would be working from home environment,	Limited or no ability to visualize facility , culture of the organization, and the body language of the auditees . Time zone issues could also affect the efficiency of remote audit session
Time required to gather evidence can spread over several weeks , instead of concentrated into a small period that takes personnel from their daily activities.	The opportunity to present doctored documents and to omit relevant information is increased . This may call for additional planning, some additional/different audit procedures, security and confidentiality violation.
Auditor can get first-hand evidence directly from the IT system as direct access may be provided.	Remote access to sensitive IT systems may not be allowed . Security aspects related to remote access and privacy needs to be assessed
Widens the selection of auditors from global network of experts.	Cultural challenges for the auditor . Lack of knowledge for local laws and regulations could impact audit. Audit procedures like physical verification of assets and stock taking cannot be performed.

6. EMERGING TECHNOLOGIES IN AUDIT

Data Analytic Techniques

- ❖ Generating and preparing **meaningful information from raw system data** using processes, tools, and **techniques** is known as Data Analytics.
- ❖ It involves analyzing large sets of data to find actionable insights, trends, draw conclusions and for informed decision making.
- ❖ It allows auditors to more **effectively audit** the large amounts of data held and processed in IT systems in larger clients.

Audit analytics helps:

- ❖ To discover and analyze patterns
- ❖ Identifying anomalies
- ❖ Extract other useful information in data

The data analytics methods used in an audit are known as **Computer Assisted Auditing Techniques or CAATs**.

Some of the popular tools used across the industry as part of CAATs are listed below:

1. **ACL - Audit Command Language (ACL)** Analytics is a data extraction and analysis software used for **fraud detection and prevention, and risk management**. It samples large data sets to find irregularities or patterns in transactions that could indicate control weaknesses or fraud. **Example** -It is used to **analyze and check complete** data sets to perform Trial Balance reconciliations during the Audits. In such case scenarios, the entity provided the General Ledger dump and system Trial Balance.
2. **Alteryx** - Alteryx is used to **consolidate financial or operational data to assess controls**.
 - A **fully transparent audit trail** of every action is performed in Alteryx in form of a workflow which makes it easier for the user to learn as no prior knowledge of coding or scripting is required.
 - Alteryx can also be **leveraged to automate analytics and perform Machine Learning** to search for patterns indicative of fraud or irregularities speed up your processes like accounting close, tax filings, regulatory reporting, forecast creation etc.
 - It can also be used to **automate set procedures that are performed periodically** like reconciliations, consolidations, marketing workflows, system integrations, continuous audits etc.

Example-

- Alteryx used for **logistics organization** to recompute the revenue entries recorded by the system to match with the financials that showcased the expected revenue turnover.
 - Due to **Alteryx's processing speed** and ease to implement functions, auditors could perform re-computation for all the transactions entry and noted that the revenue was being understated as the expected revenue was more than the actual calculated.
3. **Power Bi** is a business intelligence (BI) platform **that provides non-technical business users with tools for aggregating, analyzing, visualizing and sharing data**. From audit perspective, such visualization tools can be used to **find the outliers in the population**, it can also be used for **reporting purpose** (audit reports) to the higher management.

Example-

Power BI dashboard used for **checking the outliers of the apparel company**. Auditors were required to analyse the trends of the sales during the year. By the use of Power BI, the sales data provided by the client was further converted into dashboard to analyse the trends and patterns as per the market standards.

4. **CaseWare** - CaseWare is a **data analysis software** & provide tools that helps in conducting audit and assurance engagements quickly, accurately and consistently.
- It shares **analytical insights** which help in taking better informed decisions.
 - It helps in **streamlining processes** and eliminating the routine tasks.
 - **Used by** accounting firms, governments and corporations worldwide, this trusted platform integrates everything you need to conduct assurance and reporting engagements.

Example- It provides the solutions to build accounting software which turns any document, including financial statements into cost effective client ready report.

It automatically links to client data and securely communicate with the client in real time. Regardless of location, all authorized users have access to the same documents. Consistency of data is ensured.

7. AUTOMATED TOOLS IN AUDIT

7.1 Internet of Things

- ❖ IoT is the concept of connecting any device (cell phones, coffee makers, washing machines, and so on) to the internet.
- ❖ Key components of IoT are **data collection, analytics, connectivity, and people and process.**
- ❖ IoT not only changes the business model, but also affects the strategic objectives of the organization.
- ❖ The risk profile of the entity changes with exposure to new laws and regulations.

Audit Implications

- ❖ A shift to connected devices and systems may result in auditors **not being able to rely only on manual controls.** Instead, auditors may need to scope new systems into their audit.
- ❖ Audit firms may need to **train and upskill auditors** to evaluate the design and operating effectiveness of automated controls.
- ❖ **Consumer-facing tools that connect to business environments** in new ways can impact the flow of transactions and introduce new risks for management and auditors to consider. Example- Consider payment processing tools that allow users to pay via credit card at a retail location through a mobile device.
- ❖ Auditors would need to consider the volume of those transactions and the processes and controls related to it.

Common risks of IoT:

The key risks associated with IoT, including, **device hijacking, data siphoning, denial of service attacks, data breaches and device theft.**

7.2 AI (Artificial intelligence)

Artificial intelligence (AI) **refers to a system or a machine that can think and learn.** AI systems utilize **data analysis and algorithms to make decisions based on predictive methods.** Complex algorithms are developed to propose decisions based on a pattern or behavior learned over time.

Examples-

- ❖ Self-driving cars, manufacturing robots, smart assistants, marketing chatbots, virtual travel booking agent.

- ❖ The self-deploying robots can determine how much vacuuming there is to do based on a room's size, uses AI to scan room size, identify obstacles and remember the most efficient routes for cleaning.

Audit Implications

- ❖ Focus on logical flow- Given the invisible nature of algorithms, audits must focus on **the logical flow of processes**.
- ❖ Algorithms - A review of AI should ascertain whether unintended bias has been added to the algorithms. Auditors should assess the **effectiveness of algorithms** and whether their output is appropriately reviewed and approved.
- ❖ Bugs and vulnerabilities - Because AI is built on software modules, auditors must also consider cyber security and search for possible **bugs and vulnerabilities** that can be exploited to impact AI functionality.
- ❖ Effect of AI- Auditors should confirm their understanding of how the use of **AI affects the entity's flows of transactions, including the generation of reports or analytics used by management**.
- ❖ Decision Making - Auditors also should consider whether the AI is making decisions—or being utilized by management as part of the decision-making process.

Common risks for AI

- ❖ Security is one of the key risks - the more data the system uses, from more sources, the more entry points and connections are formed and the greater the potential risks.
- ❖ Inappropriate configuration - AI may also be used to diagnose medical conditions. If it is badly configured or malfunctions, it could harm people before the problem is spotted.
- ❖ Data privacy - The data used and shared should have the necessary explicit consent from data providers.

7.3 Block chain

- ❖ Block chain is based on a **decentralized and distributed ledger** that is secured through encryption.
- ❖ **Each transaction is validated by the block chain participants**, creating a block of information that is replicated and distributed to all participants.
- ❖ All **blocks are sequenced** so that any modification or deletion of a block disqualifies the information.
- ❖ Example- **Bitcoin, crypto currency transfer application - Block chain in money transfer, block chain smart contracts**

Audit Implications

- ❖ Auditors should consider the appropriate **governance and security transactions** around the transactions.
- ❖ As block chain **interacts with legacy systems and business partners**, concerns related to insecure application programming interfaces (APIs), data confidentiality and privacy cannot be ignored.
- ❖ **Weak block chain application development protocols** are something auditors cannot overlook. Similarly, data privacy laws and regulations may be area of concern as data are communicated across geographic boundaries.
- ❖ Auditors must be able to determine whether the data put on block chain will expose the enterprise to liability for noncompliance with applicable laws and regulations.

Common risks for block chain technology

The strengths of block chain can also be its weaknesses.

- ❖ **The inability to reverse transactions** and to access data without the required keys make the system secure, but also mean that organisations need specific protocols and management processes to ensure that they are not locked out and have clear contingency plans.
- ❖ **Operating through network nodes** could also expose the organisation to cyber-attacks and data hacks, so security issues are important.
- ❖ Auditors should also ensure that the organisation has the necessary **data management processes** and complies with regulations. The regulatory landscape is still evolving for block chain, so audit teams should check that compliance managers are following developments constantly and adapting processes accordingly.

7.3.1 NFT (Non-Fungible Token)

- ❖ **NFT means something is unique and cannot be replaced.**
- ❖ Physical money and crypto currencies are fungible (means they can be traded or exchanged for one another) NFTs are **non-fungible tokens**. NFTs contains **the digital signature** which make them unique. **NFTs are digital assets**, e.g., photos, videos, artwork, sports collectibles etc.
- ❖ NFTs are tokens used to represent **ownership of unique items**. NFTs allow their creators to tokenize things like art, collectibles, or even real estate.
- ❖ They are secured by **the block chain and can only have one official owner at a time**. No one can change the record of ownership or copy/paste a new NFT into existence.

Key Features of NFT-

- ❖ **Digital Asset** - NFT is a digital asset that represents Internet collectibles like art, music, and games with an authentic certificate created by block chain technology that underlies Crypto currency.
- ❖ **Unique** - It cannot be forged or otherwise manipulated.
- ❖ **Exchange** - NFT exchanges take place with crypto currencies such as Bitcoin on specialist sites.

Challenges of NFT-

- ❖ NFTs has its own challenges like **ownership and copyright concerns, security risks, market is not that wide, online frauds etc.**
- ❖ NFT audit considerations includes **comprehensive code review for verifying the safety of a token, valid contract, data privacy and potential cyber threat.**

7.4 Robotic Process Automation

- ❖ RPA is the **automation of the repetitive processes** performed by users.
- ❖ It is a software technology **that emulate humans' actions** interacting with digital systems and software.
- ❖ **Process efficiency, customer experience and control effectiveness** contributed to RPA.
- ❖ Robotic Process Automation software bots can interact with any application or system the same way people do—except that RPA bots can operate around the clock, nonstop, much faster and with 100% reliability and precision.

Audit Implications:

- ❖ It is of utmost importance for auditors to **understand RPA processes**, which include data extraction, aggregation, sanitization and cleansing. Unless auditors understand these processes, they will not be in a position to initiate an audit.
- ❖ A comprehensive assurance process might demand **review of the source code**.

- ❖ To perform substantive testing, auditors must have an understanding of the tools used to develop and maintain RPA.
- ❖ This will be helpful when auditors review logs, configuration controls, privileged access controls and the like. General IT controls are applicable as always.

Common Risks of RPA:

i. Operational and execution risks

- Robots are deployed without proper operating model.
- Buying the wrong tool, making wrong assumptions, taking shortcuts, and jeopardizing security and compliance.
- Assigning proper responsibilities, training and clearly stating about changing roles also can help you reduce operational risk to a great extent.

ii. Change management risks: **Not following the change management implementation** lifecycle, improper and incomplete testing (not covering all scenarios) leads to inaccurate results.

iii. RPA Strategy Risk: Setting **wrong expectations, improper KPIs, and unrealistic business goals** creates an environment of uncertainty. Management should discuss, and analyse the complete working characteristics, potential, and limitations of RPA before drafting a RPA.

8. CONTROL CONSIDERATIONS OR OBJECTIVES OF AUDITING DIGITALLY

Emerging technologies can bring great benefits, but they also come with a varied set of substantial risks.

The strength of the auditing profession is the **assessment of risks and controls**. As they address the challenge of assessing technology risk, auditors can and should focus on the following control considerations:

1. Auditors should gain **a holistic understanding of changes in the industry** and the information technology environment to effectively evaluate management's process for initiating, processing, and recording transactions and then design appropriate auditing procedures.
2. Auditors should **consider risks resulting from the implementation of new technologies** and how those risks may differ from those that arise from more traditional, legacy systems.
3. Auditors should consider whether **digital upskilling or specialists are necessary** to determine the impact of new technologies and to assist in the risk assessment and understanding of the design, implementation, and operating effectiveness of controls. E.g., cybersecurity control experts, IT specialists in the team etc.

8.1 Some examples of technology risks where auditors should test the appropriate controls for relying on the digital systems

- ❖ **Reliance on systems or programs** that are inaccurately processing data, processing inaccurate data, or both
- ❖ **Unauthorized access to data** that might result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions or inaccurate recording of transactions (specific risks might arise when multiple users access a common database)
- ❖ The possibility of information technology **personnel gaining access privileges** beyond those necessary to perform their assigned duties, thereby leading to insufficient segregation of duties
- ❖ **Unauthorized or erroneous changes** to data in master files
- ❖ **Unauthorized changes to systems** or programs

- ❖ **Failure to make necessary or appropriate changes** to systems or programs
- ❖ **Inappropriate manual intervention**
- ❖ **Potential loss of data** or inability to access data as required
- ❖ **Risks introduced** when using third-party service providers
- ❖ **Cyber security risks**

8.2 Key Steps for Auditors in a Changing Technology Environment

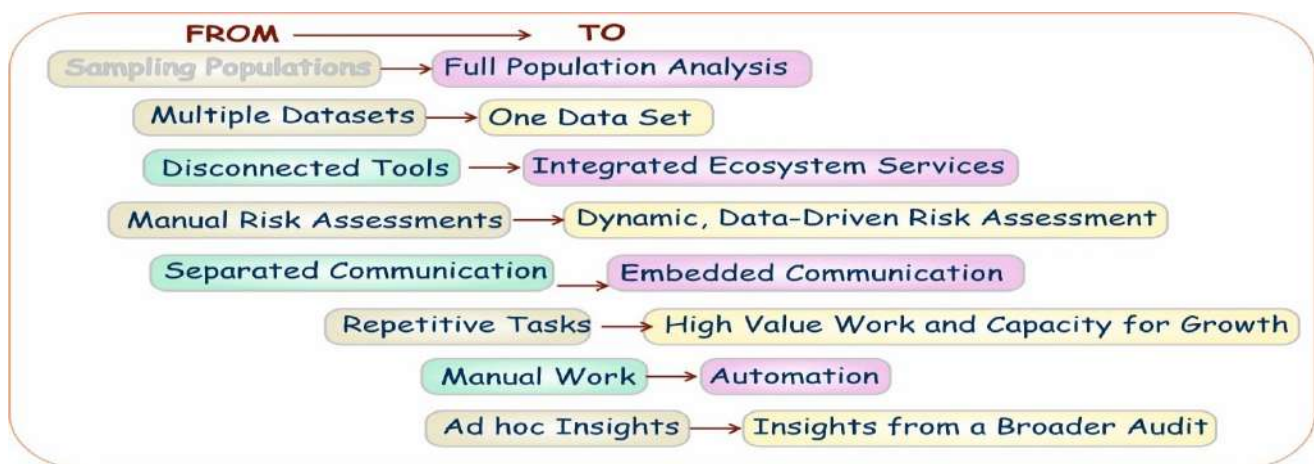
As auditors obtain an understanding of the impact of technology on a company's business, its systems of internal control, and its financial reporting, some important reminders include the following:

- ❖ Maintain **sufficient professional skepticism** when reviewing management's risk assessment for new systems.
- ❖ Understand the **direct and indirect effects of new technology** and determine how its use by the entity impacts the auditor's overall risk assessment.
- ❖ Understand **how the technologies impact the flow of transactions**, assess the completeness of the in-scope ICFR systems, and design a sufficient and appropriate audit response.
- ❖ Assess the **appropriateness of management's processes** to select, develop, operate, and maintain controls related to the organization's technology based on the extent the technology is used.

9. NEXT GENERATION AUDIT

The Next Generation Audit is human-led, tech-powered and data-driven. It is based on combining emerging technologies to redefine how audits are performed.

Next Generation Audit aims to the following:



9.1 Some of the most rapidly advancing areas, with many implications for society are -

1. **Drone Technology:** Using drone technology in the remote locations for **stock counts**. Drones have great payload capacity for carrying sensors and cameras, thus they can photograph and physically examine the count of large quantities of fixed assets and inventory.
Drone captured audit information can be combined with **various alternative sources of information** such as QR code readers, handheld bar scanners, manual counts etc.
2. **Augmented reality:** The technology allows users to **view the real-world environment with augmented (added) elements**, generated by digital devices.

One famous example was **Pokémon Go**, a game for mobile devices in which players chase imaginary digital creatures (visible on their mobile phones) around physical locations.

3. **Virtual reality:** VR goes a step forward and replaces **the real world entirely with a simulated environment, created through digitally generated images, sounds**, and even touch and smell. Using special equipment, such as a custom headset, the user can explore a simulated world or simulate experiences such as flying or skydiving.
4. **Metaverse:** The metaverse is the **emerging 3-D digital space that uses virtual reality, augmented reality**, and other advanced internet technology to allow people to have lifelike personal and business experiences online. It represents a convergence of digital technology to combine and extend the reach and use of Cryptocurrency, Artificial Intelligence (AI), Augmented Reality (AR) and Virtual Reality (VR).

9.2 Case scenarios to illustrate the potential application of the metaverse in the financial domain

- ❖ **Virtual Banking and Transactions:** A forward-thinking financial institution, establishes a presence in the metaverse to offer virtual banking services. Users can create **virtual bank accounts, access personalized financial dashboards, and perform transactions using virtual currencies**.
- ❖ **Digital Asset Management:** A digital asset management company, recognizes the growing popularity of virtual assets in the metaverse. They launch a **virtual asset trading platform** within the metaverse, allowing users to buy, sell, and trade NFTs and other digital assets.
- ❖ **Virtual Financial Education and Training:** A Financial Learning Academy aims to enhance financial literacy using the metaverse. They create a **virtual classroom environment** where participants can attend interactive financial education sessions.
- ❖ **Virtual Meetings and Conferences:** For a leading industry even, an organisation hosts a virtual conference within the metaverse. Participants from around the world can access the conference **through their virtual avatars**.
- ❖ **Data Visualization and Analytics:** A company utilizes the metaverse to offer advanced data visualization and analytics tools to financial professionals. Their **virtual analytics platform** allows users to **visualize complex financial data** in interactive and immersive 3D environments.

Common Risks associated:

- ❖ Beyond their potential, these technologies also come with challenges such as **public safety, cybersecurity, data privacy, data protection, lack of standards and technical challenges**.
- ❖ Since they often **track movements and data**, massive amounts of data are generated about the whereabouts of users. It also raises questions **about taxation, jurisdiction, and customer protection**.
- ❖ Regulators and auditors have to think of the **controls around privacy, data security, governance** to make it more regulated.

CHAPTER 05

AUDIT OF BANKS

1. FORM AND CONTENT OF FINANCIAL STATEMENTS

- ❖ Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the **Third Schedule to the Act** or as near thereto as the circumstances admit. **Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.**
- ❖ It may be noted that **implementation of Indian Accounting Standards (Ind AS) has been deferred by RBI for all scheduled commercial banks presently.** It is pertinent to state that preparation of balance sheet of a bank usually involves preparation of standalone financial statements and consolidated financial statements. **In case of private banks, the processes of accounting are centralized and there is no concept of mandatory branch audit in accordance with RBI guidelines.**

1.1 Audit of Accounts & Appointment of Auditor

Section 30 (1) of the Banking Regulation Act requires that the balance sheet and profit and loss account of a banking company should be audited **by a person duly qualified under any law for the time being in force to be an auditor of companies.**

Most banks, especially those in nationalized banks or public sector, **appoint four or more** (depending upon their size and Board decision, as per RBI guidelines) firms of chartered accountants to act jointly as **statutory central auditors (SCAs).**

1.2 Authority appointing the Auditors

As per the provisions of the relevant enactments, the auditor of a banking company is to be appointed **at the annual general meeting of the shareholders, whereas the auditor of a nationalised bank is to be appointed by the concerned bank acting through its Board of Directors.**

In either case, **approval of the Reserve Bank is required before the appointment is made.**

2. CONDUCTING THE AUDIT

The audit of banks or of their branches involves the following stages –

Stage I: Initial Considerations

- (i) **Acceptance & Continuance:** The assessment of engagement risk is a critical part of the audit process and should be done prior to the acceptance of an audit engagement.
- (ii) **Declaration of Indebtedness:** The RBI has advised that the banks, before appointing their statutory central//branch auditors, **should obtain a declaration of indebtedness.**
- (iii) **Internal Assignments in Banks by Statutory Auditors:** The RBI decided that the **audit firms should not undertake statutory audit assignment while they are associated with internal assignments in the bank during the same year.**
- (iv) **Terms of Audit Engagements:** SA 210, “Terms of Audit Engagements” requires that for each period to be audited, the auditor should agree on the terms of the audit engagement with the bank before beginning significant portions of fieldwork.
- (v) **Communication with Previous Auditor:** As per **Clause (8) of the Part I of the First Schedule to the Chartered Accountants Act, 1949**, a chartered accountant in practice cannot accept position as auditor previously held by another chartered accountant without first communicating with him/her in writing.

- (vi) **Planning:** The audit plan needs to be properly documented with respect to timing, extent of checking, audit procedures to be followed at assertion level and should be flexible and updated or changed, as and when necessary.
- (vii) **Establish the Engagement Team:** The assignment of qualified and experienced professionals is an important component of managing engagement risk. The size and composition of the engagement team would depend on the size, nature, and complexity of the bank's operations.

Stage II: Understanding

- (i) **Understanding the Bank and Its Environment including Internal Control:** An understanding of the bank and its environment, including its internal control, enables the auditor:
- to identify and assess risk;
 - to develop an audit plan to determine the operating effectiveness of the controls, and to address the specific risks
- (ii) **Understand the Bank's Accounting Process:** Understanding of the accounting process is necessary to identify and assess the risks of material misstatement whether due to fraud or not, and to design and perform further audit procedures.
- (iii) **Understanding the Risk Management Process:** Management develops controls and uses performance indicators to aid in managing key business and financial risks.

An effective risk management system in a bank generally requires the following:

Oversight by those charged with governance	Identification, measurement and monitoring of risks	Control activities	Monitoring activities	Reliable information systems
❖ Those charged with governance (BOD/Chief Executive Officer) should approve written risk management policies . The policies should be consistent with the bank's business objectives and strategies, capital strength, management expertise, regulatory requirements and the types and amounts of	❖ Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria	❖ A bank should have appropriate controls to manage its risks, including effective segregation of duties (particularly, between front and back offices), accurate measurement and reporting of positions, verification and approval of transactions, reconciliation of positions and results, setting of limits, reporting and	❖ Risk management models, methodologies and assumptions used to measure and manage risk should be regularly assessed and updated. This function may be conducted by the independent risk management unit.	❖ Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis. Those charged with governance and management require risk management information that is easily understood and that enables them to assess the changing nature of the

risk it regards as acceptable.		approval of exceptions, physical security and contingency planning.		bank's risk profile
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Stage III: Risk Assessment

- (i) **Identifying and Assessing the Risks of Material Misstatements: SA 315** requires the auditor to identify and assess the risks of material misstatement.
- (ii) **Assess the Risk of Fraud including Money Laundering:** As per **SA 240**, the auditor's objective is to identify and assess the risks of material misstatement in the financial statements. The RBI has framed specific guidelines that deal with prevention of money laundering and **"Know Your Customer (KYC)"** norms.
- (iii) **Assess Specific Risks:** The auditors should identify and assess specific risks of material misstatement at the financial statement level which refers to risks that relate to the banking industry and the use of IT therein.
- (iv) **Risk Associated with Outsourcing of Activities:** The modern-day banks make extensive use of outsourcing as a means of both reducing costs as well as making use of services of an expert not available internally. There are, however, certain risks associated with outsourcing of activities by banks.

Stage IV: Execution

- (i) **Engagement Team Discussions:** The engagement team should hold discussions to gain better understanding of bank and its environment, including internal control, and to assess the potential for material misstatements of the financial statements.
- (ii) **Response to the Assessed Risks: SA 330 "The Auditor's Responses to Assessed Risks"** requires the auditor to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level.
- (iii) **Establish the Overall Audit Strategy: SA 300 "Planning an Audit of financial Statements"** states that the objective of the auditor is to plan the audit so that it will be performed in an effective manner. For this purpose, the audit engagement partner should:
 - Establish the overall audit strategy, prior to the commencement of an audit; and
 - Involve key engagement team members and other appropriate specialists while establishing the overall audit strategy, which depends on the characteristics of the audit engagement.
- (iv) **Audit Planning Memorandum:** The auditor should summarize the team's audit plan by preparing an audit planning memorandum in order to:
 - Describe the expected scope and extent of the audit procedures to be performed by the auditor.
 - Highlight all significant issues and risks identified during their planning and risk assessment activities, as well as the decisions concerning reliance on controls.
 - Provide evidence that they have planned the audit engagement appropriately and have responded to engagement risk, pervasive risks, specific risks, and other matters affecting the audit engagement.
- (v) **Determine Audit Materiality:** The auditor should consider the relationship between the audit materiality and audit risk when conducting an audit.

- (vi) **Consider Going Concern:** In obtaining an understanding of the bank, the auditor should consider whether there are events and conditions which may cast significant doubt on the bank's ability to continue as a going concern.

Stage V: Reporting

Students should refer to the reporting requirements explained in heading 8. Auditor's Report of this Chapter.

2.1 Considerations in IT Environment

Considering the importance of IT systems in preparation and presentation of financial statements, **it is imperative that bank should share detailed information with auditors like: -**

- ❖ **Overall IT policy**, structure and environment of Bank's IT system.
- ❖ **Data processing and data interface** under various systems.
- ❖ **Data integrity and data security.**
- ❖ Business Continuity Plans and disaster Control Plans (BCP and DCP).
- ❖ **Accounting manual and critical accounting entries**, their processes and involvement of IT systems.
- ❖ **Controls over key aspects**, use of various account heads, expense booking, overdue identification etc.

2.1.1 Key security controls when undertaking audit in a computerised bank

- a. Ensure **that authorised, accurate and complete data** is made available for processing.
- b. Ensure that in case of interruption due to power, mechanical or processing failures, **the system restarts without distorting** the completion of the entries and records.
- c. Ensure that the system **prevents unauthorised amendments** to the programmes.
- d. Verify whether **"access controls"** assigned to the staff-working match with the responsibilities as per manual. It is important for the auditor to ensure that access and authorisation rights given to employees are appropriate.
- e. Verify that **segregation of duties** is ensured while granting system access to users and that the user activities are monitored by performing an activities log review.

2.2 Internal Audit and Inspection

Risk-based Internal audit is conducted based upon the risk assessment of business and control risks of branches. The risk assessment process includes: -

- ❖ Identification of inherent business risks in various activities undertaken by branches **(Business risk).**
- ❖ Assessment of effectiveness of control systems for monitoring inherent risks of business activities of branch **(Control risk).**
- ❖ Making an assessment of level and direction of various risk areas and assess level and direction of overall business risk and control risk.
- ❖ Drawing up of **risk matrix** taking into account factors viz. Risk of branch.

3. INTERNAL CONTROL IN CERTAIN SELECTED AREAS

System of Internal Control in Banks: Banks are required to implement and maintain **a system of internal controls** for mitigating risks, maintain **good governance** and to meet the **regulatory requirements**. Given below are examples of internal controls that are typically implemented in a bank:

Area of Focus	Examples of Internal Controls in a Bank
General	❖ The staff and officers of a bank should be shifted from one position to another frequently and without prior notice. ❖ The work of one person should always be checked by another person (usually by an officer) in the normal course of business. ❖ The arithmetical accuracy of the books should be proved independently every day. ❖ All bank forms (e.g. Cheque books, demand draft/pay order books, traveller's cheques, foreign currency cards etc.) should be kept in the possession of an officer, and another responsible officer should verify the issuance and stock of such stationery. ❖ The mail should be opened by a responsible officer. Signatures on all the letters and advices received from other branches of the bank or its correspondence should be checked by an officer with the signature book. ❖ The signature book and the telegraphic code book should be kept with responsible officers and access should be allowed only to authorised officers.
Cash	❖ Cash should be kept in the joint custody of two responsible officers. ❖ In addition to normal checking by the chief cashier, cash should be test-checked daily and counted in full occasionally by a responsible officer other than those handling the cash. Actual cash in hand should agree with the balance shown by the Day Book every day. ❖ The cashier should have no access to the customer's ledger accounts and the Day Book. ❖ Payments should be made only after the vouchers (e.g. cheques, demand drafts etc.) have been passed for payment by the authorised officer and have been entered in the customer's account. ❖ Receipt and payment scroll or their totals should be compared with the cash column of the Day-Book by independent persons. ❖ High value cash receipts and payments should be verified by a higher officer/ branch manager and the excess cash balance should be remitted to currency chest according to branch's retention limit on daily basis.
Clearings	❖ Under the Cheque Truncation System (CTS) implemented by RBI, an electronic image of the cheque is transmitted to the paying branch through the clearing house, along with relevant information like data on the MICR band, date of presentation, presenting bank, etc. ❖ As per RBI guidelines, the branch is required to either call the customer or email him for any cheque received for the amount of ₹ 5 lakh and above in respect of inward clearings. ❖ The Auditor is to check whether signature of the drawer of the cheque is being verified by the staff or not as else there will be liability of the paying bank.

	❖ The unpaid cheques received in outward clearing should be either sent to the customers at their recorded address or the customers be informed to collect the same from bank branch.
Bills for Collection	❖ All the documents accompanying the bills should be received and entered in the Register by a responsible officer. ❖ The accounts of customers or principals should be credited only after the bills have been collected or an advice to that effect received from the bank branch or agent to which they were sent for collection. ❖ It should be ensured that bills sent by one branch for collection to another branch of the bank, are not taken in the bills for collection twice in the amalgamated balance sheet of the bank. For this purpose, the receiving branch should reverse the entries regarding such bills at the end of the year for closing purposes.
Bills Purchased	❖ At the time of purchase of the bills, an officer should verify that all the documents of title are properly assigned to the bank. ❖ Sufficient margin should be kept while purchasing or discounting a bill to cover any decline in the value of the security etc. ❖ If the bank is unable to collect a bill on the due date, immediate steps should be taken to recover the amount from the drawer against the security provided. ❖ All irregular outstanding account/s should be reported to the Head Office. ❖ In the case of bills purchased outstanding at the close of the year the discount received thereon should be properly apportioned between the two years.
Loans and Advances	❖ The bank should make advances only after satisfying itself as to the creditworthiness of the borrowers. ❖ All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made. ❖ Sufficient margin should be kept against securities taken to cover any decline in the value thereof. ❖ All the securities should be received and returned by responsible officer. They should be kept in the Joint custody of two such officers. ❖ All accounts should be kept within both the drawing power and the sanctioned limit as per prescribed norms. Additional temporary limit may be sanctioned, for a maximum of 20% of existing limit and 90 days maximum tenure. ❖ The operation (in each advance account) should be reviewed at least once every year.)
Demand Drafts	❖ The signatures on a demand draft should be checked by an officer with the Signature Book. ❖ All the D.Ds. sold/ issued by a branch should be immediately confirmed by an advice to the paying branch.

	❖ If the paying branch does not receive proper confirmation of any D.D. from the issuing branch, it should take immediate steps to ascertain the reasons.
Inter Branch Accounts	❖ The accounts should be adjusted only on the basis of advices received from other branches, ❖ Prompt action should be taken preferably by central authority, if any entries (particularly debit entries) are not responded within a reasonable time.
Credit Card Operations	❖ Effective screening of applications with reasonably good credit assessments. ❖ Strict control over storage and issue of cards. ❖ A system whereby a merchant confirms the status of unutilised limit from the bank before accepting the settlement. ❖ A system of prompt reporting by the merchants of all settlements accepted by them through credit cards. ❖ Reimbursement to merchants should be made only after verification of the validity of merchant's acceptance of cards. ❖ All the reimbursement (gross of commission) should be immediately charged to the customer's account. ❖ A system to ensure that statements are sent regularly and promptly to the customer, monitor and follow-up customers' payments.

4. COMPLIANCE WITH CRR AND SLR REQUIREMENTS

- (i) **Cash Reserve Ratio (CRR)** is a specified minimum fraction of the total deposits of customers, which commercial banks have to hold as reserves **either in cash or as deposits with the central bank.**
- (ii) **Statutory Liquidity Ratio (SLR) Requirements** - SLR is the requirement that **every scheduled commercial bank in India** is required to maintain in the form of **certain liquid assets such as gold, cash and government approved securities** before providing credit to the customers. RBI requires statutory central auditors of banks to verify the compliance with **SLR requirements of 12 odd dates in different months of a fiscal year not being Fridays.**

Audit Approach and Procedure:

Area of Focus	Suggested Audit Procedures
Compliance with CRR and SLR requirements	❖ Obtain an understanding of the relevant circulars/ instructions of the RBI, regarding Demand and Time Liabilities. ❖ Request the branch auditors to send their weekly trial balance as on Friday and these are consolidated at the head office. Based on this consolidation, the DTL position is determined for every reporting Friday. ❖ Examine, on a test basis, the consolidations regarding DTL position prepared by the bank with reference to the related returns received from branches. ❖ While examining the computation of DTL, specifically examine that items have been excluded from liabilities as per RBI guidelines. Some of these items are:-

- ❖ Paid up capital, reserve, any credit balance in profit & loss account of bank, amount of loan taken from RBI and amount of refinance taken from EXIM bank, NHB, SIDBI and NABARD
 - (i) **Part amounts of recoveries from the borrowers** in respect of debts considered bad and doubtful of recovery.
 - (ii) **Amounts received in Indian currency** against import bills and held in sundry deposits pending receipts of final rates.
 - (iii) **Un-adjusted deposits/balances** lying in link branches for agency business like dividend warrants, interest warrants, refund of application money, etc., in respect of shares/debentures to the extent of payment made by other branches but not adjusted by the link branches.
 - (iv) **Margins held and kept in sundry deposits** for funded facilities.
- ❖ **Similarly, specifically examine that the items have been included in liabilities as per RBI guidelines. Some of these items are:-**
 - (i) **Net credit balance** in branch adjustment accounts.
 - (ii) **Borrowings from abroad by banks** in India needs to be considered as 'liabilities to other' and thus, needs to be considered at gross level unlike 'liabilities towards banking system in India', which are permitted to be netted off against 'assets towards banking system in India'. Thus, **the adverse balances in Nostro Mirror Account needs to be considered as 'Liabilities to other'**.
 - (iii) The reconciliation of Nostro accounts (with Nostro Mirror Accounts) needs to be scrutinized carefully to analyze and ascertain if any inwards remittances are received on behalf of the customers / constituents of the bank and have remained unaccounted and / or any other debit (inward) entries have remained unaccounted and are pertaining to any liabilities for the bank.
- ❖ It may be noted that, even though interest accrues daily, it is recorded in the books only at periodic intervals. Thus, **examine whether such interest accrued but not accounted for in books is included in the computation of DTL.**
- ❖ While reporting on compliance with SLR requirements, the auditor should specify **the number of unaudited branches** and state that he/she has relied on the returns received from the unaudited branches in forming an opinion. Recently, there has been introduction of **Automated Data Flow (ADF) for CRR & SLR reporting.**

5. VERIFICATION OF ASSETS

5.1 CASH, BANK BALANCES AND MONEY AT CALL AND SHORT NOTICE-

Area of Focus	Suggested Audit Procedures
Cash	❖ Carry out the physical verification of cash (including foreign currency, if any, cash at ATM and cash at cash deposit machines) as close to the balance sheet date as possible.

	❖ The cash balance as physically verified should be agreed with the balance shown in the cash register/balance in CBS.
Balance with Reserve Bank of India	❖ Verify the ledger balances in each account with reference to the bank confirmation certificates and reconciliation statements as at the year-end. ❖ Review the reconciliation statements, paying special attention to the following items appearing in the reconciliation statements: (i) Cash transactions remaining unresponded; (ii) Revenue items requiring adjustments/write-offs; and (iii) Other credit and debit entries originated in the statement provided by RBI remaining unresponded for more than 15 days.
Balance with Other Banks (Other than Reserve Bank of India)	Apart from the procedures described above in examining the balances with RBI, while reviewing the reconciliation statements, the auditor should pay particular attention to the following. ❖ Examine that no debit for charges or credit for interest is outstanding and all the items which ought to have been taken to revenue for the year have been so taken. ❖ Examine that no cheque sent or received in clearing is outstanding. ❖ Examine that all bills or outstation cheques sent for collection and outstanding as on the closing date have been credited subsequently. ❖ Examine large transactions in inter-bank accounts to ensure that no transactions have been put through for window- dressing particularly towards the close of year.
Money at Call and Short Notice	❖ Examine whether there is a proper system of authorisation, general or specific, for lending of the money at call or short notice. ❖ Call loans should be verified with the certificates of the borrowers and the call loan receipts held by the bank. ❖ Examine subsequent repayments received from borrowing banks to verify the amounts shown under this head as at the year-end. It may be noted that call loans made by a bank cannot be netted-off against call loans received. ❖ Verify that the interest has been properly accrued and accounted for on year-end outstanding balances of call/ short notice money.

5.2 Investments

Area of Focus	Suggested Audit Procedures
Internal Control Evaluation and Review of Investment Policy	❖ Review the investment policy of the bank to ascertain that the policy conforms, in all material respects, to the RBI's guidelines as well as to any statutory provisions applicable to the bank. ❖ It should clearly outline the broad investment objectives separately for the investments on its own account and investments on behalf of customers.

Separation of Investment Functions	❖ Check the segregation of duties within the bank staff in terms of executing trades, settlement and monitoring of such trades, and accounting of the same (generally termed as front office, middle office and back-office functions' segregation).
Examination of Reconciliation	❖ Examine the reconciliation of the investment account, physically verify the securities on hand, obtain confirmations from counter-party banks for Bank Receipts (BRs) issued by such banks and on hand, obtain confirmation of Subsidiary General Ledger (SGL) balances with the Public Debt Office (PDO), and examine the control and reconciliation of BRs issued by the bank.
Examination of Documents	❖ Ascertain whether the investments made by the bank are within its authority. ❖ Ensure that any other covenants or conditions which restrict qualify or abridge the right of ownership and/or disposal of investments, have been complied with by the bank. ❖ The acquisition/disposal of investments should be verified with reference to the broker's contract note, bill of costs, receipts and other similar evidence.
Physical Verification	❖ Verify the investment scrips physically at the close of business on the date of the balance sheet. ❖ Verify investments held with public debt office of RBI, custodians and depository with the statement of holdings as on date of balance sheet. Independent balance confirmation requests can be made in accordance with SA-505. In case independent confirmations are not received back, alternative audit procedures like getting bank personnel to download investment statement from E-Kuber for government securities (E-Kuber is CBS platform of RBI) in auditor's presence can be designed. ❖ If certain securities are held in the names of nominees, the auditor should examine whether there are proper transfer deeds signed by the holders.
Examination of classification and shifting	❖ Examine that entire investment portfolio of bank is classified under three categories i.e. HTM, HFT and AFS and shifting of securities is as per regulatory norms and laid down policy. ❖ Examine whether the shifting of the investments from 'available for sale' to 'held to maturity' is duly approved by the Board of Directors of the bank.
Examination of Valuation	❖ Examine whether the method of accounting followed by the bank in respect of investments, including their year-end valuation, is appropriate. ❖ Examine whether the investments have been properly classified into the three categories at the time of acquisition.

	❖ Examine compliance by the bank with the guidelines of the RBI relating to valuation of investments. ❖ Verify that investments are classified as non-performing investments (NPI) as per applicable RBI guidelines. (Non- performing investments are those where interest/principal is in arrears and remains unpaid for more than 90 days). In such cases, banks have not to reckon income on securities and are required to make provisions for depreciation in value of investment. ❖ Examine whether income from investments is properly accounted for. This aspect assumes special importance in cases where the bank has opted for receipt of income through the electronic/on line medium.
Dealings in Securities on Behalf of Others	❖ Examine whether prior approvals for carrying out such dealings have been obtained. ❖ Examine whether bank's income from such activities has been recorded and is fairly stated in the bank's financial statements. ❖ Consider whether the bank has any material undisclosed liability from a breach of its fiduciary duties, including the safekeeping of assets.
Special-purpose Certificates Relating to Investments	❖ Examine whether the bank is maintaining separate accounts for the investments made by it on their own Investment Account, on PMS (Portfolio Management Services) clients' account, and on behalf of other constituents (including brokers). ❖ As per the RBI guidelines, banks are required to get their investments under PMS separately audited by external auditors.

5.2.1 Audit, Review and Reporting of Investments

Banks should undertake **half-yearly reviews (as of 30th September and 31st March) of their investment portfolio**. These half yearly reviews should not only cover the operational aspects of the investment. The internal auditors are required to separately conduct the concurrent audit of treasury transactions and the results of their report should be placed **before the CMD once every month**.

5.3 Advances

Area of Focus	Suggested Audit Procedures
Evaluation of Internal Controls over Advances	❖ Examine area of credit appraisal and verify whether laid down procedures regarding credit appraisals including loan applications, preparation of proposals, obtaining satisfaction about credit worthiness of borrowers are being followed; ❖ Examine advances are sanctioned according to delegated authority; ❖ Examine all necessary loan documents have been executed after sanction but before disbursements are made to borrowers; ❖ Examine compliance with stipulated terms of sanction and end use of funds more particularly in case of term loans; ❖ Review operations of the accounts and look for adverse features like unauthorised over drawings beyond limits;

		❖ Examine whether system laid down in bank for review/renewals of advances is being followed; ❖ Review whether drawing power is being calculated properly on basis of stock/book debt statements received from borrowers as stipulated in respective sanction letters;
Substantive Procedures	Audit	❖ Verify correctness of master data of loan accounts updated in CBS. Check parameters like instalments, EMI, rate of interest, tenure of loans etc. ❖ Verify that each customer of bank is tagged under single customer id in respect of all its accounts including those in which credit facilities are granted. ❖ Examine accounts identified to be problem accounts but which have not yet slipped into NPA category. ❖ Examine those accounts which have been adversely commented upon by concurrent auditors/bank's internal inspection/RBI inspection team. ❖ Examine quick/early mortality accounts. Any advance slippage to NPA within 12 months of its sanction is called as quick/early mortality case. Verify completeness and accuracy of interest being charged.
Recoverability Advances	of	❖ Review periodic statements submitted by the borrowers indicating the extent of compliance with terms and conditions. ❖ Review latest financial statements of borrowers. ❖ Review reports on inspection of security. ❖ Review auditor's reports in case of borrowers having credit facilities from the banking system beyond a cut-off limit fixed by board of directors of bank

5.4 Verification of asset classification, income recognition and Provision for Non-performing assets

Area of Focus	Suggested Audit Procedures
Classification and Provision	❖ Verify whether bank has a system of ongoing identification and classification of advances through CBS without manual intervention and its accuracy in crystallizing date of NPA. ❖ Examine whether the classification made by the branch is appropriate. Particularly, examine the classification of advances where there are threats to recovery. ❖ Examine whether the secured and the unsecured portions of advances have been segregated correctly and provisions have been calculated properly. ❖ Review and compare the date of NPA of loan accounts mentioned in current year statements with that of previous year. Reasons for any change should be ascertained.

Accounts regularized near Balance sheet date	❖ As per the Reserve Bank guidelines, if an account has been regularised before the balance sheet date by payment of overdue amount through genuine sources, the account need not be treated as NPA. ❖ The auditor should carefully assess whether the repayment was out of genuine sources or not. ❖ Where the account indicates inherent weakness based on the data available, the account should be deemed as NPA. ❖ It is to be ensured that the classification is made as per the position as on date and hence classification of all standard accounts be reviewed as on balance sheet date.
Drawing Power Calculation	❖ Ensure that the drawing power is calculated as per the extant guidelines (i.e. the Credit Policy of the Bank) formulated by the Board of Directors of the respective bank and statutory auditors. ❖ Special consideration should be given to proper reporting of sundry creditors and stocks covered under LCs/guarantees for the purposes of calculating drawing power. ❖ The drawing power needs to be calculated carefully in case of working capital advances to companies engaged in construction business. The valuation of work in progress should be ensured in consistent and proper manner. ❖ The stock audit including audit of book debts should be carried out by the bank for all accounts having funded exposure of more than stipulated limit.
Accounts with temporary deficiencies	❖ Banks should not classify an advance account as NPA merely due to the existence of some deficiencies which are temporary in nature such as non-availability of drawing power based on latest available stock statement, balance outstanding exceeding the limit temporarily and non-renewal of limits on the due date. ❖ However, stock statements relied upon by the banks for determining drawing power should not be older than 3 months. The outstanding in the account based on drawing power calculated from stock statements older than 3 months are considered as irregular.
Limits not reviewed	Accounts where regular/ad hoc limits are not reviewed within 180 days from the due date/date of ad hoc sanction , should be considered as NPA. Auditors should also ensure that the ad hoc/short reviews are not done on repetitive basis.
Asset classification to be borrower wise and not facility wise	Ensure that asset classification is borrower wise and not facility wise. Therefore, it is to be ensured that all the facilities granted by a bank to borrower will have to be treated as NPA and not particular facility which has become irregular.
Government Guaranteed Advances	❖ If government guaranteed advance becomes NPA, then for the purpose of income recognition, interest on such advance should not to be taken to income unless interest is realized.

	❖ However, for purpose of asset classification, credit facility backed by Central Government Guarantee, though overdue, can be treated as NPA only when the Central Government repudiates its guarantee, when invoked. This exception is not applicable for State Government Guaranteed advances, where advance is to be considered NPA if it remains overdue for more than 90 days. ❖ In case the bank has not invoked the Central Government Guarantee though the amount is overdue for long, the reasoning for the same should be taken and duly reported in LFAR.
Agricultural Advances	❖ Ensure that NPA norms have been applied in accordance with the crop season determined by the State Level Bankers' Committee in each State. Depending upon the duration of crops - short term/ long term - raised by an agriculturist, the NPA norms would also be made applicable to agricultural term loans availed of by them. ❖ In respect of agricultural loans, other than those specified in the circular, ensure that identification of NPAs has been done on the same basis as non-agricultural advances.
Provisioning Towards Standard Assets	It is be understood that provision for standard assets is also required to be made at variable rates in respect of different sectors for the funded outstanding in accordance with RBI norms as a matter of prudence.
Restructured Advances	❖ Restructuring is an act in which a lender, for economic or legal reasons relating to borrower's financial difficulty, grants concessions to the borrower. ❖ Banks may restructure the accounts classified under standard, substandard or doubtful categories. Banks cannot restructure accounts with retrospective effect. Once the bank receives an application/proposal in respect of an account for restructuring, it implies that the account is intrinsically weak. ❖ On restructuring, the account will be downgraded from Standard to substandard. NPAs will remain in the same category.
Upgradation of Account	❖ Examine all the accounts upgraded from NPA to standard category during the year, to ensure that the upgrading of each account is strictly in terms of RBI guidelines. ❖ There can be a possibility of incorrect upgradation of account on the basis of partial recoveries made in the account and overdue portion might not have wiped out completely.
Sale/ Purchase of NPAs	In case of Sale/Purchase of NPA by Bank, the auditor should examine: ❖ The policy laid down by the Board of Directors regarding non-performing financial assets that may be purchased/sold, norms or such purchase/sale, valuation procedure and accounting policy. ❖ Only such NPA has been sold which has remained NPA in the books of the bank for at least 2 years.

- ❖ The assets have been sold/ purchased **"without recourse"** only i.e the entire credit risk associated with the non-performing asset should be transferred to the purchasing bank.
- ❖ Subsequent to the sale of the NPA, the bank does not assume any legal, operational or any other type of risk relating to the sold NPAs.
- ❖ **The NPA has been sold at cash basis only.** Under no circumstances, NPA can be sold to another bank at a contingent price. The entire sale consideration has to be received on upfront basis.
- ❖ The bank has not purchased an NPA which it had originally sold.

In case of sale of an NPA, the auditor should also ensure that:

- ❖ On the sale of the NPA, the same has been removed from the books of the account of selling bank on transfer;
- ❖ If the sale is at a price below the net book value (NBV) (i.e., book value less provisions held), **the shortfall should be debited to the profit and loss account of that year.**
- ❖ If the sale is for a value higher than the NBV, the excess provision shall not be reversed but will be utilised to meet the shortfall/ loss on account of sale of other non-performing financial assets.

Similarly, in case of purchase of NPAs, the auditor should verify that:

- ❖ The NPA purchased has been subjected to the provisioning requirements appropriate to the classification status in the books of the purchasing bank.
- ❖ Any recovery in respect of an NPA purchased from other banks is first adjusted against its acquisition cost and only the recovered amount in excess of the acquisition cost has been recognised as profit.
- ❖ For the purpose of capital adequacy, **banks have assigned 100% risk weights to the NPAs purchased from other banks.**

5.5 Fixed Assets

Area of Focus	Suggested Audit Procedures
Internal Controls	Examine the system of internal controls broadly covering the following: ❖ Control over expenditures incurred on fixed assets acquired or self-constructed. ❖ Accountability and utilization controls. ❖ Information controls for ensuring availability of reliable information about fixed assets. ❖ Ascertain whether the accounts in respect of fixed assets are maintained at the branch or centrally. ❖ Ascertain the location of documents of title or other documents evidencing ownership of various items of fixed assets. ❖ Examine whether acquisitions, disposals, etc. effected at the branch during the year have been properly communicated to the head office.

Premises	❖ Verify the opening balance of premises with reference to schedule of fixed assets, ledger or fixed assets register. ❖ Acquisition of new premises should be verified with reference to authorisation, title deeds, record of payment, etc. ❖ Self-constructed fixed assets should be verified with reference to authorisation and documents such as, contractors' bills, work order records and record of payments. ❖ Examine whether the balances as per the fixed assets register reconcile with those as per the ledger and the final statements. ❖ In the case of leasehold premises, capitalisation and amortisation of lease premium, if any, should be examined. Any improvements to leasehold premises should be amortised over their balance useful life. ❖ In case the title deeds are held at the head office or some other location, the branch auditor should obtain a written representation to this effect from the branch management and should bring this fact to the notice of the central statutory auditor through a suitable mention in the report. This fact should also be brought in the Long Form Audit Report (LFAR).
	❖
Sale of Fixed Assets	❖ Verify the copy of sale deed and receipt of the sale value, in respect of fixed assets sold during the year. Ensure that the profit/ loss on sale of assets has been properly accounted for.
Leased Assets	❖ Verify accounting and provisioning norms to be followed by banks undertaking leasing activity in accordance with RBI circulars and guidelines. The auditor, in respect of leased assets, should also have regard to the requirements of AS 19, "Leases".
Impairment of Assets	❖ Verify whether the guidelines given by RBI's circular on compliance with Accounting Standards, and the requirements of AS 28 have been followed.

5.6 Other Assets

Area of Focus	Suggested Audit Procedures
Inter-Office Adjustments	❖ Examine whether Inter-branch accounts are normally reconciled at the central level. The auditor should report on the year-end status of inter-branch accounts indicating the dates up to which all or any segments of the accounts have been reconciled. ❖ The auditor should also indicate the number and amount of outstanding entries in the inter branch accounts, giving the relevant information separately for debit and credit entries. ❖ The auditor should ensure that any discrepancies found in inter-branch accounts have been properly dealt with in the books. ❖ The auditor can obtain the relevant information primarily from branch audit reports.

Interest Accrued	❖ Examine whether the interest has been accrued on the entire loans and advances portfolio of the bank. Special consideration should be given to the overdue bills purchased/discounted. ❖ Ensure that only such interest as can be realised in the ordinary course of business. This is based on the principle, recognised in AS 9, that revenue cannot be recognised if there is a significant uncertainty about its collectability.
Tax Paid in Advance/Tax Deducted at Source	❖ Ensure that the certificates for such tax deducted at source is collected by the branch and the original copy is sent to the Head Office along with the transfer of such Tax Deducted at Source (TDS) amount to Head Office on periodic basis as defined. ❖ TDS Certificates / credits in the form 26AS, and claim of the same in Income Tax returns filed should be checked to ensure the justification of the claim towards such certificates. ❖ At Head Office level, the availability of all the TDS Certificates / credits in the form 26 AS, and claim of the same in Income Tax returns filed should be checked to ensure the justification of the claim towards such certificates.
Stationery and Stamps	❖ Ensure that the item "Stationery and Stamps" includes only exceptional items of expenditure on stationery like bulk purchase of security paper which is to be written off over a period of time. Such items should be valued at cost. Normal expenditure on stationery is charged to profit & loss account. Therefore, this item may not appear at branch level as considerable part of stationery is supplied to branches by head office. ❖ Evaluate the existence, effectiveness and continuity of internal controls over these items in the normal course of audit. ❖ Physically verify the stationery and stamps on hand as at the year-end, especially stationery of security items. Any shortage should be inquired into as it could expose the bank to a potential loss from misuse.
Non-Banking Assets Acquired in Satisfaction of Claims	❖ Ensure that the heading includes those immovable properties/tangible assets which the bank has acquired in satisfaction of debts due or its other claims and these are being held with intention of being disposed off. Verify such assets with reference to the relevant documentary evidence. ❖ Check that the ownership of the property is legally vested with the bank. If there is any dispute or other claim about the property, the auditor should examine whether the recording of the asset is appropriate or not. ❖ Ensure compliance with Section 9 of Banking Regulation Act, on holding period of such assets. (exceeding seven years) ❖ Ensure that as at date of acquisition, the assets should be recorded at lower of net book value of advance or net realisable value of asset acquired.
Non-Interest-Bearing Staff Advances	❖ Examine non-interest-bearing staff advances with reference to the relevant documentation and the policy in this regard which is framed by the bank. The availability, enforceability and valuation of security, if any, should also be examined.

	❖ Ensure that the same relates to employees on the rolls of the bank on the date of the preparation of financial statements.
Loans Advances Officials Relatives	❖ The auditor should verify that loans have been ordinarily sanctioned by the next higher sanctioning authority as compared to the recipient of loan. ❖ Loans to senior officers or of higher amount should have been reported to the Board.
Security Deposits	❖ Examine security deposits with various authorities (e.g., on account of telephone, electricity, etc.) and with others (e.g., deposits in respect of premises taken on rent) with reference to documents. ❖ Ensure that the deposit amount has not become due as per the terms and conditions. If it is so, then the recoverability of the same needs to be considered.
Suspense Account	❖ Obtain from the management details of old outstanding entries in suspense account along with reasons for delay in adjusting the entries. Where the outstanding balances comprised in suspense account require a provision/write-off, the auditor should examine whether the necessary provision has been made/write-off.
Prepaid Expenses	❖ Examine whether the basis of allocation of expenditure to different periods is reasonable. ❖ Examine whether the allocation of discounting and rediscounting charges paid by the bank to different accounting periods is in consonance with the accounting policy followed for the bank as a whole.
Miscellaneous Debit Balances on	❖ Review the ageing statements pertaining to these items. ❖ Examine the recoverability of old outstanding items.
Government Account	❖ Examine whether claims for reimbursement have been lodged by the branch in accordance with the relevant terms and conditions. ❖ The net balances of the amount recoverable at the Head Office level should also be taken along with the age-wise analysis of the same. In case of old outstanding balances without any confirmation or proper justification of the same, should be provided for in the accounts. ❖ For major variance as compared to the previous year figures, verify whether reasons for the same have been recorded and reviewed.

6. VERIFICATION OF CAPITAL & LIABILITIES

6.1 Capital

6.1.1. Stress Testing

Stress tests are designed to understand **whether a bank has enough capital to survive plausible adverse economic conditions and to maintain enough buffer to stay afloat under extreme scenarios.**

6.1.2 BASEL III framework

Basel III norms relate to the Capital Adequacy requirement compliance which the Bank has to achieve as contained in the BASEL III accord. Basel capital adequacy norms are meant for the protection of depositors and shareholders by prescriptive rules for measuring capital adequacy.

The Basel III accord, aims at:

- (a) improving the banking sector's ability to absorb shocks arising from financial and economic stress, irrespective of reasons thereof;
- (b) improving risk management and governance practices; and
- (c) strengthening banks' transparency and disclosure standards.

6.1.3 Capital Adequacy Measures in India:

Capital is divided into tiers according to the characteristics/qualities of each qualifying instrument. **For supervisory purposes capital is split into two categories: Tier I and Tier II, representing different instruments' quality as capital.**

- ❖ **Tier I capital** consists mainly of share capital and disclosed reserves and it is a bank's highest quality capital because it is fully available to cover losses.
- ❖ **Tier II capital** consists of certain reserves and certain types of subordinated debt. The loss absorption capacity of Tier II capital is lower than that of Tier I capital.

Capital Risk Adequacy Ratio (CRAR) : The CRAR is computed as follows :

$$\frac{\text{Eligible Total Capital Funds}}{\text{Risk weighted assets and off - balance sheet items}} \times 100$$

The RBI requires banks to maintain a **minimum CRAR of 9 per cent** on an ongoing basis. The Master Circular on Capital Adequacy contains detailed guidelines on calculation of risk weighted assets and off-balance sheet items for CRAR.

6.2 Reserves and Surplus

The following are required to be disclosed in the balance sheet under the head 'Reserves and Surplus'.



***In respect of these items above, opening balance, additions during the year and deductions during the year are to be shown separately in respect of each item**

Audit Approach and Procedures

- ❖ The auditor should verify the **opening balances** of various reserves with reference to the audited balance sheet of the previous year.
- ❖ **Additions to or deductions** from reserves should also be verified in the usual manner, e.g., with reference to board resolution.
- ❖ In the case of **statutory reserves and share premium**, compliance with legal requirements should also be examined. Thus, the auditor should specifically examine whether the requirements of the governing legislation regarding transfer of the prescribed percentage of profits to reserve fund have been complied with.

- ❖ Similarly, it should be examined whether **the appropriations from share premium account** conform to the relevant legal requirements.
- ❖ **Compliance with foreign laws in respect of overseas branches, need to be verified by the auditor.**

6.3 Deposits

Area of Focus	Suggested Audit Procedures
Current saving accounts and	❖ Verify on a sample basis current account and saving accounts opened during the year for adherence to KYC norms. ❖ Verify that saving accounts are opened in name of individuals, HUF, some approved institutions like trusts, educational institutes etc. Remember that saving accounts are not opened for business or professional concern. ❖ Verify the balances in individual accounts on a sample basis. ❖ Check the calculations of interest on a test check basis. Remember that no interest is paid generally on current accounts by banks. ❖ Examine whether the procedure for obtaining balance confirmation periodically has been followed consistently. Examine, on a sampling basis, the confirmations received. ❖ Ensure that debit balances in current accounts are not netted out on the liabilities side but are appropriately included under the head 'advances'. ❖ Inoperative accounts (both current and saving) are a high-risk area of frauds in banks. As per RBI guidelines, a savings/ current account should be treated as inoperative/dormant if there are no transactions in the account for over a period of two years.
Term deposits	❖ Examine whether the deposit receipts and cash certificates are issued serially and all of them are accounted for in the registers. ❖ Verify in case of bulk deposits (₹ 2 crore and above for scheduled commercial banks presently), correct rate of interest has been offered. ❖ In case of closure of term deposit, test check whether required foreclosure penalty has been deducted from applicable rate of interest payable. ❖ Verify on sample basis some of recurring deposit accounts opened during the year. ❖ Verify correctness of rate of interest on term deposits on sample basis.
Deposits designated in foreign currencies	❖ Verify some of FCNR accounts opened during the year on sample basis and ensure these conform to RBI directions. ❖ Verify on sample basis permissible credits and debits in FCNR accounts as per RBI directions. ❖ In case of FCNR accounts, examine whether these have been converted into Indian Rupees at rate notified in this behalf by head office. ❖ Examine whether any resultant increase or decrease has been taken to the profit and loss account. ❖ Verify that interest on deposits has been paid on the basis of 360 days in a year.

Others	❖ In case of NRE and NRO accounts, verify on a sample basis credits and debits as per RBI guidelines. Also check repatriability. NRE accounts are repatriable whereas NRO accounts are not repatriable except for all current income subject to certain conditions.
General	❖ Verify that deposits of a bank are not inflated for purpose of balance sheet presentation. For example, some customers might be given overdrafts near date of balance sheet and the resultant overdrawn amounts may be placed as deposits with banks and further advances may be given on strength and security of these deposits. It would lead to inflated deposits as well as advances. The transactions may be reversed after close of the year. ❖ In such cases which indicate the possibility of window-dressing, the auditor should consider making a suitable qualification in main audit report besides other applicable reporting. ❖ Examine that interest accrued but not due on deposits is not included under the relevant deposits but is shown under the head 'other liabilities and provisions'. ❖ Ensure that framework relating to 'Know Your Customer' and Anti- Money Laundering measures is formulated and put in place by the bank.

6.4 Borrowings

Area of Focus	Suggested Audit Procedures
Borrowings	❖ Obtain and verify confirmation certificates and other supporting documents such as, agreements, correspondence, etc. ❖ External confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence that the auditor requires to respond to significant risks of material misstatement. ❖ Examine whether a clear distinction has been made between 'rediscount' and 'refinance' for disclosure of the amount under the above head since rediscount does not figure under this head. ❖ Examine whether borrowings of money at call and short notice are properly authorised. The rate of interest paid/payable on, as well as duration of such borrowings should also be examined by the auditor. ❖ Examine the relevant correspondence or other documents to ensure that the branch has been authorised by the Head Office to borrow/retain other borrowings.

6.5 Other Liabilities and Provision

Area of Focus	Suggested Audit Procedures
Bills Payable	Evaluate the existence, effectiveness and continuity of internal controls over bills payable. Such controls should usually include the following- ❖ Drafts, mail transfers, traveller's cheques, etc. should be made out in standard printed forms. ❖ Unused forms relating to drafts, traveller's cheques, etc. should be kept under the custody of a responsible officer.

	❖ The bank should have a reliable private code known only to the responsible officers of its branches, coding and decoding of the telegrams should be done only by such officers. ❖ The signatures on a demand draft should be checked by an officer with the specimen signature book.
Inter-office Adjustments	The balance in inter-office adjustments account, if in credit, is to be shown under this head.
Interest Accrued	Examine interest accrued with reference to terms of the various types of deposits and borrowings. It should be specifically examined that such interest has not been clubbed with the figures of deposits and borrowings shown under the head 'Deposits and Borrowings'.
Others (Including Provisions)	It may be noted that the figure of advances and investments in the balance sheet of a bank excludes provisions in respect thereof made to the satisfaction of auditors. The auditor should examine other provisions and other items of liabilities in the same manner as in the case of other entities.

6.6 Contingent Liabilities

Contingent Liabilities
❖ Claims against the bank not acknowledged as debts. ❖ Liability for partly paid investments. ❖ Liability on account of outstanding forward exchange contracts & Derivative Contracts. ❖ Guarantees given on behalf of constituents (within India; outside India). ❖ Acceptances, endorsements and other obligations. ❖ Other items for which the bank is contingently liable.
Bills for Collection

6.6.1 Audit Approach

In respect of contingent liabilities, the auditor is primarily concerned with seeking reasonable assurance that all contingent liabilities are identified and properly valued. **The auditor should obtain representation from management that:-**

- All off-balance sheet transactions** have been accounted in the books of accounts as and when such transaction has taken place;
- All off balance sheet transactions have been **entered into** after following due procedure laid down;
- All off balance sheet transactions are **supported by the underlying documents**;
- All year end contingent liabilities** have been disclosed;
- The disclosed contingent liabilities **do not include any crystallised liabilities** which are of the nature of loss/ expense and which, therefore, require creation of a provision/adjustment in the financial statements;

6.6.2 Audit procedures

Area of Focus	Suggested Audit Procedures
Contingent Liabilities	❖ Ensure that there exists a system whereby the non-fund based facilities or additional/ad hoc credit facilities to parties are extended only to their regular constituents, etc. ❖ Ascertain whether there are adequate internal controls to ensure that transactions giving rise to contingent liabilities are executed only by

	persons authorised to do so and in accordance with the laid down procedures. ❖ Verify in case of LCs for import of goods, the payment to the overseas suppliers is made based on shipping documents and after ensuring that the said documents are in strict conformity with the terms of LCs. ❖ Ascertain whether the accounting system of the bank provides for maintenance of adequate records in respect of such obligations and whether the internal controls ensure that contingent liabilities are properly identified and recorded. ❖ Test the completeness of the recorded obligations. ❖ Review the reasonableness of the year-end amount of contingent liabilities in the light of previous experience and knowledge of the current year's activities.
Claims Against the Bank Not Acknowledged as Debts	❖ Examine the relevant evidence, e.g., correspondence with lawyers/ others, claimants, workers/officers, and workmen's/officers' unions. ❖ Review the minutes of meetings of board of directors/committees of board of directors, contracts, agreements and arrangements, list of pending legal cases, and correspondence relating to taxes, and duties, etc. to identify claims against the bank. ❖ Ascertain from the management the status of claims outstanding as at the end of the year. ❖ A review of subsequent events would also provide evidence about completeness and valuation of claims.
Liability on Account of Outstanding Forward Exchange Contracts & derivative contracts	❖ Verify the outstanding forward exchange contracts with the statement of outstanding forward exchange contracts generated from the bank's computerised accounting system or manual register maintained by the branch. The auditor may physically verify the underlying documents including confirmations from merchants to test the existence of such outstanding contracts. ❖ The auditor may verify outstanding derivative contracts like options, interest rate swaps etc with reports generated in this regard.
Guarantees Given on Behalf of Constituents	❖ Ascertain whether there are adequate internal controls over issuance of guarantees, e.g., whether guarantees are issued under proper sanctions. ❖ Ascertain whether there are adequate controls over unused guarantee forms, e.g., whether these are kept under the custody of a responsible official, ❖ Examine the guarantee register to seek evidence whether the prescribed procedure of marking off the expired guarantees is being followed or not. ❖ Examine that expired guarantees are not included in this head. Verify guarantees with the copies of the letters of guarantee issued by the bank and with the counter-guarantees received from the customers.

Acceptances, Endorsements and Other Obligations	❖ Evaluate the adequacy of internal controls over issuance of letters of credit and over custody of unused LC forms in the same manner as in the case of guarantees. ❖ Verify the balance of letters of credit from the register maintained by the bank. The register indicates the amount of the letters of credits and payments made under them. T ❖ The auditor may examine the guarantees of the customers and copies of the letters of credit issued. The security obtained for issuing letters of credit should also be verified. ❖ Examine whether the bank has incurred a potential financial obligation in respect of letters of comfort and if such obligation has been cast, ensure the amount to be disclosed under contingent liability.
Other Items for which the Bank is Contingently Liable	❖ Determine and verify any other items under this head as required. For Example, outstanding underwriting contracts, bills rediscounting, disputed tax demands,
Bills for Collection	❖ Ensure that the bills drawn on other branches of the bank are not included in bills for collection. ❖ Verify outward bills for collection with reference to the corresponding register maintained. ❖ Examine collections made subsequent to the date of the balance sheet to obtain further evidence about the existence and completeness of bills for collection as on the date of Balance Sheet. ❖ Examine the procedure for crediting the party on whose behalf a bill has been collected. ❖ Examine that adequate internal controls exist that debits the customer's account with the amount of bank's commission as soon as a bill collected is credited to the customer's account.

7. AUDITOR'S REPORT

In the case of a nationalised bank, the auditor is required to make a report to **the Central Government**. It should also conform to the Standards on Reporting - SA 700-720. However, it is pertinent to mention that CARO 2020 is not applicable to Banking Companies.

9.1 Long Form Audit Report (LFAR)

- ❖ The terms of appointment of auditors of public sector banks, private sector banks and foreign banks (as well as their branches), require the auditors to also furnish a **long form audit report (LFAR)**.
- ❖ The long form audit report is to be given by statutory branch auditors as well as statutory central auditors. The LFAR for branch auditors is in **form of questionnaire** where observations/comments have to be provided on range of matters including cash, balance with banks, investments, advances, deposits etc. **These are submitted by the statutory branch auditors to statutory central auditors.**
- ❖ **The consolidation is done at head office level and LFAR for bank is submitted by statutory central auditors to management.**

- ❖ A copy of the LFAR, together with the Board's views or directions, is submitted to RBI within 60 days of submission of LFAR by statutory auditors.

8. CONCURRENT AUDIT

Concurrent audit is an audit or verification of transactions or activities of an organisation concurrently as the transaction/activity takes place. It is not a pre-audit. It is akin to internal audit which is a concept recognised under the Companies Act.

8.1 Types of Activities to be Covered

House Keeping

- ❖ Ensure that the maintenance and balancing of accounts, ledgers and registers including clean cash is proper.
- ❖ Early reconciliation of entries outstanding in the inter-branch and inter-bank accounts, Suspense Account, Sundry Deposits Account, DRRR Account, Drafts Account, etc.
- ❖ Ensure timely adjustment of large value entries.
- ❖ Carry out a percentage check of calculations of interest, discount, commission and exchange.
- ❖ Check the transactions of staff accounts.
- ❖ Examine the day book to verify as to how the differences in clearing have been adjusted.
- ❖ Detection & prevention of revenue leakages through close examination of income and expenditure accounts.

8.2 Appointment of Concurrent Auditors and Accountability

- ❖ The option to consider whether concurrent audit should be done by bank's own staff or external auditors is left to the discretion of individual banks.
- ❖ The staff engaged on concurrent audit must be independent of the branch where concurrent audit is to be conducted.
- ❖ ACB (Audit Committee of Bank) of the bank shall decide the maximum tenure of external concurrent auditors with the bank. Generally, tenure of external concurrent auditors with a bank shall not be more than five years on continuous basis. However, no concurrent auditor shall be allowed to continue with a branch/business unit for a period of more than three years.

8.4 Reporting Systems

- ❖ There should be proper reporting of the findings of the concurrent auditors. For this purpose, each bank should prepare a structured format. A quarterly review containing key features brought out during the concurrent audits should be placed before the ACB.
- ❖ There should be zone-wise reporting of the findings of the concurrent audit to ACB and an annual appraisal/report of the audit system should be placed before the ACB. Before submission of the report, the auditor should discuss the important issues on which he/she wishes to report with the branch manager and concerned officers. This will enable the auditor to take into consideration the opposite view point and clarify any doubts.
- ❖ Minor irregularities pointed out by the concurrent auditors are to be rectified in a timely manner.
- ❖ Whenever fraudulent transactions are detected, they should immediately be reported to Inspection & Audit Department (Head Office) as also the Chief Vigilance Officer as well as Branch Managers concerned (unless the branch manager is involved).
- ❖ Follow-up action on the concurrent audit reports should be given high priority by the controlling office/Inspection and Audit Department.

CHAPTER 06

SPECIAL FEATURE OF NBFC AUDIT

WHAT IS NBFC?**Answer:****Section 45-I (f) of the RBI Act defines a NBFC as**

- ❖ **a Financial institution which is a company;**
- ❖ having principle business of receiving of deposits or lending in any manner;
- ❖ such other non-banking institution as prescribed by CG.

Examples : Unit trust of India, Life Insurance Corporation (LIC), General Insurance Corporation (GIC)

Please Note :

1. The Company will be treated as a NBFC when a company's financial assets constitute more than 50% of total assets and income from financial assets constitutes more than 50 % of the gross income.
2. As per Section 45-IA of Reserve Bank of India (Amendment) Act, 1997, no NBFC is allowed to commence or carry on the business of NBFC without
 - Obtaining a certificate of registration issued by RBI
 - Having a net owned fund requirement of **minimum ₹ 10 crore { Previously 2 cr }**
3. Minimum Net owned fund amount may be different for different type of NBFC's.
4. RBI has prescribed a time line to meet **NOF requirement of 10 cr** in a phased manner for existing NBFC's by 31st March, 2027. However, for NBFC-P2P, NBFC-AA, and NBFCs with no public funds and no customer interface, the NOF shall continue to be INR 2 Crore.

COMPANIES EXEMPTED FROM REGISTRATION UNDER RBI

Companies that do financial business but are regulated by other regulators are given specific exemption by the Reserve Bank from its regulatory requirements for avoiding duality of regulation. Following NBFCs have been exempted from the requirement of registration under Section 45 -IA of the RBI Act, 1934 subject to certain conditions.

1. Housing Finance Institutions (regulated by National Housing Bank).
2. Merchant Banking Companies (regulated by Securities and Exchange Board of India).
3. Stock Exchanges (regulated by Securities and Exchange Board of India).
4. Companies engaged in the business of stock-broking/sub-broking (regulated by Securities and Exchange Board of India).
5. Venture Capital Fund Companies (regulated by Securities and Exchange Board of India);
6. Nidhi Companies (regulated by Ministry of Corporate Affairs, Government of India);
7. Insurance companies (regulated by Insurance Regulatory and Development Authority); and
8. Chit Companies (as defined in clause (b) of section 2 of the Chit Funds Act, 1982 (Act 40 of 1982).
9. Micro Finance Companies.
10. Securitization and Reconstruction Companies.
11. Mutual Benefit Companies.
12. Mortgage Guarantee Companies.
13. Core Investment Companies. { CIC with Asset size of less than ₹ 100 cr and Asset side of ₹ 100 crore or above but not accessing public funds are exempted from registration with RBI }

14. Alternative Investment Fund (AIF) Companies.

CLASSIFICATION OF NBFC'S**NBFCs registered with RBI are categorized as follows:**

- (a) **In terms deposit acceptance** or otherwise into Deposit and Non-Deposit accepting NBFCs;
- (b) **Non deposit taking NBFCs** by their size into systemically important and non-systemically important (NBFC-NDSI and NBFC-ND); and
- (c) **By the kind of activities, they conduct.** { All NBFC's are either deposit taking or non- deposit taking. If they are non-deposit taking , ND is suffixed to their name (NBFC-ND) }
 - Investment and Credit Company(ICC)
 - Infrastructure Finance Company(IFC)
 - Systematically Important Core Investment Company (CIC-ND-SI)
 - Infrastructure Debt fund NBFC(IDF-NBFC)
 - NBFC- Micro Finance Institution(NBFC-MFI)
 - NBFC Factors
 - NBFC-Non Operative Financial Holding Company
 - Asset Finance Company, Loan Company , Mortgage Companies etc.

TOP 4 LAYERS OF NBFC

Pursuant to the announcement of **Scale Based Regulations {SBR}**- A Revised Regulatory Framework for NBFCs on 22 October 2021 to be effective from 01 October 2022, RBI has revised different facets of existing NBFC Classification and regulation like Capital Requirements, Governance Standards, Prudential Regulations, etc. based on four layers that are defined based on their size, activity, and perceived riskiness.

Base Layer**The Base Layer shall comprise of**

- (a) non-deposit taking NBFCs **below the asset size of ₹1000 crore** and
- (b) **NBFCs undertaking the following activities-**
 - (i) NBFC-Peer to Peer Lending Platform (NBFC-P2P),
 - (ii) NBFC-Account Aggregator (NBFC-AA),
 - (iii) Non-Operative Financial Holding Company (NOFHC) and
 - (iv) NBFCs not availing public funds and not having any customer interface.

Middle Layer**The Middle Layer shall consist of**

- (a) all deposit taking NBFCs (NBFC-Ds), irrespective of asset size,
- (b) non-deposit taking NBFCs with **asset size of ₹1000 crore and above** and
- (c) **NBFCs undertaking the following activities**
 - (i) Standalone Primary Dealers (SPDs),
 - (ii) Infrastructure Debt Fund - Non-Banking Financial Companies (IDF-NBFCs),
 - (iii) Core Investment Companies (CICs),
 - (iv) Housing Finance Companies (HFCs) and
 - (v) Infrastructure Finance Companies (NBFC-IFCs).

Upper Layer

The Upper Layer shall comprise of those NBFCs which are specifically identified by the Reserve Bank as warranting enhanced regulatory requirement based on a set of parameters and scoring methodology. The **top ten eligible NBFCs in terms of their asset size** shall always reside in the upper layer, irrespective of any other factor.

Top Layer

The Top Layer will ideally remain empty. This layer can get populated if the Reserve Bank is of the opinion that there is a substantial increase in the potential systemic risk from specific NBFCs in the Upper Layer. Such NBFCs shall move to the Top Layer from the Upper Layer.

Categorization of NBFCs carrying out specific activity

As the regulatory structure envisages scale based as well as activity -based regulation, the following prescriptions shall apply in respect of the NBFCs.

- NBFC-P2P, NBFC-AA, NOFHC and NBFCs without public funds and customer interface will always remain in the **Base Layer of the regulatory structure**.
- NBFC-D, CIC, IFC and HFC will be included in Middle Layer or the Upper Layer (and not in the Base layer), as the case may be. SPD and IDF-NBFC will always remain in the **Middle Layer**.
- The remaining NBFCs, viz., Investment and Credit Companies (NBFC-ICC), Micro Finance Institution (NBFC-MFI), NBFC-Factors and Mortgage Guarantee Companies (NBFC-MGC) could lie in any of the layers of the regulatory structure depending on the parameters of the scale based regulatory framework.
- Government owned NBFCs** shall be placed in the Base Layer or Middle Layer, as the case may be. They will not be placed in the Upper Layer till further notice.

References to NBFC-ND, NBFC-ND-SI & NBFC-D-from October 01, 2022:

All references to NBFC-ND shall mean NBFC-BL and all references to NBFC-D and NBFC- NDSI shall mean NBFC-ML or NBFC-UL, as the case may be.

DIFFERENCE BETWEEN BANKS AND NBFC

Basis	Banks	NBFC's
Demand Deposit	Can accept demand deposits.	Cannot accept demand deposits.
Issuance of cheque	Form part of payment and settlement system and can issue cheque.	Do not Form part of payment and settlement system and cannot issue cheques drawn on itself.
Deposit Insurance Facility	Deposit insurance policy of Deposit Insurance and Credit Guarantee Corporation (DICGC) is available to depositors of Banks.	Deposit insurance policy of Deposit Insurance and Credit Guarantee Corporation (DICGC) is not available to depositors of NBFC's.
Priority Sector	Minimum Exposure to priority sector is required.	No Minimum Exposure to Priority Sector required by NBFCs.

AUDIT PROCEDURES TO BE FOLLOWED

- Ascertain the business of the company-** Review MOA/AOA, Minutes of Board/Committee Meetings, Hold discussions with Top level Management etc.
- Evaluation of Internal Control System-** An auditor should also ascertain whether the internal controls put in place by the NBFC are adequate and are being effectively followed. He should ascertain whether the NBFC has an effective system of periodical review of advances in place which would facilitate effective monitoring and follow up.
- Registration with the RBI-** The auditor is required to ensure whether company is required to be registered u/s 45-IA of RBI Act & if yes, whether registration is obtained.
- Check compliance of NBFC Acceptance of Public Deposit Directions (Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016).

5. Check compliance of Prudential norms by NBFC.

Public Deposit Directions (Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016

1. **Credit Rating:**

- Obtain a copy of the credit rating assigned to NBFC and check whether the public deposits accepted/held by it are in accordance with the level of credit rating assigned to it.
- In the event of upgrading/ downgrading of credit rating, auditor shall bear in mind that NBFC will have to increase/decrease its deposits in accordance with revised credit rating and inform about it in writing to RBI.
- **If downgraded below min investment grade, regularise excess deposits as under:**
 - Not accept fresh deposits & not renew existing ones
 - Existing deposits run off till maturity
 - **Report within 15 days** to Regional office of RBI where it is registered.
 - No matured public deposit renewed without express and voluntary consent of depositor

2. **Interest and Brokerage Payments:** Test check the interest calculations in respect of public deposits mobilised by a NBFC to ascertain that the NBFC has not paid interest in excess as per specification.

3. **Public deposit:**

- a. Ascertain whether the NBFC has accepted or renewed any public deposit only after a written application from the depositor in the form to be supplied by the company.
- b. Further ensure whether it contain the specific category of depositor, i.e., whether depositor is a shareholder or a director or a promoter or a member of public.

4. **Deposit Register:** Verify the deposit register maintained by a NBFC and test check the particulars that have been entered therein in respect of each depositor with supporting receipts issued to the depositors.

5. **Custody of Investments:** Check whether the investments made in approved liquid assets by a NBFC holding public deposits have been lodged in safe custody with a designated scheduled commercial bank.

6. **Filing of Annual Return:** Check whether the NBFC has filed its prescribed returns in a timely manner.

7. **NBFCs not accepting/holding public deposits:** check whether a board resolution has been passed by the NBFC to the effect that it has neither accepted any public deposits nor would it accept any public deposits during the year.

PRUDENTIAL NORMS BY NBFC-AUDIT CHECKLIST

1. Check **compliance with prudential norms** encompassing income recognition, income from investments, accounting standards, accounting for investments, asset classification, provisioning for bad and doubtful debts, capital adequacy norms etc.
2. Ensure that the **Board of Directors of every NBFC** granting/intending to grant demand/call loans shall frame and implement a policy for the company.
3. Verify that **advances and other credit facilities** have been properly classified as standard/substandard/doubtful/loss and that proper provision has been made in accordance with the Directions.
4. In respect of Non-Performing Assets, an auditor should check whether the **unrealised income** in respect of such assets has not been taken to the Profit & Loss Account on an accrual basis. Income from NPAs should be accounted for on realisation basis only.
5. Check **whether all accounts which have been classified as NPAs** in the previous year also continue to be shown as such in the current year also and if the same has been classified as performing, whether payments have been received.

CLASSIFICATION OF FRAUD BY NBFC

- a) **Cheating and Forgery.**
- b) **Cash Shortages** (treated as intentional fraud if >10000 and >5000, if detected by management/inspecting officer but not reported).
- c) Misappropriation and criminal breach of trust.
- d) Fraudulent encashment through forged instruments, manipulation of Books of Accounts.
- e) Irregularity in foreign exchange transactions. Reporting as fraud is required only if the intention to cheat/defraud is suspected /proved.
- f) Any other type of frauds.

Audit of NBFC - Investment and credit company/audit checklist (Common for all NBFC's)

Merging of NBFC's- three categories of NBFCs viz. Asset Finance Companies (AFC), Loan Companies (LCs) and Investment Companies (ICs) into a new category called Investment and Credit Company (NBFC-ICC).

Points to be covered in Audit of NBFC's { For example NBFC-ICC are given below (Learning 8 points are enough)

1. **Physically verify all the shares and securities** held by a NBFC. Where any security is lodged with an institution or a bank, a certificate from the bank/institution to that effect must be verified.
2. Verify whether the **NBFC has not advanced any loans** against the security of its own shares.
3. Verify that **dividend income wherever** declared by a company, has been duly received by an NBFC and interest wherever due [except in case of NPAs] has been duly accounted for.
4. **Test check bills/contract notes** received from brokers with reference to the prices vis-à-vis the stock market quotations
5. **Verify the Board Minutes** for purchase and sale of investments. Ascertain from the Board resolution or obtain a management certificate to the effect that the investments so acquired are current investments or Long-Term Investments.
6. Check whether the **investments have been valued** in accordance with the NBFC Prudential Norms Directions and adequate provision for fall in the market value of securities, wherever applicable, have been made there against, as required by the Directions.
7. Obtain a **list of subsidiary/group companies** from the management and verify the investments made in subsidiary/group companies during the year. Ascertain the basis for arriving at the price paid for the acquisition of such shares.
8. Check whether investments in unquoted debentures/bonds have not been treated as investments but as term loans or other credit facilities for the purposes of income recognition and asset classification.
9. An auditor will have to ascertain whether the requirements of AS 13 **"Accounting for Investments"** or other accounting standard, as applicable, (to the extent they are not inconsistent with the Directions) have been duly complied with by the NBFC.
10. An auditor should examine whether each loan or advance has been properly sanctioned. He should verify the conditions attached to the sanction of each loan or advance i.e. limit on borrowings, nature of security, interest, terms of repayment, etc.

Matters to be included in Auditor's report in case of NBFC

(A) In case of all NBFC's	(B) For NBFC's accepting or holding Public Deposits	(C) For NBFC's not accepting or holding Public Deposits	(D) In case of NBFC's not required to hold Certificate of Registration (COR)
a) whether co. has obtained COR. b) whether continues to hold COR as on 31/3. c) whether the non-banking financial	a) Whether the public deposits held by company is in excess of RBI Directions. b) Whether company has defaulted in repayment	a) Whether BOD has passed a resolution for non-acceptance of deposits. b) Whether Company has accepted any public	The auditor shall include a statement whether company has obtained advice from the Bank that is not required to hold COR and whether the Company

company is meeting the required net owned fund requirement. Note- Every non-banking company shall submit certificate from its statutory auditor within 1 month of finalization of B/s date not later than Dec 30 th of Year.	of public deposits and / interest. c) Whether prudential norms are being complied on income recognition, accounting standards, asset classification etc. d) Whether CAR is disclosed in the return submitted to Bank. e) Whether Company has furnished return on deposits timely. f) Whether Company has furnished half yearly return on Prudential Norms as per RBI DIRECTION. g) Whether Company has complied with the liquid asset's requirement.	deposits during the relevant period/year. c) Whether prudential norms are being complied on income recognition, accounting standards, asset classification etc. d) Whether CAR is disclosed in the return submitted to Bank.	is Complying with requirement given by bank.
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OBLIGATION OF AUDITOR TO SUBMIT AN EXCEPTION REPORT TO THE BANK

Answer:

Where, in the case of a non-banking financial company, the statement regarding any of the matters to be included in the auditor's report is unfavourable or qualified, or in the opinion of the auditor the company has not complied with:

- (i) the provisions of Chapter III B of Reserve Bank of India Act, 1934; or
- (ii) the NBFC Acceptance of Public Deposits (Reserve Bank) Directions, 2016; or
- (iii) NBFC-Non-Systematically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and
- (iv) NBFC -Systematically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016,

it shall be the obligation of the auditor to make a report containing the details of such unfavourable or qualified statements and/or about the non-compliance, as the case may be, in respect of the company to the concerned Regional Office of the Department of Non-Banking Supervision of the Bank under whose jurisdiction the registered office of the company is located.

AUDIT PROCEDURES FOR REPORTING UNDER CARO, 2020 W.R.T. NBFC'S

Compliance with CARO 2020

As per CARO 2020, the auditor is required to report that -

I. Loans , Advances, guarantee or security

- (a) Whether during the year the company has made **investments in**, provided any **guarantee or security** or granted **any loans or advances** in the nature of loans, secured or unsecured, to companies, firms, Limited Liability Partnerships or any other parties, If so;
- (b) Whether the investments made, guarantees provided, security given and the terms and conditions of the grant of all loans and advances in the nature of loans and guarantees provided **are not prejudicial to the company's interest**;
- (c) in respect of loans and advances in the nature of loans, whether **the schedule of repayment of principal and payment of interest** has been stipulated and whether the repayments or receipts are regular;

- (d) if the amount is overdue, state **the total amount overdue for more than ninety days**, and whether reasonable steps have been taken by the company for recovery of the principal and interest;
- (f) whether the company has granted any **loans or advances** in the nature of loans either repayable on demand or without specifying any terms or period of repayment, if so, specify the aggregate amount, percentage thereof to the total loans granted, aggregate amount of loans **granted to Promoters, related parties** as defined in clause (76) of section 2 of the Companies Act, 2013; [Paragraph 3(iii)].

(II) **Registration of NBFCs**

- (a) Whether the company is required to be registered under section 45 -IA of the Reserve Bank of India Act, 1934 and if so, whether the **registration** has been obtained;
- (b) Whether the company has conducted any Non-Banking Financial or Housing Finance activities without a valid **Certificate of Registration (CoR)** from the Reserve Bank of India as per the Reserve Bank of India Act, 1934;
- (c) Whether the company is a **Core Investment Company (CIC)** as defined in the regulations made by the Reserve Bank of India, if so, whether it continues to fulfil the criteria of a CIC, and in case the company is an exempted or unregistered CIC, whether it continues to fulfil such criteria;
- (d) Whether the Group has more than one CIC as part of the Group, if yes, indicate the number of CICs which are part of the Group; **[Paragraph 3(xvi)]**.

APPLICABILITY OF IND-AS ON NBFC'S

- (i) **Accounting periods beginning 1 April 2018:** Listed and unlisted NBFCs having **a net worth of 500 crore or more** and holding, subsidiary, joint venture or associate companies of such NBFCs;
- (ii) **Accounting periods beginning 1 April 2019:** All other listed NBFCs, unlisted NBFCs having a **net worth of ₹ 250 crore or more but less than ₹ 500 crore** and holding, subsidiary, joint venture or associate companies of such NBFCs.

INCOME RECOGNITION AND ASSET CLASSIFICATION

(i) **Income Recognition**

- Income including interest/ discount/ hire charges/ lease rentals or any other charges on NPA shall be recognised only when it is actually realised.
- Any such income recognised before the asset became non-performing and remaining unrealised shall be reversed.

(ii) **Asset classification and Provisioning**

	Classification	Meaning	% of Provision
a)	Standard	It shall mean the asset in which no default in repayment is perceived.	0.4%
b)	NPA	Any asset, a term, a demand or call loan, a bill, debt under the head "Other Current Assets", any due on account of sale → Overdue for a period of 6 months or more	
		Lease rental & hire purchase → overdue for a period of 12 months or more.	
c)	Sub-Standard	An asset which has been classified as NPA for period not exceeding 18 months.	10%

d)	Doubtful	A term loan or lease asset or hire purchase asset or any other asset which remains sub-standard asset for a period exceeding 18 months.	
	Secured Portion	Upto 1 year	20%
		1 to 3 years	30%
		More than 3 years	50%
	Unsecured Portion	Advances without collateral	100%
e)	Loss assets	An asset which is adversely affected by potential threat of non-recoverability due to erosion in value of security or non-availability of security or fraud or any omission.	100%

DIFFERENCE BETWEEN

	Division III (IndAS NBFCs) of schedule III	Division II (IndAS other than NBFCs) of Schedule III
a)	NBFCs have been allowed to present the items of balance sheet (B/S) in order of their liquidity.	Not allowed.
b)	NBFCs are required to classify items of B/S into Financial & Non-Financial.	Other companies are required to classify items of B/S into Current and Non-Current.
c)	NBFC is required to Separately disclose any item of "Other Income" or "Other Expenditure" which excess 1% of Total Income.	NBFC is required to Separately disclose any item of "Other Income" or "Other Expenditure" which excess 1% of Total Income or rupees 10 Lakhs whichever is higher.
d)	Separate discloser under " Receivables " the debt due from any LLP in which director is a partner or member.	No such disclosure.
e)	NBFCs are required to disclose items comprising " Revenue from Operations " and " Other comprehensive Incomes " on face of the statement.	No such disclosure

PRUDENTIAL NORMS FOR CAPITAL REQUIREMENTS

- ❖ Every NBFC shall maintain a minimum capital ratio consisting of Tier I and Tier II capital which shall **not be less than 15 % of its aggregate risk weighted assets** on-balance sheet and of risk adjusted value of off-balance sheet items. The Tier I capital in respect of applicable NBFCs (other than NBFC-MFI and IDF-NBFC), at any point of time, **shall not be less than 10%** by March 31, 2017.
- ❖ Applicable NBFCs primarily engaged in **lending against gold jewellery** (such loans comprising 50 percent or more of their financial assets) shall maintain a minimum **Tier I capital of 12%.**

Risk Weights

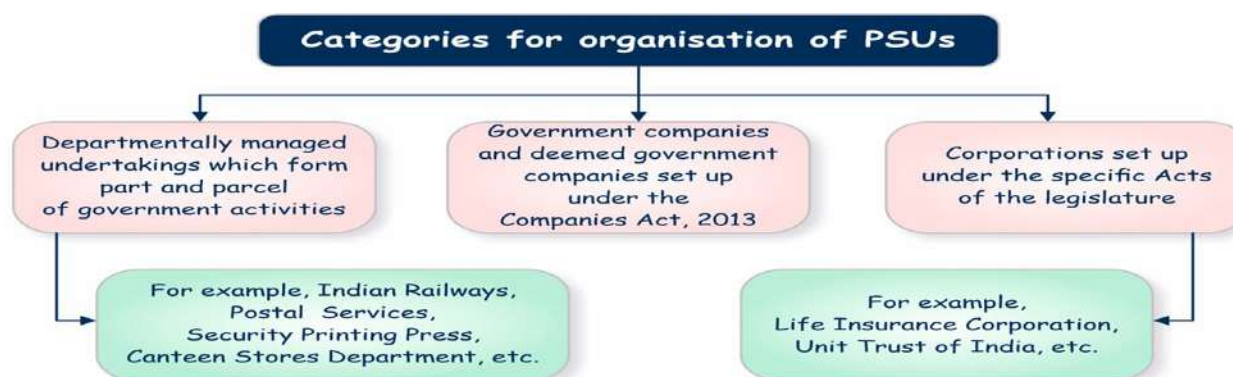
- ❖ In these Directions, degrees of credit risk expressed as percentage weightages have been assigned to balance sheet assets. **For example, percentage weights assigned to Fixed Assets is 100, Cash & Bank Balances is 0, etc.** Hence, the value of each asset / item requires to be multiplied by the relevant risk weights to arrive at risk adjusted value of assets.
- ❖ The aggregate shall be taken into account for reckoning the **minimum capital ratio. Percentage weight of 0** has been assigned to many non-risky assets like- Cash and Bank, All approved securities, Fully secured loans and advances, Loans to employees, TDS deducted, Advance Tax, All CG and SG securities, and CG guarantee claims.
- ❖ **For State Govt claim** { Risk weight percent is 20 if not in default for > 90 days and 100 if in default for > 90 days }. **For all types of Fixed assets, risk weight percent is 100.**
- ❖ For **Bonds of Public Sector Banks, risk weight percent is 20** and For all assets in PPP { Public-Pvt Partnership } Model- **risk weight percent is 50.**

CHAPTER 07

OVERVIEW OF PSU AUDIT

1. INTRODUCTION

Public sector undertakings in India are fundamentally owned or controlled by central government, or any state government or governments, or partly by the central government and one or more state governments.



2. FRAMEWORK FOR CAG AUDIT

In India, the Government audit is performed by an independent constitutional authority, i.e. **Comptroller and Auditor General of India (C&AG)**, through the **Indian Audit and Accounts Department**. The Constitution of India gives a special status to the C&AG and contains provisions to safeguard his independence.

Article 148 to 151 of the Constitution prescribes the role of C&AG as follows:

Article 148	❖ Appointment of C&AG by the President ❖ Special procedure for removal of C&AG, only on the ground of proven misbehaviours or incapacity. ❖ Salary and other conditions of service to be determined by the Parliament.
Article 149	❖ Perform such duties and exercise such powers in relation to the accounts of the Union and States and of any other authority or body as may be pre- scribed by or under any law made by the Parliament. ❖ The C&AG's (Duties, Powers and Conditions of Service) Act, 1971 defines these functions and powers in detail ❖ On the advice of the C&AG, President to prescribe such form in which accounts of the Union and States shall be kept.
Article 150	❖ On the advice of the C&AG, President to prescribe such form in which accounts of the Union and States shall be kept.
Article 151	❖ Audit reports of the C&AG relating to the accounts of the Central/ State Government should be submitted to the President/Governor of the State who shall cause them to be laid before Parliament/State Legislative Assemblies.

Tenure of CAG

- ❖ C&AG shall hold office for a term of six years or upto the age of 65 years, whichever is earlier.

Organisations subject to CSU Audit Includes

- ❖ All the **Union and State Government departments** and offices including the Indian Railways and Posts and Telecommunications.
- ❖ **Public commercial enterprises** controlled by the Union and State governments, i.e. government companies and corporations.
- ❖ **Non-commercial autonomous bodies** and authorities owned or controlled by the Union or the States.
- ❖ Authorities and bodies substantially **financed* from Union or State revenues**.

Meaning of Government Company

Section 2(45) of the Companies Act, 2013, defines a "Government Company" as a company in **which not less than 51% of the paid-up share capital** is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary company of such a Government company.

Types of Committees**A. Public Accounts Committee (PAC)**

It is the duty of the Public Accounts Committee to satisfy itself:

- (i) that the moneys were **disbursed legally** on the service or purpose to which they were applied;
- (ii) that the **expenditure** incurred was **authorised**;
- (iii) that **re-appropriation** has been made in accordance with the provisions made (i.e. distribution of funds)

B. Estimates Committee

The Committee examines the estimates with a view to

- (i) report what economies, improvements in organization, efficiency or administrative reform, consistent with the policy underlying the estimates may be effected;
- (ii) suggest alternative policies;
- (iii) examine whether the money is well laid out within the limit; and
- (iv) suggest the form in which the estimates shall be presented to Parliament.

C. Committee on Public Undertakings (COPU)

The Committee on Public Undertakings exercises the same financial control on the public sector undertakings as the PAC exercises over the functioning of the Government departments. The functions of the Committee are

- (i) to examine the **reports and accounts of public undertakings**.
- (ii) to examine the **reports of the C&AG on public undertakings**.
- (iii) to examine the **autonomy and efficiency of public undertakings** and to see whether they are being managed in accordance with sound business principles and prudent commercial practices.
- (iv) to exercise such other functions vested in the PAC and the Estimates Committee as are not covered above and as may be allotted by the Speaker from time to time.

C&AG's Role:

- (i) His reports generally form the basis of the Committees' working, although they are not precluded from examining issues not brought out in his Reports;
- (ii) He **scrutinises the notes** which the Ministries submit to the Committees and helps the Committees to check the correctness of submissions to the Committees.
- (iv) The Financial Committees present their Report to the **Parliament/ State Legislature** with their observations and recommendations. The various Ministries are required to inform the Committees of

the action taken by them on the recommendations of the Committees and the Committees present **Action Taken Reports** to Parliament / Legislature;

- (v) In respect of those Audit Reports, which could not be discussed in detail by the Committees, written answers are obtained from the Department / Ministry concerned and are sometimes incorporated in the Reports presented to the Parliament / State Legislature.

Role of CAG in Companies Act, 2013

143(5)

In the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, CAG India shall appoint the auditor under of section 139(5) and (7) and direct such auditor the manner in which the accounts of the company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the CAG of India.

143(6)

The Comptroller and Auditor-General of India shall **within sixty days from the date of receipt of the audit report** under sub-section (5) have a right to—

- comment upon or **supplement such audit report**, and
- conduct any supplementary audit** of the company's accounts by himself or by such person or persons as he may authorise in this behalf and such person or persons shall have the same rights and obligations as the auditor who has submitted the report.

Provided that any comments given by the CAG on the report of the supplementary audit conducted by him shall be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

143(7)

The CAG of India may, in case of any company covered under Section 139(5) and (7) , if he considers necessary, by an order, **cause test audit to be conducted of the accounts of such company**.

3. OBJECTIVE AND SCOPE OF PSU AUDIT

- ❖ **Audit of PSUs not constrained to Financial and Compliance Audit:** Audit of public enterprises in India is **not restricted to financial and compliance audit**; it extends also to performance (efficiency, economy and effectiveness with which these operate and fulfil their objectives and goals).
- ❖ **Propriety Audit:** Another aspect of audit relates to questions of propriety. This audit is directed towards an **examination of management decisions** in sales, purchases, contracts, etc. to see whether these have been taken in the best interests of the undertaking and conform to accepted principles of financial propriety.
- ❖ **Comprehensive Audit:** Under comprehensive audit, the C&AG do not really cover again the field which has already been covered. He conducts an appraisal or an efficiency-cum- performance audit. He sees whether the undertakings have fulfilled the objectives for which they have been established, whether value-for-money spent has been obtained, whether the targets have been achieved, etc.
- ❖ **Organisation's Decision to be taken by Competent Authority:** In examining the decisions of a management, the auditor examines that these were taken by the competent authority after examination of all aspects (economic, technological, public interest) on the basis of all the relevant information available at that time.
- ❖ **Helping Government:** Audit is an instrument of accountability. But an equally important purpose of audit of public enterprises in India is to help the Government and the enterprise managements improve their efficiency and effectiveness.
- ❖ **Highlighting Issues of Efficient and Economic Operations:** Financial performance is linked with physical performance and issues of efficient and economic operations and management of resources are highlighted.

- ❖ **Fiscal and Managerial Accountability:** Government audit encompasses two main elements, viz., (a) Fiscal Accountability: It includes audit of provisions of funds, sanctions, compliances and propriety; and (b) Managerial Accountability: It includes audit of efficiency, economy and effectiveness (This is often referred to as efficiency-cum-performance audit).

Note-Efficiency- cum-performance audit, wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater efficiency, economy, and effectiveness.

4. ELEMENTS OF PSU AUDIT

(a) **Parties Involved**

- **The Auditor:** In PSU, the role of auditor is fulfilled by Supreme Audit Institution, India and by its personnel delegated with the task of conducting audits. (CAG) and the Indian Audit and Accounts Department (IAAD) functioning under him, constitute the Supreme Audit Institution of India. Senior functionaries of the SAI representing the CAG in the state are called Accountants General.
- **The Responsible party:** Generally, auditable entities and TCWG of the auditable entities would be the responsible parties. The responsible parties may be responsible for the subject matter information, for managing the subject matter or for addressing recommendations.
- **Intended users:** The intended user is primarily the Parliament or the Legislature which represents the citizens by determining the priorities of public finance, purpose and content of public spending and income.

(b) **Subject Matter, Criteria and Subject Matter Information**

- **Subject matter:** refers to the information, condition or activity that is measured or evaluated against certain criteria.
- **Criteria:** The criteria are the benchmarks used to evaluate the subject matter.
- **Subject matter information:** refers to the outcome of evaluating or measuring the

(c) **Types of Engagement**

- **Attestation engagement:** In attestation engagements, the responsible party measures the subject matter against the criteria and presents the subject matter information, on which the auditor then gathers sufficient and appropriate audit evidence to provide a reasonable basis for expressing a conclusion.
- **Direct Reporting engagement:** It is the auditor who measures or evaluates the subject matter against the criteria.

Points to Remember:

- ❖ Financial audits are always attestation engagements, as they are based on financial information presented by the responsible party.
- ❖ Performance audits and compliance audits are generally direct reporting engagements.

5. GENERAL PRINCIPLES OF PSU AUDIT

A.



B. Principles related to the Audit Process

Planning the Audit	Conducting the Audit	Reporting and follow up
❖ Establish the terms of the audit. ❖ Obtain understanding of the entity. ❖ Conduct Risk assessment of problem analysis ❖ Identify risks of fraud ❖ Develop an audit plan	❖ Perform the planned procedure to obtain audit evidence. ❖ Evaluate audit evidence and draw conclusions.	❖ Prepare a report based on the conclusions reached.

6. TYPES OF PSU AUDIT6.1 Financial Audit

- ❖ Financial audit is primarily concerned to:
 - Express an audit opinion on the financial statements
 - Enhance the degree of confidence of intended users in the financial statements.
- ❖ The C&AG shall express an opinion as to whether the financial statements are prepared, in all material respects in accordance with applicable FRF.

6.2 Compliance Audit

- ❖ Compliance audit is the independent assessment of whether a given subject matter is in compliance with the applicable authorities identified in criteria.
- ❖ Compliance audit is concerned with:
 - Regularity-adherence to laws, regulations and agreements applicable to the entity.
 - Propriety-observations of the general principles governing sound financial management and the ethical conduct of public officials.
- ❖ Perspective of compliance audit:
Compliance Auditing is generally conducted either
 - In relation with the audit of financial statements, or
 - Separately as individual compliance audits, or
 - In combination with performance auditing
- ❖ Compliance Audit Process
 - Step 1- General Principles and Annual Compliance Audit Plan
 - Step 2- Planning Compliance Audits
 - Determine compliance audit objective and scope
 - Develop audit strategy and plan
 - Identify subject matter and criteria
 - Understand the entity and its environment
 - Understand internal control
 - Establish materiality for planning purpose
 - Assess risk

- Plan audit procedures

Step 3- Performing the Audit and Gathering Evidence

Step 4- Evaluating Evidence and Forming Conclusions

Step 5- Reporting

6.3 Propriety Audit

E.L. Kohler has defined the term propriety as "that which meets the tests of public interest, commonly accepted customs, and standards of conduct, and particularly as applied to professional performance, requirements of law, Government regulations and professional codes".

In 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. A transaction may satisfy all the requirements of regularity audit insofar as the

Propriety requires the transactions, and more particularly expenditure, to conform to certain general principles. These principles are:

- that the **expenditure is not prima facie more than the occasion demands** and that every official exercises the same degree of vigilance in respect of expenditure as a person of ordinary prudence would exercise in respect of his own money;
- that the **authority exercises its power of sanctioning expenditure** to pass an order which will not directly or indirectly accrue to its own advantage ;
- that **funds are not utilised for the benefit of a particular person** or group of persons and
- that, apart from the agreed remuneration or reward, no other avenue is kept open to indirectly benefit the management personnel, employees and others.

Functions of Auditor in context of Propriety Audit:

- ❖ see that all expenditure incurred are **properly planned**.
- ❖ see that the size and channels of expenditure are rightful and expected to give maximum results.
- ❖ appraise whether those expenditure are likely to give **optimum result**.
- ❖ see that any **substitute plan of action** can bring about an improvement on current operation and as well as return from capital expenditure.
- ❖ examine the actions and decisions of the management to see that they are conducive to public interests and that they meet the standards of conduct.

Propriety Audit-Problems

- Propriety audit has an **inherent element of subjectivity** because it is very difficult to establish standards of public interest, commonly accepted customs, standards for conduct which are not firm basis for audit evaluation.

6.4 Performance Audit

- ❖ **A performance audit is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function** in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action.
- ❖ According to the guidelines issued by the C&AG, Performance Audits usually address the issues of
 - Economy-** It is minimising the cost of resources {**human, financial and material**} used for an activity, having regard to appropriate quantity, quality and at the best price.
 - Efficiency-** It is the input-output ratio. In the case of public spending, efficiency is achieved when the output is maximised at the minimum of inputs, or input is minimised for any given quantity and quality of output.

Audit efficiency embraces aspects such as whether:

- sound procurement practices are followed;

- b. resources are properly protected and maintained;
 - c. human, financial and other resources are efficiently used;
 - d. optimum amount of resources (staff, equipment, and facilities) are used in producing or delivering the appropriate quantity and quality of goods or services in a timely manner;
 - e. public sector programmes, entities and activities are efficiently managed, regulated, organised and executed;
 - f. efficient operating procedures are used; and
- (iii) **Effectiveness-** It is the extent to which objectives are achieved and the relationship between the intended impact and the actual impact of an activity.

In auditing effectiveness, performance audit may, for instance:

- (a) assess whether the objectives of and the means provided (legal, financial, etc.) for a new or ongoing public sector programme are **proper, consistent, suitable or relevant to the policy**;
- (b) determine the extent to which a program achieves a desired level of program results;
- (c) assess and establish with evidence whether the observed direct or indirect social and economic impacts of a policy are due to implementation of the policy or to other causes;
- (d) identify factors inhibiting **satisfactory performance** or goal-fulfilment;
- (e) assess whether the programme complements, duplicates, overlaps or counteracts other related programmes;
- (f) **Factors to be considered while planning Performance Audit**
 - a. Obtain **understanding of the program** to be audited.
 - b. **Needs of the potential user** of audit report.
 - c. To consider **legal and regulatory requirements**.
 - d. To consider **management controls**.
 - e. To consider **work of other auditors** and auditor's expert.
 - f. To **identify established criteria**.
 - g. To identify **significant findings and recommendations** from previous audit

❖ **Planning for Performance Audit /Steps to be followed while planning the performance Audit**

1. **Understanding the entity/programme**

<u>Sources for understanding the entity</u>	
➤ Documents of the entity	➤ Past Audits
➤ Legislative Documents	➤ Media Coverage
➤ Policy Documents	➤ Special focus groups
➤ Academic or special research	

2. **Defining Objective and Scope of Audit**

3. **Determining the Audit criteria**

<u>Few Sources to obtain the Audit Criteria</u>	
➤ procedure manuals of the entity	➤ criteria used by the same entity or other entities in similar activities or programmes.
➤ policies, standards, directives and guidelines.	➤ independent expert opinion and know how.

4. **Deciding Audit Approach**

Some of the methods which could be used in conducting performance audits include

- (i) **Analysis of Procedures** : review of the systems in place for planning, conducting, checking and monitoring the activity. This would consist of examination of documents such as financial reports, budgets, programme guidelines, procedure manuals, etc.
 - (ii) **Case studies**: A case study is a descriptive analysis of an entity, scheme or a programme. It involves analysis of a particular issue within the context of the whole area under review.
 - (iii) **Use of existing data**: The audit staff should investigate the data held by entity management and by other relevant sources.
 - (iv) **Surveys**: Survey is a method of collecting information from members of a population to assess the interrelation of events and conditions.
 - (v) **Analysis of results**: It requires the auditor to carry out actual output-input analysis to determine the efficiency of the programme.
 - (vi) **Quantitative analysis**: It involves examination of available data relating to financials like earnings, revenue, or data relating to programme implementation like details of beneficiaries etc.
5. **Developing Audit Questionnaire**- Subsequent to designing of audit objectives and determination of audit criteria, the audit team is required to prepare a list of questions to which they would seek answers.
 6. **Assess team competence**
 7. **Assess requirement of outside consultancy and need of experts.**
 8. **Preparing Audit Design Matrix {ADM}**

Specimen of ADM is as given under :

Audit Objective	Audit Questions	Audit Criteria	Evidence	Data Collection and Analysis Method
(1)	(2)	(3)	(4)	(5)

9. **Establish the time table and resources.**
10. **Intimation to audited entities before commencing the work.**

6.5 Comprehensive Audit

- ❖ The areas covered in comprehensive audit naturally vary from enterprise to enterprise depending on the nature of the enterprise, its objectives and operations.
- ❖ The auditors combine aspects of **Financial, Compliance and Performance audits**.
- ❖ Some of the issues examined in Comprehensive Audit are :
 - (a) How does the **overall capital cost of the project** compare with the approved planned costs? Were there any substantial increases and, if so, what are these and whether there is evidence of extravagance or unnecessary expenditure?
 - (b) Have the **planned production or operational outputs** been achieved? Has there been under-utilisation of installed capacity or shortfall in performance and, if so, what has caused it?
 - (c) Has the **planned rate of return been achieved?**
 - (d) Are the systems of **project formulation and execution sound?** Are there inadequacies? What has been the effect on the gestation period and capital cost?
 - (e) Are **cost control measures adequate** and are there inefficiencies, wastages in raw materials consumption, etc.?
 - (f) Are the **purchase policies adequate?** Or have they led to piling up of inventory resulting in redundancy in stores and spares?

CHAPTER 08

INTERNAL AUDIT

MEANING AND SCOPE OF INTERNAL AUDIT**1.1 Definition of Internal Audit**

As defined in Framework Governing Internal Audits, "Internal Audit provides independent assurance on the effectiveness of internal controls and risk management processes to enhance governance and achieve organisational objectives." The internal auditing is **not confined to financial transactions only** and include review of operational activities, underlying internal controls, compliance to applicable laws and regulations.

1.2 Applicability of Internal Audit (Section 138 read with Rule 13)

The following class of companies shall be required to appoint an internal auditor or a firm of internal auditors. **Every listed company and Private and unlisted public companies meeting "any" of the following criteria.**

Criteria	Unlisted Public	Private
Turnover	Two hundred crore rupees or more during the preceding financial year.	Two hundred crore rupees or more during the preceding financial year
Outstanding loans or borrowings from banks or public financial institution	Exceeding one hundred crore rupees or more at any point of time during preceding financial year.	Exceeding one hundred crore rupees or more at any point of time during preceding financial year.
Paid up Share Capital	Fifty crore rupees or more during the preceding financial year.	No share capital criteria
Outstanding deposits	Twenty five crore rupees or more at any point of time during preceding financial year.	No deposits criteria.

Who can be appointed as an Internal Auditor?

- ❖ As per section 138, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in the practice or not), or such other professional as may be decided by the Board to conduct an internal audit of the functions and activities of the company.
- ❖ The internal auditor may or may not be an employee of the company.

1.3 Objective and Scope of Internal Audit

The objectives and scope of Internal Audit Function as per **SA 610, "Using the Work of an Internal Auditor"** may include:

- A. **Monitoring of Internal Controls- Example.** Performing 3 way matching of purchase order , receipt of material and vendor invoices before approving vendor payment.
- B. **Examination of financial and operating information- Example.** Internal Audit of Sales records, delivery records , sales commission for identifying correctness of revenue recorded.
- C. **Review of operating activities-Example.** Reviewing Inventory Management Activities and appropriate handling to prevent damages.
- D. **Review of Compliance with Laws and Regulation- Example.** Review of Compliance with New applicable Tax Regime. He is responsible for auditing the compliance framework and not managing it. Similarly, he does not accept compliance related risks like directly engaging with regulator.
- E. **Risk Management- -Example.** Evaluation and Management of Risk Exposure for complex financial transactions.

- F. **Governance- Example.** Assessment of Governance Process in the accomplishment of objectives on values and ethics.

Additionally, The scope of internal auditor's work should also include a review of-

(i) **Review of Internal Control System and Procedures**

- (a) The review of internal control system and procedures involves assessing the design and operational efficiency and effectiveness of the internal control system to strengthen the overall internal control environment of the entity. The objective to review is to minimise the overall residual risk by suggesting the appropriate controls to reduce the inherent risk.
- (b) Internal Control System should be reviewed considering the limitations of internal controls, i.e., cost-benefit comparison, human errors, collusion, and abuse by process owners.

Example- Review of three-way matching internal control involves matching of Purchase Orders, Goods Receipt Notes and Invoice to ensure all the ordered quantity of the intended goods have been received and invoiced accordingly. The failure of this internal control may involve over-invoicing, over- payment, non-receipt, or under-receipt of goods.

Example- The establishment of a separate credit control department would not be justified if the objective of reducing credit risk and minimising debt recovery period could be met through controls in-built in the accounting and sales systems, especially in smaller and medium-sized concerns.

(ii) **Review of Custodianship and Safeguarding of Assets**

- This involves verifying the existence of the assets.
- The internal auditor should review the segregation of duties is in place.
- The internal auditor should review the control systems to ensure that all assets are accounted for fully. He should review the means used for safeguarding assets against losses **e.g. fire, improper or negligent activity, theft and illegal acts**, etc.

(iii) **Review of Compliance with Policies, Plans, Procedures and Regulations -** It is essential that the various functional segments of an enterprise comply with the relevant policies, plans, procedures, laws and regulations so that the operations are carried out in a coordinated manner.

(iv) **Review of Relevance and Reliability of Information**

- The internal auditor should review the information systems to evaluate the reliability and integrity of financial and operating information given to management and to external agencies such as governmental bodies, investors, trade organisations, labour unions, etc.
- The Internal Auditor should examine the accuracy and reliability of financial and operational records.

(v) **Review of the Organisation Structure-** The internal auditor should conduct an appraisal of the organisation structure to ascertain whether it is in harmony with the objectives of the enterprise and whether the assignment of responsibilities is in consonance therewith.

- ❑ He should review the manner in which the activities of the enterprise are grouped for managerial control.
- ❑ The internal auditor should examine the organisation chart to find out whether the structure is simple and economical and that no function enjoys an undue dominance over the others.
- ❑ He should particularly see that the responsibilities of managerial staff at headquarters do not overlap with those of chief executives at operating units.
- ❑ The internal auditor should examine the reasonableness of the span of control of each executive (the number of subordinates that an executive controls). He should examine whether there is a unity of command i.e., whether each person reports only to one superior.
- ❑ Where dual responsibilities cannot be avoided, the primary one should be specified and the specific responsibility to each senior fixed. This must be made known to all concerned.

(vi) **Review the Utilisation of Resources-** identifying the facilities which are under-utilized is an important function of the internal auditor.

For example-, it may consist of under-utilized machines, unoccupied storage space, huge cash or bank balances, idle manpower, etc. While commenting on staffing, the internal auditor should pay special attention to non-productive work being performed. This would require an inquiry into the job descriptions of employees combined with an intelligent observation of the work being done

- (vii) **Review of Accomplishment of Goals and Objectives** - The internal auditor should review the overall objectives of the enterprise to evaluate whether they are clearly stated and are attainable.

1.4 Critical Activities performed by the Auditor to achieve Internal Audit Function

- Define the **overall plan, scope and methodology** of the Internal Audit Function on a periodic basis
- Oversee and monitor various audit assignments**, their proper planning, execution, reporting of findings and subsequent closure of reported observations.
- Plan, acquire, engage and review** the performance, training and development of professional staff, talent and other resources to achieve its objectives
- Identify, source, engage and manage** external experts and technical solutions, if required.
- Communicate and engage** with all key stakeholders regarding progress and achievement of objectives
- Develop and maintain** a quality evaluation and improvement program

2. INTEGRITY, OBJECTIVITY AND INDEPENDENCE OF INTERNAL AUDITOR

- The Internal Auditor shall be **free from any undue influences** which force him to deviate from the truth. This independence shall be **not only in mind but also in appearance**.
- The Internal Auditor shall be **honest, truthful and be a person of high integrity**. He shall operate in a highly professional manner and seen to be fair in all his dealings. He shall avoid all conflicts of interest and not seek to derive any undue personal benefit or advantage from his position.
- The Internal Auditor shall conduct his work in a **highly objective manner**, especially in gathering and evaluation of facts and evidence. He shall **not allow prejudice or bias** to override his objectivity, especially in arriving at conclusions or reporting his opinion.

3. QUALITIES OF INTERNAL AUDITOR

- The internal auditor should have the **special expertise** necessary for evaluating management control systems, especially financial and accounting controls.
- The internal auditor must have **accounting and financial expertise** to be able to discharge his duties.
- The internal auditor is also expected to evaluate both financial and operational controls. This requires a **good knowledge of the operations of the organization, technology and commercial practices of the enterprise**.
- He should also have a **good knowledge of commerce, laws, taxation, cost accounting, economics, quantitative methods and EDP systems**
- An understanding of the **accounting software, ERP system** and other applications being used by the organization along with the knowledge of the basic controls related to Information Technology.
- An understanding of **management principles and techniques** is another essential qualification of an internal auditor as also the ability to deal with people.
- By his conduct the internal auditor should provide an assurance to the management that the confidentiality of such information would be maintained.

4. STEPS INVOLVED IN PERFORMING INTERNAL AUDIT ENGAGEMENT

STEP 1-Obtaining knowing of the Business and its Environment

- ❖ Internal Auditor must **conduct meetings with key stakeholders**, Board of Directors and Key management personals to obtain understanding of the organization's business environment, its operations, organization's vision, mission and top management's expectations from the audit functions.
- ❖ Internal auditor must **obtain understanding of various business documents** - Standard Operating Procedures and Financial Statement Etc.
- ❖ Internal auditor must also **obtain understanding of the underlying Information Technology** landscape, various applications and ERP systems of the organization and Management Information System of the Organization.
- ❖ Internal auditor must also **obtain understanding of the regulatory landscape** and various laws and regulations that are applicable to the organization

STEP 2-Perform Audit Planning

- ❖ Internal Auditor must plan the audit engagement as per the Standard on Internal Audit (SIA) 310, **Planning the Internal Audit Assignment**. Audit scope must be approved by Audit Committee and Board of Directors.
- ❖ Once approved, Internal Auditor must **share detailed Audit Plan with the key managerial personnels** and plan in advance the detailed schedule of the Internal Audit to be conducted.
- ❖ Internal Auditor must conduct the **opening meeting with key stakeholders** before start of audit engagement and share details of Information and System Access required to perform the audit.
- ❖ **Detailed work plan** must be prepared by the audit managers and approved with Head of Internal Audit / Chief Internal Auditor.

STEP 3-Gather required Information

- ❖ Internal Auditor must obtain the required information and perform checks to ensure correctness and integrity of information received. To the extent possible, Internal Auditor must obtain the information directly from the source.

STEP 4-Performing Audit Checks

- ❖ Internal Auditor should **collate all data and perform analytical procedures** to identify key trends and outliers. Analytical procedures should be performed in accordance with the Standard on Internal Audit (SIA) 6, Analytical Procedures
- ❖ Wherever needed, Internal Auditor must **select the sample** in accordance with Standard on Internal Audit (SIA) 5, Sampling.
- ❖ Internal Auditor must ensure **adequate evidences** must be collected and stores in accordance to Standard on Internal Audit (SIA) 320, Internal Audit Evidence
- ❖ Internal Auditor must prepare detailed listed of the **identified audit issues and controls gaps. Interim reports** may be issued after proper review of the work performed as per the Standard on Internal Audit (SIA) 350, Review and Supervision of Audit Assignments.
- ❖ Adequate document of the **internal audit work papers** needs to be ensured as per Standard on Internal Audit (SIA) 330, Internal Audit Documentation

STEP 5-Reporting of Internal Audit Issues

- ❖ Internal Auditor must prepare a **draft report of Internal Audit** issues comprising of the business process/ function reviewed as per scope, detailed audit coverage and exclusions, if any, audit period covered during the audit, summary along with detailed issues over the gaps noted along with implication of the business and recommendation to mitigate the identified gaps.
- ❖ **Management Action Plan** should be agreed along with responsibility of action and timelines for actions.
- ❖ Internal Auditor must also **review the status of actions taken by the management** against the actions agreed during previous audits and report the status of such follow up in the audit report.
- ❖ Internal Auditor should thereafter **circulate Final Report** and presentation his findings to the Audit Committee. 5. Internal Audit Report

REPORTING AS PER SIA 370 "Reporting Results "**Reporting of internal audit results is generally undertaken in two stages-**

- A. **At the end of a particular audit assignment**, an **"Internal Audit Report"** covering a specific area, function or part of the entity is prepared by the Internal Auditor highlighting key observations arising from those assignments.
- B. **Further, on a periodic basis, at the close of a plan period**, a comprehensive report of all the internal audit activities covering the entity and the plan period is prepared by the Chief Internal Auditor (or the Engagement partner, in case of external service provider).

This Standard on Internal Audit (SIA) deals with the internal auditor's responsibility to issue only the first type of reports, the Internal Audit Report pertaining to specific audit assignments and not to the periodic (e.g. Quarterly) reporting for the whole entity as per the Annual/Quarterly audit plan.

5.1 Basis of Internal Audit Report

- ❖ Each Internal audit report is prepared on the basis of the audit procedures conducted and the analysis of the audit evidence gathered. Conclusions reached shall be based on all the findings rather than on a few deviations or issues noted.

5.2 Conducted in Accordance with SIA's

- ❖ The internal audit is conducted in compliance with the Standards of Internal Audit, (within the Framework governing Internal Audits)
- ❖ The internal audit report shall include a statement confirming that "the internal audit was conducted in accordance with the Standards of Internal Audit issued by the Institute of Chartered Accountants of India".

5.3 Contents of Internal Audit Report

- ❖ Manner in which the internal audit report is drafted and presented is a matter of professional judgment
- ❖ **No particular format is prescribed in SIA's**
- ❖ Where some level of assurance is being provided, the form and content of the report shall be as per SIA 380, "Issuing Assurance Reports.
- ❖ **A typical internal audit report should include the following {SIA 380}**
 - Audit period Covered
 - Executive Summary
 - Summary of the critical findings
 - Detailed audit findings with elaboration on business impact and root cause of such issues
 - Rating of the highlighted issues (E.g High / Medium / Low) in accordance to the rating criteria approved by Audit Committee
 - Audit recommendation to improve control environment and address the highlighted finding
 - Response received from the responsible functional authority containing action plan and target timelines for action.

6. FOLLOW UP

- ❖ As per SIA 390 Monitoring and Reporting of Prior Audit Issues, the Chief Internal Auditor is responsible for continuously monitoring the closure of prior audit issues through timely implementation of action plans included in past audits.
- ❖ In monitoring and reporting of prior audit issues, the responsibility of the Internal Auditor is usually in the form of an **"Action Taken Report (ATR) of previous audits"**.
- ❖ The internal auditor should review whether **follow-up action is taken by the management on the basis of his report**. If no action is taken within a reasonable time he should draw the management's

attention to it. Where the management has not acted upon his suggestions or not implemented his recommendations, the internal auditor should ascertain the reasons thereof.

6.1 CONTENTS OF ACTION TAKEN REPORT

Typical Action Taken Report may include the following:

- ❖ Reference to the previous audit reporting containing the reported issues
- ❖ Implementation Action agreed by the management along with target implementation date
- ❖ Status of action taken by management. The same may be classified under Implemented / Not Implemented
- ❖ Residual risk and rating for any unimplemented action
- ❖ Audit findings not implemented for long period of time
- ❖ Any critical audit finding that require immediate action for action or implementation

7. RELATIONSHIP BETWEEN INTERNAL AND EXTERNAL AUDITORS

- ❖ The work done by the internal auditor has an important bearing on the work performed by the statutory auditor as evaluation done by the internal auditor in respect of internal controls, reliability of financial information, verification of assets, etc. is also required to be done by the external auditor. The function of an internal auditor is an integral part of the system of internal control.
- ❖ It is obligatory for a statutory auditor to examine the scope and effectiveness of the work carried out by the internal auditor. For the purpose, he should examine the Internal Audit Department of the organisation, the strength of the internal audit staff, their qualification and their powers.
- ❖ The **extent of independence exhibited** by the internal auditor in the discharge of his duties and his status in the organisation are important factors for determining the effectiveness of his audit.
- ❖ The external auditor should, as part of his audit, **evaluate the internal audit function** to the extent he considers that it will be relevant in determining the nature, timing and extent of his compliance and substantive procedures. Depending upon such evaluation, the external auditor may be able to adopt less extensive procedures than would otherwise be required.

7.1 Evaluation of Internal Audit Functions by External Auditor

The external auditor's general evaluation of the internal audit function will assist him in determining the extent to which he can place reliance upon the work of the internal auditor. The external auditor should document his evaluation and conclusions in this respect. The important aspects to be considered in this context are:

- (a) **Organisational Status** - Whether internal audit is undertaken by an outside agency or by an internal audit department within the entity itself, the internal auditor reports to the management.
- (b) **Scope of Function** - The external auditor should ascertain the nature and depth of coverage of the assignment which the internal auditor discharges for management. He should also ascertain to what extent the management considers, and where appropriate, acts upon internal audit recommendations.
- (c) **Technical Competence** - The external auditor should ascertain that internal audit work is performed by persons having adequate technical training and proficiency. This may be accomplished by reviewing the experience and professional qualifications of the persons undertaking the internal audit work.
- (d) **Due Professional Care** - The external auditor should ascertain whether internal audit work appears to be properly planned, supervised, reviewed and documented. An example of the exercise of due professional care by the internal auditor is the existence of adequate audit manuals, audit programmes and working papers.

7.2 INTERNAL AUDIT VS EXTERNAL AUDIT

BASIS FOR COMPARISON	INTERNAL AUDIT	EXTERNAL AUDIT
1. Performed by	Internal audit is performed by an independent internal auditing	It is an audit function performed by the independent body which is not a part of the organization.

	function within the organisation or by external body	
<u>2. Examination</u>	The Internal auditor examines the adequacy of operational controls of the organisation	The External auditor examines the Accuracy and Validity of Financial Statements
<u>3. Appointment</u>	The Internal auditor is appointed by the Audit Committee or Board of Directors.	The External auditor is appointed by the Members.
<u>4. Users of Report</u>	Generally, internal audit report is used by top Management and referred by statutory auditor	The user of external audit report is Stakeholders
<u>5. Reporting</u>	Internal Audit Report provides weakness in internal controls and effectiveness of the operational activities.	The opinion is provided on the truthfulness and fairness of the financial statement of the company
<u>6. Status of Auditor</u>	The Internal auditor could be an employee of the company.	The External auditor is mandatorily not an employee of the company.

8. INTERNAL AUDIT AS A MANAGEMENT FUNCTION

- ❖ Management is a process by which the affairs of an enterprise are conducted in such a manner that its goals and objectives are attained through optimum utilisation of all available resources, within the legal, social, economic and environmental constraints.
- ❖ Management functioning is a set of five general functions: **planning, organizing, staffing, directing and controlling.**
- ❖ As per the revised definition of the term 'Internal Audit' as per para 3 of the ICAI's Framework Governing Internal Audits, "Internal audit provides independent assurance on the effectiveness of internal controls and risk management processes to enhance governance and achieve organisational objectives".
- ❖ Accordingly, Internal Auditor is expected to **critically evaluate the management activities** and advise them on the areas of improving internal controls and manage business and operational risks effectively by recommending appropriate mitigating controls.
- ❖ Internal Audit is an important element of **management controlling function**, it helps management to set up appropriate systems and processes in place to mitigate risk while remaining independent to the operations.
- ❖ Internal Auditor is expected **to report on the identified gaps and areas of weak internal control**, further he is expected to identify the root cause of the problems and suggest appropriate mitigating steps and strengthen the internal controls environment of the organization.
- ❖ Accordingly, Internal Audit is seen as an important function that helps management to achieve organization goals and perform its function in an orderly manner.

9. AUDIT TRAIL

1. **Audit Trail (or Edit Log) is a visible trail of evidence** enabling one to trace information contained in statements or reports back to the original input source. Audit trails are a chronological record of the changes that have been made to the data. Any change to data including creating new data, updating or deleting data that must be recorded.
2. Records maintained as audit trail may include the following information:
 - **when** changes were made i.e., date and time (timestamp)
 - **who** made the change i.e., User Id
 - **what** data was changed i.e., data/transaction reference; success/failure

3. Audit trails may be enabled at the accounting software level depending on the features available in such software.
4. In order to demonstrate that the audit trail feature was functional, operated and was not disabled, a company would have to design and implement specific internal controls (predominantly IT controls) which in turn, would be evaluated by the auditors, as appropriate.

An illustrative list of internal controls which may be required to be implemented and operated are given below:

- Controls to ensure that the audit trail feature has not been disabled or deactivated.
- Controls to ensure that User IDs are assigned to each individual and that User IDs are not shared.
- Controls to ensure that changes to the configurations of the audit trail are authorized and logs of such changes are maintained.
- Controls to ensure that access to the audit trail (and backups) is disabled or restricted and access logs, whenever the audit trails have been accessed, are maintained.
- Controls to ensure that periodic backups of the audit trails are taken and archived as per the statutory period specified under the provisions of the Act.

CHAPTER 09

DUE DILIGENCE, INVESTIGATION & FORENSIC AUDIT

PART A - DUE DILIGENCE

1. DUE DILIGENCE REVIEW

- ❖ Due diligence is a process of investigation, performed by investors, into the details of a potential investment such as **an examination of operations and management and the verification of material facts**. Due Diligence may also be required to be performed in cases of **corporate restructuring, venture capital financing, lending, leveraged buyouts, public offerings, disinvestment, corporatisation, etc.**
- ❖ **Due diligence is different from audit.** Audit is an independent examination and evaluation of the financial statements on an organization with a view to express an opinion thereon.

Whereas due diligence refers to an examination of a potential investment to confirm all material facts of the prospective business opportunity. It involves **review of financial and non-financial records** as deemed relevant and material.

2. IMPORTANCE OF DUE DILIGENCE

Reasons for Due Diligence

- ❖ To confirm that the business is what it appears to be;
- ❖ To identify potential 'deal killer' defects in the target company and avoid a bad business transaction;
- ❖ To gain information that will be useful for valuing assets, defining representations and warranties, and/or negotiating price concessions; and to verify that the transaction complies with investment or acquisition criteria.

3. CLASSIFICATION OF DUE DILIGENCE

- (i) **Commercial/Operational Due Diligence-** evaluation from commercial, strategic and operational perspectives. For example, whether proposed merger would create operational synergies.
- (ii) **Financial Due Diligence -** It involves analysis of the books of accounts and other information pertaining to financial matters of the entity. It should be performed after completion of commercial due diligence.
- (iii) **Tax Due Diligence-** The accountant has to look at the tax effect of the merger or acquisition.
- (iv) **Information Systems Due Diligence -** It pertains to all computer systems and related matter of the entity.
- (v) **Legal Due Diligence -** This may be required where legal aspects of functioning of the entity are reviewed.
- (vi) **Environmental Due Diligence -** It is carried out to study the entity's environment, its flexibility and adaptiveness to the acquirer entity.
- (vii) **Personnel Due Diligence -** It is carried out to ascertain that the entity's personnel policies are in line or can be changed to suit the requirements of the restructuring.

4. SCOPE OF FINANCIAL DUE DILIGENCE

- (a) **Brief history of the target company and background of its promoter**

The accountant should begin the financial due diligence review by

- Looking into the **history of the company** and the **background of the promoters**.
- The details of how the company was set up and who were the original promoters.

- Reveal its **turning points, survival strategies** adopted by the target company from time to time, the market share enjoyed by the target company and changes therein, product life cycle and adequacy of resources.
 - The accountant should make relevant enquiries about the history of **target's business products, markets, suppliers, expenses, operations.**
- (b) **Accounting policies**
- The accountant should study the accounting policies being followed by the target company and ascertain whether any **accounting policy is inappropriate.**
 - The accountant should also see the effects of the **recent changes** in the accounting policies.
- (c) **Review of financial statements**
- Examine whether the financial statements of the target company have been prepared in accordance with the statute governing the target company, Framework for Preparation and Presentation of the Financial Statements and the relevant Accounting Standards.
 - The accountant should review the **operating results of the target company** in great detail.
 - Consider the presence of an **extraordinary item of income or expense** that might have affected the operating results of the target company.
 - Compare the **actual figures with the budgeted figures** for the period under review and those of the previous accounting period.
 - **Look specifically for any hidden liabilities or over-valued assets.**
 - Pay particular attention to the **valuation of intangible assets.**
- (d) **Taxation**
- Check if the company is regular in paying various taxes to the Government.
 - The accountant has to also look at the **tax effects of the merger or acquisition.**
- (e) **Cash flow**
- A review of **historical cash flows** and their pattern would reflect the cash generating abilities of the target company.
 - It is important to know if the company is able to meet its cash requirements through internal accruals or does it have to seek external help from time to time.
- (f) **Financial Projection**
- The accountant should obtain from the target company the **projections for the next five years** with detailed assumptions and workings.
 - In case he feels the projections provided by the target company are not achievable or aggressive he has to mention this in his report.
- (g) **Management and Employees**
- **Status of work force, staff and their demands** etc. excess work force and implications, pay package, employee benefit like PF, gratuity, E.S.I. leave encashment and superannuation etc. to be taken care.
 - Identify **the key employees** who will not continue after the acquisition either because they are not willing to continue or because they are to be transferred to another company within the 'group' of the target company.
- (h) **Statutory Compliance**
- Make a list of laws/ statutes that are applicable to the entity as well as to make a checklist of compliance required from the company under those laws.
 - **Quantify punitive charges applicable for non-compliances in financial results of the company.**

5. HOW TO CONDUCT DUE DILIGENCE

- ❖ Start with an open mind.
- ❖ Get the best team of people (In house or Hire Expert Professionals).
- ❖ Get help in all areas like finance, tax accounting, legal, marketing, technology, and any others relevant to the assignment so that you get a **360-degree view of the acquisition candidate**.
- ❖ Talk to customers, suppliers, business partners, and employees are great resources.
- ❖ Take a risk management approach. So, while you want to do your research, you also want to make sure that you do not antagonise the team of people of the target company by bogging them down with loads of questions.
- ❖ Prepare a comprehensive report detailing the compliances and substantive risks / issues.

6. CONTENTS OF DUE DILIGENCE REPORT

- ❖ **Executive Summary, Introduction, Background** of Target company, **Objective** of DD.
- ❖ Terms of Reference and Scope of Verification, Brief history of the company including **shareholding pattern**, Assessment of management structure.
- ❖ Assessment of **financial liabilities** with special emphasis on Interlocking investments and financial obligations with group/associates' companies, amounts receivables subject to litigation, any other likely liability which is not provided for in the books of account.
- ❖ Assessment of **valuation of assets** including comments on properties, terms of leases, lien and encumbrances including status of charges, liens, mortgages, assets and properties of the company.
- ❖ Assessment of **operating results**.
- ❖ Assessment of **taxation and statutory liabilities**.
- ❖ Assessment of **possible liabilities** on account of **litigation and legal proceedings** against the company and suggestion on ways and means including affidavits, indemnities, to be executed to cover unforeseen and undetected contingent liabilities.
- ❖ Assessment of **net worth**.
- ❖ **SWOT Analysis**.
- ❖ Comments on **future projection**.
- ❖ Suggestions on various aspects to be taken care of before and after the proposed merger / acquisition.

7. MAJOR AREAS TO EXAMINE OVERVALUED ASSETS AND HIDDEN LIABILITIES

Hidden Liabilities	Overvalued Assets
❖ Review Contingent Liabilities not shown in books. ❖ Review Letter of Comforts. ❖ Pending sales tax assessments. ❖ Tax Liabilities under direct and indirect tax laws. ❖ Warranty claims, other liability claims, Pending litigations, liquidated damages for late delivery (Dominos). ❖ Future Lease Liabilities (AS- 19). ❖ Third party claims. ❖ Labour claims under negotiation.	❖ Litigated assets and property. ❖ Intangibles of no value. ❖ Investments valued at cost where NRV is much low. ❖ Investments carrying a low rate of return. ❖ Capitalization of foreign exchange earnings. ❖ Impairment of Assets not recognized. ❖ Obsolete P&M shown at higher value. ❖ Obsolete and slow-moving inventory valued above NRV. ❖ Uncollected/Uncollectable receivables.

PART B-INVESTIGATION

8. AUDIT VS INVESTIGATION

Basis of Difference	Investigation	Audit
(i) Objective	An investigation aims at establishing a fact or a happening or at assessing a particular situation.	The main objective of an audit is to verify whether the financial statements display a true and fair view of the state of affairs and the working results of an entity.
(ii) Scope	The scope of investigation may be governed by statute or it may be non- statutory.	The scope of audit is wide and in case of statutory audit the scope of work is determined by the provisions of relevant law.
(iii) Periodicity	The work is not limited by rigid time frame. It may cover several years, as the outcome of the same is not certain.	The audit is carried on either quarterly, half-yearly or yearly.
(iv) Nature	Requires a detailed study and examination of facts and figures. Investigation is voluntary in nature.	Involves tests checking or sample technique to draw evidences for forming a judgement and expression of opinion. It is mandatory for companies.
(v) Inherent Limitations	No inherent limitation owing to its nature of engagement.	Audit suffers from inherent limitation.
(vi) Evidence	It seeks conclusive evidence.	Audit is mainly concerned with prima- facie evidence.

9. STEPS INVOLVED IN INVESTIGATION

Step 1 - Determination of Objectives and Establishment of Scope of Investigation

- ❖ At the stage of acceptance of the assignment, the investigator should be absolutely clear about what is sought to be achieved by the investigation.
- ❖ Purpose of the investigation should be borne in mind while determining the period which an investigation should cover.

Step 2 - Formulating the Investigation Program

The investigation programme should be drawn up having regard to :

- The **nature** of the business.
- The **structure** of business organization.
- The instructions from the client embodying the **objectives and scope of work**.
- The consequent **scope and depth** of investigation.
- The necessity to extend the investigation into books and records belonging to others.
- Concentrate on relevant areas.

Step 3 - Collection of Evidence

- ❖ The investigator would be gathering relevant evidence connected with the matters to be investigated.
- ❖ The investigator should look for the most convincing evidence and unlike the auditor he is not to restrict himself to prima facie evidence ordinarily available.

- ❖ The investigating accountant can take help of external experts/ persons like, related parties outside the organization, valuation experts etc. to obtain specific evidence.

Step 4 - Analysis and Interpretation of Findings

- ❖ Careful analysis and correlation of facts and figures will be necessary before the investigator can reach his conclusion.
- ❖ The conclusion should be well reasoned, backed by established facts and evidenced by proper records/ data.

Step 5 - Reporting of findings

- ❖ Investigation report is submitted and addressed to the party at whose instance the investigation has been carried out.
- ❖ **The important issues to be kept in mind by the investigator while preparing his report are as follows :**
 - The report should not contain anything which is not relevant either to highlight the nature of the investigation or the final outcome thereof.
 - Every word or expression used should be properly considered.
 - Relevant facts and conclusions** should be properly linked with evidence.
 - Bases and assumptions** made should be explicitly stated. Investigation is a fact-finding assignment, assumptions should be made only when it is unavoidably necessary.
 - The report should clearly spell out the **nature and objective of the assignment** accepted its scope and limitations, if any.

10. SPECIAL ISSUES IN INVESTIGATION

- Whether an investigator is required to undertake a cent per cent verification approach or whether he can adopt selective verification-**
 - The answer to this question depends on the **exact circumstances of the case** under investigation. If the investigator has to establish the amount of cash defalcated by the cashier, he has probably no option but to carefully examine all the cash vouchers and related records.
 - On the other hand, if he is to arrive at the profitability of a concern, he may verify constituent transactions on a selective basis taking extreme care to see that no material transaction that affects profit has remained concealed from his eyes.
- Whether the investigator can put reliance on the already audited statement of account-**
 - If the investigation has been launched because of some doubt in the audited statement of account, no question of reliance on the audited statement of account arises.
 - However, if the investigator has been requested to establish value of a business or a share or the amount of goodwill payable by an incoming partner, ordinarily the investigator would be entitled to put reliance on audited materials made available to him.
- Whether an investigator necessarily requires assistance of expert -** Get the written general consent of his client, to refer special matters for views of different experts at the beginning of investigation and he should settle the question of costs for obtaining the views and other related implications.
- Investigation out of disputes and conflicting claims—**
 - Cases for investigation sometimes arise out of disputes and conflicting claims.
 - It is needless to emphasise that the investigator should remain above disputes or conflicting claims and be alert to the possibilities of the information or documents made available to him to be prejudiced.
 - For example, A seller of a business or controlling shares may request him to see that he gets the most favourable price. Similarly, if he is appointed by the buyer, he may be requested to deliberately depress the value.

5. **Basis of opinion of an investor** - The investigator should refrain from issuing speculative opinion. He should confine his opinion to the established facts and nothing more.
6. **Whether an investigator can make futuristic statements** - Even if the appointing authority is willing to obtain a futuristic statement, the investigator should refuse to be futuristic.
7. **Whether to retain working papers or not** - Another important precaution is that the investigating accountant should retain in his files full notes of the work carried out, copies of schedules and all working papers, annexures, facts, figures, record of conversations and the like. Also, the working papers should link up the figures as shown by the books of business with the final figures produced by the investigating accountant.

11. SPECIAL ISSUES IN CONNECTION WITH BUSINESS INVESTIGATION

(a) **Studying the overall picture**

In such a business investigation, it is of utmost importance first to have an overall picture of the position of the business which is being investigated before the details are gone into.

(b) **Statement of Profit and Loss**

To study the Statement of Profit and Loss of a concern, it is necessary to consider each item, included therein, in relation to the corresponding items in the Statement of Profit and Loss of the previous years.

The trend of these ratios should be examined and, if there is a wide divergence in them, an explanation for the same should be sought. **In the preparation of the summary attention should also be paid to the following matters-**

Turnover - The figures of sales should be broken down between the various products sold to show variations in turnover of individual products from year to year. In this way, it would be possible to find out the products the sales of which have been increasing and those the sales of which have been falling.

Wage structure - The method of computing wages and the rates of wages should be examined.

Depreciation and Maintenance - The charge on account of depreciation and maintenance of machinery and other assets included in the accounts of different years should be compared to verify that depreciation has been provided from year to year on a consistent basis and that it is adequate.

Managerial Remuneration - It should be verified that the remuneration payable to various members of managerial personnel is not excessive in relation to the profits of the business after taking into account the time devoted by each of them. Also requirement of relevant section of Companies Act, 2013 is to be seen.

Exceptional and non-recurring items - adjustments are to be made in respect of exceptional items which do not recur from year to year or can be considered exceptional having regard to their materiality or periodicity.

Repairs and maintenance - It is one of the recurring expenses of a business. it would be the duty of the investigating accountant to scrutinise this head thoroughly to establish correct and normal charge for repairs.

Unusual year - A company's record of profitability may show a trend of increasing or decreasing profit or loss or it may be highly erratic and fluctuating.

(c) **Balance Sheets**

➤ **Fixed Assets**

- Obtain **age analysis** of various items of fixed assets.
- **Title deeds** should be verified to ascertain the extent of enterprise's ownership in such assets, like land and building jointly owned by two or more companies or their subsidiaries.
- In addition, from a study of **the maintenance expenses** incurred from year to year, it should be judged whether the assets have been properly maintained.
- Investigator has to assure whether assets whose recoverable amount is less than carrying amount are impaired and requirement of AS 28, "Impairment of Asset", has been complied.

➤ **Investments**

- Investments should be broadly classified into **long term investments and current investments.**
- Current investments are valued **on the basis of lower of cost and fair value** determined either on an individual investment basis or by category of investment but not on an overall basis.
- **Long-term investments are usually carried at cost.** However, when there is a permanent decline in the value of long-term investments, the carrying amount should be reduced to recognise the decline. The carrying amount of long-term investments is determined on an individual investment basis.

➤ **Inventories**

- It should be seen that inventories have been valued consistently and that the basis of valuation was such that the value placed on inventories did not include any element of profit.
- Examine whether valuation is as per **AS 2.**

➤ **Trade Receivables**

- Assess Whether provision for bad debts have been made in the years in which the relevant sales took place instead of in the year in which they have been written off.
- Determine Debtors to Sales Ratio and do age analysis.

- (d) **Interpretation of figures - Fixed Assets** - The amount of capital expenditure which would be necessary in the future for the continuation of the business, in its existing stage, should be assessed.

Other Considerations

Turnover - In assessing the turnover which the business would be able to maintain in the future, the following factors should be taken into account:

- Trend** : Whether in the past sales have been increasing consistently or they have been fluctuating. A proper study of this phenomenon should be made.
- Marketability** : Is it possible to extend the sales into new markets or that these have been fully exploited? Product wise estimation should be made.
- Political and economic considerations** : Are the policies pursued by the Government likely to promote the extension of the market for goods to other countries? Whether the sales in the home market are likely to increase or decrease as a result of various emerging economic trends?
- Competition** : What is the likely effect on the business if other manufacturers enter the same field or if products which would sell in competition are placed on the market at cheaper price? Is the demand for competing products increasing? Is the company's share in the total trade constant or has it been fluctuating?

Working Capital - In making assessment of the working capital requirements in the future, the following matters should be taken into account:

- Has the ratio of inventory to turnover been increasing and if so, is it a continuing or only a temporary trend?
- Are the trade payables being paid promptly or is there a backlog which will have to be dealt with?
- What will be the effect on inventory, trade receivables and trade payables, if the turnover is increased or if new products are introduced?

12. TYPES OF INVESTIGATION

- Statutory-** By an inspector under Sections 210, 212, 213 and 216 of the Companies Act, 2013.
- Non-Statutory-** These are listed as under:

- Investigation on behalf of an incoming partner.

- | | |
|-----|---|
| (b) | Investigation for valuation of shares in private companies. |
| (c) | Investigation on behalf of a bank proposing to advance loan to a company. |
| (d) | Investigation of frauds. |
| (e) | Investigation on behalf of an individual or a firm proposing to buy a business. |
| (f) | Investigation in connection with review of profit/financial forecast. |

12.1 Investigation on behalf of an Incoming Partner

Primarily, an incoming partner would be interested to know whether the terms offered to him are reasonable having regard to the nature of the business, profit records, capital contribution, personal capability of the existing partners, socio-economic setting, etc.

Broadly, the steps involved are the following :

- Ascertainment of the history of the **inception and growth** of the firm.
- Study of the **provisions of the deed of partnership**, particularly for composition of partners, their capital contribution, drawing rights, retirement benefits, job allocation, financial management, goodwill, etc
- Scrutiny of the record of profitability** of the firm's business over a suitable number of years, with usual adjustments that are necessary in ascertaining the true record of business profits.
- Examination of the **asset and liability position** to determine the tangible asset backing for the partner's investment.
- Position of **orders at hand** and the range and quality of clientele should be thoroughly examined, which the firm is presently operating.
- Study the **composition and quality of key personnel employed by** the firm and any likelihood of their leaving the organisation in the near future.
- Investigation for Valuation of Shares in Private Companies

i) In respect of equity shares, there are two main methods of valuation, according to the first method, **value is determined on the basis of net worth of the company.**

- The amount of net worth is divided by the number of shares comprising the equity capital to arrive at the value for one share.
- When this method is followed, goodwill of the business, and non-trading assets (like investments) based on the estimated future maintainable profit, is included among the assets to arrive at the amount of net worth.

ii) According to the second method, **the average profit earned by the business during the preceding 5 to 7 years is computed.**

- Afterwards, on the assumption that the same would continue to be earned in the future, the value of business is calculated by capitalising it at a reasonable rate of interest.
- If the rate assumed is high, the value of the business would be smaller. Correspondingly, it would be high if the rate of interest applied is low.
- The value of preference shares is estimated on the basis of the yield on preference shares of companies engaged in a similar trade or industry after making allowance for factors like restriction on transferability, average rate of earnings as compared to the rate of dividend, etc.

12.3 Investigation on behalf of a Bank/Financial Institution Proposing to Advance/Loan to a Company

A bank is primarily interested in knowing the purpose for which a loan is required, the sources from which it would be repaid and the security that would be available to it, if the borrower fails to pay back the loan.

On these considerations, the investigating accountant, in the course of his enquiry, should attempt to collect information on the under-mentioned points:

- i. The **purpose for which the loan is required** and the manner in which the borrower proposes to invest the amount of the loan.
- ii. The **schedule of repayment of loan** submitted by the borrower, particularly the assumptions made therein as regards amounts of profits that will be earned in cash and the amount of cash that would be available for the repayment of loan to confirm that they are reasonable and valid in the circumstances of the case.
- iii. The **financial standing and reputation for business** integrity enjoyed by directors and officers of the company.
- iv. Whether the company is authorised by the **Memorandum or the Articles of Association** to borrow money for the purpose for which the loan will be used.
- v. The **history of growth and development of the company** and its performance during the past 5 years.

To investigate the profitability of the business for judging the accuracy of the schedule of repayment furnished by the borrower, as well as the value of the security in the form of assets of the business already possessed and those which will be created out of the loan, the investigating accountant should take the under-mentioned steps.

- (a) Prepare a **condensed income statement** from the Statement of Profit and Loss for the previous five years, showing separately therein various items of income and expenses, the amounts of gross and net profits earned and taxes paid annually during each of the five years.
- (b) Compute the **under-mentioned ratios** separately and then include them in the statement to show the trend as well as changes that have taken place in the financial position of the company:
 - (i) Sales to Average Inventories held.
 - (ii) Sales to Fixed Assets.
 - (iii) Equity to Fixed Assets.
 - (iv) Current Assets to Current Liabilities.
 - (v) Quick Assets (the current assets that are readily realisable) to Quick Liabilities.
 - (vi) Equity to Long Term Loans.
 - (vii) Sales to Book Debts.
 - (viii) Return on Capital Employed.
- (c) Enter in a separate part of the statement the break-up of annual sales product-wise to show their trend.

Steps involved in the verification of assets and liabilities included in the Balance Sheet of the borrower company which has been furnished to the Bank - The investigating accountant should prepare schedules of assets and liabilities of the borrower and include in the particulars stated below:

- (a) **Fixed Assets**
 - A full description of each asset its gross value, the rate at which depreciation has been charged and the total depreciation written off. In case the rate at which depreciation has been adjusted is inadequate, the fact should be stated.
 - In case any asset is encumbered, the amount of the charge and its nature should be disclosed.
 - In case an asset has been revalued recently, the amount by which the value of the asset has been decreased or increased on revaluation should be stated along with the date of revaluation.
- (b) **Inventory**
 - The value of different types of inventories held (raw materials, work-in-progress and finished goods) and the basis on which these have been valued.
 - Details as regards the nature and composition of finished goods should be disclosed.

- If any inventory has been pledged as a security for a loan the amount of loan should be disclosed.
- (c) **Trade receivables , including bills recievable- Trade Receivables, including bills receivable -**
 - Their composition should be disclosed to indicate the nature of different types of debts that are outstanding for recovery; also whether the debts were being collected within the period of credit as well as the fact whether any debts are considered bad or doubtful and the provision if any, that has been made against them.
 - If any debts are due from directors or other officers or employees of the company, the particulars thereof should be stated.
 - Amounts due from subsidiary and affiliated concerns, as well as those considered abnormal should be disclosed.
- (d) **Investments**
 - The schedule of investments should be prepared.
 - It should disclose the date of purchase, cost and the nominal and market value of each investment.
 - If any investment is pledged as security for a loan, full particulars of the loan should be given.
- (e) **Secured and Unsecured Loans**
 - Debentures and other secured loans should be included together in a separate schedule.
 - In case any debentures have been issued as a **collateral security**, the fact should be stated.
 - **Particulars of assets pledged** or those on which a charge has been created for re-payment of a liability should be disclosed.
 - **Details of loans proposed** to be obtained from Promoters/ Directors/ Related Parties should be stated separately.
 - In case any unsecured loan is to be repaid prior to repayment of Bank loan, its terms and conditions should be verified.
- (f) **Provision of Taxation**
 - The previous year's up to which taxes have been assessed or assessment order received should be ascertained.
 - If provision for taxes not assessed appears to be inadequate, the fact should be stated along with the extent of the shortfall.
- (g) **Other Liabilities**
 - It should be stated whether all the liabilities, actual and contingent, are correctly disclosed.
 - an analysis according to ages of trade payables should be given to show that the company has been meeting its obligations in time.
- (h) **Insurance**
 - A schedule of insurance policies giving details of risks covered, the date of payment of last premiums and their value should be attached as an annexure to the statements of assets.
 - Report as to whether or not the insurance-cover appears to be adequate, having regard to the value of assets should also be attached.
- (i) **Contingent Liabilities**
 - The investigating accountant should ascertain particulars of any contingent liabilities which have not been disclosed.
 - In case, there are any, these should be included in a schedule and attached to the report.

12.4 Investigation of Frauds

Fraud has been defined in paragraph 11(a) of **SA 240**, as 'an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.' **Section 447 of the Act** has explained the term 'fraud' as "fraud in relation to affairs of a company or any body corporate, includes any act, omission, concealment of fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss.

12.4.1 Types of Frauds

- A. **Fraudulent Financial Reporting-** Discussed in SA 240.
- B. **Misappropriation of Assets-** Discussed in SA 240.
- C. **Corruption-** Conflict of Interest, Bribery, Illegal Gratuities, Money Laundering etc.
- D. **Fraudulent Entries-** Late entry, No entry, Part entry, Inserting wrong entries to divert attention.
- E. **Sales Fraud**
 - **Price enhancement.**
 - **Omission to make receipt** of sale of scrap.
 - Billing and sales **reversals** in amusement parks.
 - Food production yield ratio in hotels and suppression of Revenue.
 - Omission in preparation of dispatch note for sale.
 - Sale of Assets recorded as Income.
 - Cash sale adjusted as credit sale.
 - Writing off a good debt as bad debt and recoverable.
- F. **Collection Frauds**
 - Defalcation of contributions to charity funds.
 - Crediting donation to loan accounts.
 - Rental collected in cash but not recorded.
- G. **Expenses Frauds**
 - Entering ineligible discount.
 - Overcharging expenses.
 - Falsification of documents.
 - Untimely payment.
 - Introduction of fictitious vendor.
 - Unnecessary /huge provisioning of expenses.
- H. **Payroll Frauds**
 - Extra number of employees.
 - Extra hours.
 - Not deactivating the retired employees id.
 - Fictitious employees/workers salary paid.
- I. **Data Frauds.**
 - Change in computer data
 - Destroy, suppress or insert records.
 - Using open fields in computerized accounting system.
- J. **Technology related Frauds**

- Employing hostile Software Programs or Malware attacks.
- Phishing Mails.
- Vishing-Voice mail.
- Smishing-Text messages.
- Whaling-Targeted fishing on high network individuals.
- Card duplications.
- Stealing Confidential data.

K. **Banking Frauds**

- Forged Signatures.
- Cheque Frauds- Alteration in Amounts, Alteration in accounts titles, Kite flying.
- Missing notes in bundles.
- Use of same notes bundles by two branches.
- Wrong posting in other accounts.
- Misuse of sensitive stationery.
- ATM transactions misuse.
- Using pins of debit card / credit card holders.
- Advances against inflated stock statements, inflated projections , forged/duplicate land documents. L/C's.

L. **Others- Teeming and Lading , Pilferage issues, Fictitious journal entries etc.**

12.4.2 Frauds Arising at Different Levels

1. **Fraud for personal gains-Bribery:**

- Money, gift or other favours offered to procure (often illegal or dishonest) action or decision in favour of the giver.
- When money, gift or other favours are offered to public official to influence an official act of government then such kind of Bribery is called Official Bribery. In contrast to Commercial Bribery or favours to vendors, in case of Official Bribery, Company usually is criminally prosecuted.

2. **Corporate Frauds / Irregularities**

- (i) **Advance billing-** Advance billing is a situation where the company officials indulge in booking fictitious sales in anticipation of actual sales. This results in misrepresentation of revenue in the books thereby misleading financiers and stakeholders. When the management treats borrowings from money lenders as customer advances in the books against sale orders or for adjusting bills receivables, the fraudulent act gets unnoticed for an extended period. This situation results in a death knell for the corporation as the company is dragged into an irredeemable debt trap.
- (ii) **Shell/ Dummy Company Schemes:** Generally, represents a fictitious company or a 'paper company' to transfer profits or funds from the main company. This could also involve fictitious bills (mostly for services rendered or consultancy charges that cannot be corroborated) which are used in the name of dummy companies diverting the funds taken from banks and financial institutions.
- (iii) **Money-Laundering Activities:** As per the Prevention of Money-Laundering Act, 2002, "whosoever directly or indirectly attempts to indulge or knowingly assists or knowingly is a party or is actually involved in any process or activity connected with the proceeds of crime and projecting it as untainted property shall be guilty of offence of money-laundering."

3. **Fraud at Operational Level Employees**

- a. **Tampering of Cheques/Drafts/On-line payments/receipts** - Tampering of cheques, payee name being altered, or preparation of cheques without the same being issued to payee, etc., are methods that may also lead to falsification of accounts.

- b. **Off Book Frauds** - In off book frauds, the fraud perpetrator misappropriates the cash before these are recorded in the books or before the sale is recorded in the books.
- c. **Cash Misappropriation** - Cash is misappropriated after the accounting entries are already passed in the books. These are identified through surprise checks and through shortages in cash balances.
- d. **Teeming and Lading** - This is also achieved through cash deposits or cheques collected from customers being overlapped with the collections from subsequent customers and the amount collected is diverted to personal account.
- e. **Fraudulent Disbursements** - Fraudulent disbursements or reimbursements take place either by issuing or submission of false bills, or personal expense bills being converted into official expenses bills.
- f. **Expense Reimbursement Schemes** - These fraudulent schemes involve employees resorting to treating their personal expenses as incurred for business purpose and claiming reimbursement.
- g. **Payroll Fraud** - The payroll fraud could include payment to non-existent employees or in a contractual arrangement inflating of the manpower resources than those actually deployed while billing the client. It may also include showing higher pay than actual disbursement to employees/workers, etc.
- h. **Commission Schemes** - The salesman exaggerates the sales through fictitious billings to earn higher commission or alter the sales prices of the products sold from those stipulated by the company or share the sales volumes achieved with other employees to share higher commission.

4. **Procedure for Investigation of Fraud:**

Before proceeding to investigate frauds of the type aforementioned,

- The investigating accountant should ascertain **the exact duties of the person** concerned who is suspected to have committed a fraud; **his relationship** to the general routine of the office, and **the circumstances** in which any known instances of defalcation have come to light. Such an enquiry would give a clue to promising avenues of investigation.
- Greater the authority of the individual suspected of a fraud, wider would be the field which would have to be covered by the investigation. At times, an accountant is called upon to investigate a suspected fraud, the details or the nature whereof is not known.
- He should have a look at the **system of internal control** in operation for spotting out the weaknesses, if any, that may exist in it.

12.4.3 Situations in which money may be embezzled and the various forms that such frauds usually take place along with their investigation procedure include the following:

A. **Embezzlement in Cash Receipts**

The amount or amounts of receipts embezzled may be subsequently covered up by the perpetrator adopting one or other of the under-mentioned devices:

- (i) Issuing a receipt to the payee for the full amount collected and entering only a part of the amount on the counterfoil.
- (ii) Showing a **larger cash discount** than actually allowed.
- (iii) Adjusting a **fictitious credit** in the account of a customer for the value of goods returned by him.
- (iv) Adjusting a **cash sale as a credit sale**, and raising a debit in the account of the customer.
- (v) **Writing off a good debt** as bad and irrecoverable to cover up the amount collected which has been misappropriated.
- (vi) **Short-debiting the customer's account** in the ledger with an intention to withdraw the difference when the full amount payable by him is collected.
- (vii) **Under-casting the receipts** side of the Cash Book or over-casting the payment side.
- (viii) Carrying over a **shorter total of the receipts** from one page of the Cash Book to the next or over-carrying the total of the payment from one page of the Cash Book to the next with a view

to covering up misappropriation; either **short banking of cash collection** or a part of the amount of withdrawal from the bank.

Verification of Cash Receipts

- (i) Evidence as regards income received from different sources should be **scrutinised**, e.g., inventory, sales summaries, rental registers, correspondence with customers, etc.
- (ii) **Carbon copies of receipts** marked 'duplicate', should be scrutinised to confirm that they are in fact copies of receipts issued earlier.
- (iii) In addition, by **recalling paying-in-slips** from the bank the details of cash deposited on each day should be compared with those shown in the Cash Book.
- (iv) The record of **sales of scrap** of waste paper, that of collection of rents from labourers temporarily accommodated in the company's quarters, that of refunds of amounts deposited with the electric supply co., or any other Government authorities should be examined for finding out if any of these amounts have been misappropriated.
- (v) Cash sales should be vouched in details.

B. Inflating cash payment-

Cash payment frauds may be in the form of :

- (i) Making **double payment** of an invoice or paying a false invoice.
- (ii) Paying **personal expenses out of the business** by falsifying details. e.g., showing betting losses as advertisement charges.
- (iii) Withdrawing **unclaimed credit balances** of customers or amounts falsely credited in the accounts of parties.
- (iv) **Falsely adjusting a refund** in the account of a customer and withdrawing the credit balance.
- (v) **Wrong totalling** of the wage sheets and misappropriating the excess amount withdrawn from the bank for payment of wages.

Verification of Cash Payments

- (i) All the evidence as regards cash payments made, including acknowledgment by parties for payments shown to have been made to them, should be carefully scrutinised.
- (ii) All payments by **bearer cheques** should be examined.
- (iii) The system of **recording of wages** should be reviewed, especially over totalling of wage sheets, and existence of dummy workmen.
- (iv) Conformations should be obtained from partners or Directors in respect of amounts shown to have been paid to them.
- (v) The petty cash book should be **vouched and totalled**.

C. Frauds through Supplier Ledger

- a. Adjusting **fictitious or duplicate invoices** as purchases in the accounts of suppliers and subsequently misappropriating the amounts when payments are made to the suppliers in respect of these invoices.
- b. **Suppressing the Credit Notes** issued by suppliers and withdrawing the corresponding amounts not claimed by them.
- c. **Withdrawing amounts** unclaimed by suppliers, for one reason or another by showing that the same have been paid to them.
- d. Accepting purchase invoices at prices considerably **higher than their market prices** and collecting the excess amount, paid in cash, from the suppliers.

Verification of balances in suppliers' ledger -

- a. The Purchase Journal should be **vouched by reference to entries** in the Goods Inward Book and the suppliers' invoices to confirm that amounts credited to the accounts of suppliers were in

respect of goods, which were duly received and the suppliers' accounts had been credited correctly.

- b. All the suppliers should be requested to **furnish statements** of their accounts to see whether or not any balance is outstanding or due so as to confirm that allowances and rebates given by them have been correctly adjusted and were duly authorized by the authorized person/ officer.
- c. Examine the **system of internal control** in relation to purchase orders issued and identify possibilities of collusion with suppliers.

D. Frauds through Customer Ledger

- a. By the **'teeming and lading' method**, i.e., misappropriating the amount collected from a customer and crediting his account by the amount paid by him only when an amount is subsequently collected from another customer; repeating this practice with several items collected and depositing back the amount or amounts so misappropriated before the close of the year.
- b. Misappropriating the amount collected from a customer and subsequently adjusting his account by crediting the amount on account of allowance or a rebate for excess price charged.
- c. Crediting the amount received from a customer to the account of another customer and subsequently withdrawing the amount wrongly credited.

Verification of balances in customers' ledger:

- a. Special attention should be paid to **allowances adjusted** on account of goods returned or difference in price or on any other account as well as to amounts written off as bad debts.
- b. To confirm that the accounts of customers have been debited in respect of goods supplied to them, entries in the **Order Book should be cross-checked** with those in the Sales Day Book where the same is kept.
- c. The investigating accountant should obtain **confirmation of customers** in respect of the amounts standing in their accounts. Those of them who have no balance in their accounts should be requested to confirm the statement of their account (which should be sent to them) for ascertaining that the entries shown therein were genuine.

E. Inventory Frauds

Inventory frauds are many and varied but here we are concerned with misappropriation of goods and their concealment.

- (i) Employees may simply **remove goods** from the premises.
- (ii) **Theft of goods** may be concealed by writing them off as damaged goods, etc.
- (iii) **Inventory records** may be **manipulated by employees** who have committed theft so that book quantities tally with the actual quantities of inventories in hand.
- (iv) **Inflating the quantities issued** for production is another way of defalcating raw materials and store items.
- (v) Stocks actually dispatched but **not entered in sales/ debtor's account**.

Verification procedure for Defalcation of Inventory:

- (i) It may be of trading stock, raw materials, manufacturing stores, tools or of other similar items (readily) capable of conversion into cash. The loss may be the result of a theft by an employee once or repeatedly over a long period, when the same have not been detected. Such thefts usually are possible through **collusion among a number of persons**. Therefore, for their detection, the entire system of receipts, storage and dispatch of all goods, etc. should be reviewed to localise the weakness in the system.
- (ii) The first step in such an investigation is to establish the different items of inventory defalcated and their quantities by **checking physically the quantities** in inventory held and those shown by the Inventory Book.
- (iii) Investigating accountant should ascertain the **exact duties of persons** handling the stocks received in and issued from store for production/ sale or any other purpose.

- (iv) Identify the **excessive control in the hands of a single person**, without any supervision as it will widen the scope of investigation.
- (v) All the receipts and issues of inventory recorded in the Inventory Book should be verified by reference to entries in the Goods Inward and Outward Registers and the documentary evidence as regards purchases and sales.
- (vi) Further, entries in respect of returns, both inward and outward, recorded in the financial books should be checked with corresponding entries in the Inventory Book.
- (vii) **The totals of the inventory book should also be checked.**

12.4.4 Indicators of Fraud - Covered in SA 240

12.4.5 The fraud Diamond/4 elements of Fraud

Fraud Diamond i.e. four elements of fraud is a theory which was established by David T. Wolfe and Dana R. Hermanson. Under this Wolfe and Hermanson classified the indicators of fraud into 4 categories.

Fraud Diamond: Four Elements of Fraud

Incentive: I want to, or have a need to, commit fraud.

Opportunity : There is a weakness in the system that the right person could exploit. Fraud is possible.

Rationalization: I have convinced myself that this fraudulent behavior is worth the risks.

Capability: I have the necessary traits and abilities to be the right person to pull it off. I have recognized this particular fraud opportunity and can turn it into reality.

12.5 Investigation on behalf of an Individual or Firm Proposing to Buy a Business

Scope of investigation - The objective of such an investigation is to collect such information as would enable the purchaser to decide whether it is worthwhile to buy the business and if so, for what amount. The investigation should proceed broadly on the same lines as for valuation of shares.

Additional matters which must receive the attention of the investigating accountant on which, if appropriate, information to the client should be given.

(A) **In case of proprietary concerns or partnerships -**

- (i) **Reasons for the sale of the business** and the effect on turnover and profits that there would be on retirement of the present proprietor (or partners).
- (ii) The **length of lease** under which the premises are held, the prospects of its renewal or extension.
- (iii) The **unexpired period of any patents** owned by the vendors.
- (iv) The **age of the present managerial staff** and the prospects of continuing in service under the new proprietorship and the possible liability, not already provided for that would arise as regards payment of pensions or gratuities in case of old and aged employees/ retrenched employees.
- (v) If the bulk of sales are made to customers whose number is small, the profitability of the business would be greatly shaken on withdrawing their support. This would be an element of weakness which should be investigated as it might affect future profitability.
- (vi) The valuation that could be placed on goodwill to determine whether that appearing in the book is less or more; if none is included to determine the amount that should be included, if at all.

(B) **If the business belongs to a limited company -**

The vendors' interest in this case will be purchased by the acquisition of shares. On that account, the following additional matters would also require consideration:

- (i) The **authorised and issued capital** of the company.
- (ii) Whether there is any **uncalled liability** on the shares.

- (iii) If the capital is divided into different classes of shares - the rights that are attached to each class.
- (iv) Particulars of **dividends paid** in the past and the amounts thereof which are in arrear (on cumulative preference shares).
- (v) If there are any **mortgages/ charge created** on the assets appearing in the company's books, a search should be made in the Register of Charges in the office of the Registrar of Companies.
- (vi) **The price** at which the **shares are being offered**. If the company is a public company, the price will usually be in excess of market price quoted on the Stock Exchange, but in the case of unquoted shares particularly where the company whose shares are being acquired is a private company, a valuation will have to be placed on the shares for the purpose of purchase.

12.6 Investigation in connection with review of Profit/Financial Forecasts

There are many investigations which involve an examination of future profits like,

- (1) Profit reports can be required as part of a general investigation into the purchase of a business or,
- (2) By banks and financial institutions with regard to project cash flow and profitability statements for appraisal of loan applications submitted by the intending borrowers.

13. REASONS FOR HIGHER SALES TURNOVER BUT DECLINING NET PROFITS

- ❖ **Unfavourable sales mix**-Sales are increasing of the products having a lower PV ratio.
- ❖ **High Financial Leverage**- Higher debt-equity ratio. Huge interest obligation would result in low profit despite of increase in sales.
- ❖ **Other items included in sales**-Incomes which should have not been credited has been credited in Statement of Profit.
- ❖ **Increase in fixed cost.**
- ❖ Increase in **administration and selling expenses.**
- ❖ **Competitive price**-Sales have been made at cut throat prices.

14. FORENSIC ACCOUNTING-THE INTRODUCTION

Forensic Accounting has established itself as **dynamic and strategic tool in combating corruption, financial crimes and frauds** through investigations and resolving allegations of fraud and embezzlement. Thus, a new area, known as Forensic Accounting, was needed to detect the frauds in companies that suspected fraudulent transactions. Simply stated, **Forensic Accounting includes the use of accounting, accounting and investigative skills to assist in legal matters.**

Important Definitions:

Forensic Accounting :

Forensic Accounting by Hopwood, Leiner, and Young :

- ❖ Forensic accounting is the **application of investigative and analytical skills** for the purpose of resolving financial issues in a manner that meets standards required by courts of law.
- ❖ Forensic accountants apply special skills in accounting, auditing, finance, quantitative methods, certain areas of the law, research and investigative skills to collect, analyse and evaluate evidential matter and to interpret and communicate findings.

Red Flag: Red flags are **indicators or warning of any impending danger or inappropriate behavior**. Red flag does not necessarily indicate the existence of fraud however are indicators that caution needs to be exercised while investigating the situations. Red flags are classified in categories such as financial performance red flag, accounting system red flags, operational red flags and behavioral red flags.

How is a forensic accounting analysis different from an audit?

The general public believes that a financial auditor would detect a fraud if one were being perpetrated during the financial auditor's audit. The truth, however, is that the procedures for financial audits are designed to detect material misstatements, not immaterial frauds.

Forensic Accounting vs Statutory Audit/Key elements

Basis	Statutory Audit	Forensic Accounting
Objective	To give true and fair picture.	Discover facts & evidence.
Technique	Substantive and Compliance-Sample based.	Investigative , substantive or in depth checking.
Focus	Very general-An overall review of the Books of Accounts	Narrow- Validate transactions and balances
Meaning	Independent opinion on F/s to express opinion.	Application of investigative and analytical skills for the purpose of resolving financial issues.
Conducted by	A Chartered Accountant	Non CA is permitted
Approach	CONTROL TESTS OF TRANSACTIONS AND SUBSTANTIVE TESTS OF BALANCES.	FOCUSED TESTING TO CONFIRM SUSPICION / ALLEGATION.
Target	Identify Material misstatement of F/s.	Identify/Confirm Nature of Violation.
Skills	Testing & Checking , Analysis, Inquiry and Observation.	Scrutiny and Analysis , Fact-Finding, Interviews.
Presumption	Professional Skepticism, Due Professional Care.	Neutrality.
Methodology	Sampling selection methodology.	Detailed examination of transactions and balances.
Mentality	Professional Skepticism.	Investigative Methodology.
Outcome	Audit Report Opinion (Qualification- Subject to / Except for).	Present evidence to court of law.

15. FORENSIC ACCOUNTING PROFESSIONAL

A Forensic Accountant Professional is often retained to analyze, interpret, summarize and present complex financial and business-related issues in a manner which is both understandable and properly supported. Forensic Accountants Professional are trained to look beyond the numbers and deal with the business reality of the situation.

Forensic Accountant Professional can be engaged in public practice or employed by insurance companies, banks, police forces, government agencies and other organizations.

Forensic Accounting Services: An indicative list of services that can be provided by the Professional in this area are as follows:

- ❖ Financial Statement manipulations.
- ❖ Fund diversions/Asset tracing.
- ❖ Anti-Money laundering.
- ❖ Licence Fees/Dues/Tax Evasion.
- ❖ Related party transactions/valuations .
- ❖ Valuations/Estimations of loss/damage.
- ❖ Suspicious transactions under IBC (Insolvency and Bankruptcy Code).

A Forensic Accountant Professional is often involved in / Areas of Forensic Audit

- A. **Fraud detection**- Investigation and analyzing financial, analyzing financial evidence, detecting financial frauds and tracing misappropriated funds.

- B. **Computer Forensic Audit**-Developing computerized applications to assist , in the recovery , analysis and presentation of financial evidence.
- C. **Fraud Prevention**- Either reviewing Internal controls to verify their adequacy or providing consultation in the development and implementation of internal control framework aligned to an organization's risk profile.
- D. **Providing Expert Testimony**-Assisting in legal proceedings, including testifying in court as an expert witness and preparing visual aids to support trial evidence.

16. PROCESS OF FORENSIC ACCOUNTING

Step 1- Initialization

- ❖ It is often useful to carry out a preliminary investigation prior to the development of a detailed plan of action.
- ❖ This will allow subsequent planning to be based upon a more complete understanding of the issues.

Step 2- Develop Plan

- ❖ This plan will take into account the knowledge gained by meeting with the client and carrying out the initial investigation.
- ❖ This plan will also set out the objectives to be achieved and the methodology to be utilized to accomplish them.

Step 3- Obtain Relevant Evidence

- ❖ In order to gather detailed evidence, the investigator must understand the specific type of fraud that has been carried out, and how the fraud has been committed.
- ❖ The evidence should be sufficient to ultimately prove the identity of the fraudster(s), the mechanics of the fraud scheme, and the amount of financial loss suffered.

Step 4- Perform the analysis

- ❖ Depending upon nature of assignment, analysis may involve-calculate economic damages, summarizing large no of transactions, perform sensitivity analysis etc.

Step 5- Reporting

- ❖ Issuing an audit report is the final step of a fraud audit.
- ❖ Auditors will include information detailing the fraudulent activity, if any has been found.
- ❖ The report may include sections on the nature of the assignment, scope of the investigation, approach utilized, limitations of scope and findings, recommendations and/or opinions.

Step 6-Court Proceedings

- ❖ The investigation is likely to lead to legal proceedings against the suspect, and members of the investigative team will probably be involved in any resultant court case.
- ❖ The evidence gathered during the investigation will need to be presented at court, and team members may be called to court to describe the evidence they have gathered and to explain how the suspect was identified.

17. FORENSIC ACCOUNTING AND INVESTIGATION REPORT

- ❖ **This Forensic Accounting and Investigation Standard (FAIS or "Standard")** 510 deals with the responsibility of the Professional to issue a written report to the stakeholders at the conclusion of the assignment.
 - ❖ Reporting results of the work procedures completed and the findings from those procedures, is the concluding part of the assignment. Since one engagement may include multiple assignments, multiple reports may have to be issued; one for each assignment.
1. **Written Report:** The Professional shall issue a written report which conveys the results of the assignment clearly and accurately. The findings reported shall be based on evidence gathered which are reliable and relevant. Thus, the Professional shall issue a written report which is precise and unambiguous.

2. **Report addressee and distribution:** The report shall be addressed to the Primary Stakeholders and shared with other stakeholder(s) if required or otherwise permissible.
3. **Format or Content of Report:** While no fixed form or content of the report is mandated by this Standard, the report shall include certain key elements to enable the recipient to understand the purpose of the assignment, the extent and scope of work performed by the Professional, any limitations, assumptions or disclaimers, the facts and evidence gathered and the conclusions drawn.
Key Elements of the Report: The Professional shall consider the inclusion of the following key elements in the report (indicative list):
 - **Title, addressee and distribution list** (if any).
 - **Scope and objectives** of the assignment.
 - **Approach and broad work** procedures undertaken.
 - **An Executive Summary** of the results, covering all important aspects and the essence of the findings.
 - Reference to **use of an expert**, where applicable.
 - The fact that the assignment has been conducted in **accordance with FAIS**, or any material departures therefrom.
 - **List of findings** supported by key evidences, sources of evidences, and other relevant matter.
 - **Assumptions, limitations and disclaimers** of the assignment.
 - **Conclusions (if any)** drawn from the assessment undertaken.
4. **Discussion of Draft Report-** Where the mandate of the engagement requires a discussion of the findings with the subject party prior to finalisation, a summary of the responses received from them shall be included in the report.
5. **Assumptions and Limitations:** The Professional shall list any relevant assumptions made during the assignment having a significant bearing on the subject matter.
6. **Reporting Timelines:** The report shall be issued within reasonable time frame as per the engagement terms. The Professional may be required to provide interim reports as per the engagement terms which can be given to the extent practicable without compromising the progress of the investigation.

18. OVERVIEW OF FORENSIC ACCOUNTING AND INVESTIGATION STANDARDS (FAIS)

The FAIS at a broad level seeks to provide :

- ❖ The Professionals with the minimum standards for undertaking forensic accounting and investigation (FAI) assignments;
- ❖ The Users of FAI services with an indication of the quality of service that can be expected from such engagements;
- ❖ The Regulators and Governmental agencies with an appreciation of what can be expected from FAI services; and
- ❖ To everyone, guidance on matters of implementation and related practical issues.

If, for any reason, a member is unable to comply with any of the requirements of the FAIS, or if there is a conflict between the Standards and other mandates, such as a statutory or regulatory requirement, the FAI report (or such similar communication) should draw attention to the material departures therefrom along with appropriate explanation.

CHAPTER 10

EMERGING AREAS: SDG & ESG ASSURANCE

1. ESG -ENVIRONMENT (E), SOCIAL(S), GOVERNANCE(G)**1.1 Introduction**

The concept of sustainable development is named after the **Brundtland report**, which reports sustainable consumption in developed countries. "Sustainable development is development that strives to meet the needs of developing countries seeking to achieve a more sustainable world. Sustainable development addresses the needs of the present moment without compromising current and future generations to meet their own sustainable lifestyles"

Sustainable development can be applied to corporate policy in the business world as it encompasses following **three pillars of sustainability**.

A. Environment (E):

Environment stands for corporate climate policies, energy use, waste, pollutions, natural resource conservation, and treatment of animals. **Thus, one is dependent on the environment for carrying out its operations.**

B. Social(S):

It addresses the relationships the entity has and the reputation it fosters with people and institutions in the communities where you do business and the value chain involved. It further includes **labour relations, diversity, and inclusions.**

C. Governance(G):

It is the **internal system of practices, controls, and procedures entity adopts** in order to govern itself, make effective investment decisions, comply with the law, and meet the needs of all stakeholders.

The above pillars include the following elements as under:

ENVIRONMENT <u>Climate Change:</u> - Carbon Emissions - Product Carbon FootPrints - Financing Environmental Impact - Climate Change Vulnerability <u>Natural Resources:</u> - Water Stress - Bio-diversity & land use - Raw Material sourcing <u>Pollution & Waste:</u> - Toxic emission and waste - Packing Material and waste - E- Waste <u>Environment Opportunity:</u> - Clean Tech - Green Building - Renewable Energy	SOCIAL <u>Human Capital:</u> - Labour Management - Health & Safety - Human Capital Development - Supply Chain Labour Standards <u>Product Liability:</u> - Product Safety & Quality - Chemical Safety - Financial Product Safety - Privacy and Data Security - Responsible Investment <u>Stakeholders Opposition:</u> - Controversial Sourcing <u>Social Opportunity:</u> - Access to Communication - Access to Finance - Access to Health Care - Opportunities in Nutrition & Health	GOVERNANCE <u>Corporate Governance:</u> - Broad Diversity - Executive Pay - Ownership - Accounting <u>Corporate Behaviour</u> - Business Ethics - Anti - Competitive Practices - Corruption & Instability - Financial system and stability - Tax Transparency
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Environmental, Social and Governance (ESG) reporting is all about disclosure of information, data, metrics that explain the added value in these three areas. **ESG reporting can be both quantitative and qualitative in nature.**

Qualitative reports tend to describe a company's strategy or policy around the relevant topics, while a quantitative approach includes metrics, and key performance indicators (KPIs) linked to each area in order to measure progress against goals and report on achievements. Naturally, **a mixed approach that makes use of both qualitative and quantitative information tends to add the maximum value to the quality of disclosures.**

1.2 Evolution of ESG in India

2009	'Corporate Social Responsibility Voluntary Guidelines 2009'
2011	'National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business'
2012	SEBI Mandates top 100 listed companies to file Business Responsibility Report
2015	BRR (Business Responsibility Report) in respect of ESG became part of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015
2017	SEBI recommended Integrated Reporting for top 500 listed companies
2019	National Guidelines on Responsible Business Conduct (NGRBC) 2018 to prepare BRR to adopt IR on a voluntary basis from the financial year 2017-18.
2019	BRR became mandatory for top 1,000 listed companies As per SEBI (Listing Obligations and Disclosure Requirements) (Fifth Amendment) Regulations, 2019, with effect from December 26, 2019, the annual report of the top 1,000 listed entities based on market capitalization shall contain a business responsibility report as per clause (f) of sub regulation (2) of regulation 34 of Listing Regulations.
2021	New reporting requirements on ESG parameters called the Business Responsibility and Sustainability Report (BRSR).

- ❖ SEBI introduced new reporting requirements on ESG parameters called the Business Responsibility and Sustainability Report (BRSR).
- ❖ The BRSR seeks disclosures from listed entities on their performance against the nine principles of the '**National Guidelines on Responsible Business Conduct**' (NGRBCs) and reporting under each principle is divided into essential and leadership indicators.

1.3 Initiatives by ICAI

In Feb 2020, ICAI constituted **Sustainability Reporting Standards Board (SRSB)**. Mission of the SRSB is to take appropriate measures to increase awareness and implement measures towards responsible business conduct, developing audit guidance for Integrated Reporting

In last 2 years, ICAI has issued following publications:

- ❖ **Standard on Assurance Engagements (SAE 3410)** - Assurance Engagements on Greenhouse Gas Statements
- ❖ Background Material on BRSR (revised 2021)
- ❖ **Sustainable Development Goals** - Accountants creating sustainable World - Parts 1 covering SDGs 1 to 5
- ❖ **Sustainable Development Goals** - Accountants creating sustainable World - Parts 1 covering SDGs 6 to 11
- ❖ **Sustainable Development Goals** - Accountants creating sustainable World - Parts 1 covering SDG 11 to 17
- ❖ **FAQs on Sustainability Reporting** - Heart of Good Governance
- ❖ **Sustainability Reporting Maturity Model (SRMM)** - Version 1.0 - SRMM Version 1.0 is a self-assessment tool for Indian corporates based on Business Responsibility and Sustainability Reporting formats issued by the Committee on Business Responsibility Reporting of the Ministry of Corporate Affairs. It has four levels: **Formative Stage, Emerging Stage, Established Stage & Leading by Example.**

1.4 Business Responsibility And Sustainability Report (BRSR)

Reporting under BRSR is mandatory from financial year 2022-23. However, disclosure was voluntary in financial year 2021-22.

The reporting questionnaire is divided into three sections:

- Section A -General Disclosures**
 - This section contains the details of the listed companies, its products, services, operations, employee related details, its holding, subsidiary, associate companies etc.
- Section B -Management Process and disclosures**

- It contains questions related to policy and management processes, governance, leadership, and oversight.

(iii) **Section C - Principle wise performance disclosures**

- Companies are required to report upon Key performance indicators (KPIs) in alignment with the nine principles of the NGRBC. The section classifies KPIs into two categories that companies are required to report upon:
- **Essential indicators (Mandatory disclosures)**
This would include data on training programs conducted, environmental data on energy, emissions, water, waste management etc.
- **Leadership indicators (Optional disclosures)**
It would include life cycle assessments, details of conflict management policy, additional data, on biodiversity, energy consumptions, supply chain managements etc.

1.5 Nine Principles of BRSR

Principle 1 - Ethics, Transparency and Accountability:

The first principle emphasizes that the business decisions in an organisation should be open to disclosure and accessible to the relevant interested parties.

The essence of the core elements associated with the first principle are:

- The **entities' governing structure** should develop policies, procedures, and practices for their offices, factories, and work areas, ensuring that ethics is not compromised.
- The information relating to the policies, procedures, and practices along with the performance should be made available to the stakeholders.
- In case of adverse effects, more care has to be taken for transparent disclosures.
- The entities in the value chain should be encouraged to adopt these principles by the governance structure.
- The entities should proactively respond to the outside entities that violate the nine principles of the BRSRs. This includes their suppliers, distributors, sub-contractors, or regulatory officers that may engage with the business concern.



Principle 2 - S

The entities should ensure the safety and health of their employees, consumers and end-users.

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The essence of the core elements associated with the second principle is:

- When a product is designed by the entity, the production methods and technologies have to be devised in such a way so as to minimize the resource usage to make it sustainable.

- b) The entities are also responsible to educate and make aware their consumers and clients about their rights.
- c) The entities should take measures that reduce the over exploitation of the nature's resources by consuming sustainably and encourage methods for reduce, reuse and recycling of the resources.

Principle 3 - Promote wellbeing of all employees including those in the value chain:

The third principle relates to all the initiatives an entity has to take for the benefit of its employees from the point of view of their dignity, health, well-being

The essence of the core elements associated with the principle is:

- a) The entity should ensure **compliance with all regulatory requirements** as far as employees are concerned.
- b) The entities are to respect the **dignity of employee** as a human being and should not restrict their freedom of associations, unions, and other participatory mechanism for collective bargaining of their rights and redressal of issues they face at the workplace.
- c) The entities should **prevent all kinds of child labour, bonded labour, and any other forms of involuntary labour**.
- d) The entities should have a system in which the **work-life balance of the employees** is not compromised.
- e) The businesses have to ensure **timely payment of the worker's wages** and compensation.
- f) The payment of the wages has to be as per the living wages, that can take care of the basic needs and provide economic security to the employees.

Principle 4 - Respect for stakeholders' interests and responsiveness:

The concept of interested party or stakeholders to a business has been a point of discussion in all the regulatory and voluntary systems that relate to the management system of any organisation, be it related to the quality, environment or the occupational health and safety of the workers.

The essence of the core elements associated with the principle is:

- a) The entities have to be transparent and communicate with the stakeholders about the impacts of their operations and business decisions on the people and the nature.
- b) The entities have to systematically determine the context of their operation and identify their interested parties.
- c) The entities should fairly share the benefits to the stakeholders or give an opportunity to them to benefit from the operations in an equitable manner.

Principle 5 - Respect and promote human rights:

The concept of human rights is a vast topic that covers a wide variety of violence and belligerent abusive issues faced by people. It refers to the human rights issues that happen directly or indirectly due to the operation of the business.

The essence of the core elements associated with the principle are:

- a) The entities should have a **clear understanding of the human rights** and various ways by which human rights can be violated from the perspective of the Constitution of India, national laws and policies and the content of International Bill of Human Rights.
- b) The entities when developing their management systems, should **integrate the human rights** element into their policies, procedures, and practices.
- c) Businesses should recognize and **respect the human rights** of all relevant stakeholders and groups within and beyond the workplace, including that of communities, consumers, and vulnerable and marginalized groups.

Principle 6 - Protection and restoration of Environment:

The sixth principle looks at the environmental responsibility as a basic requirement for the economic prosperity and sustainability.

The core elements associated with the principle are:

- a) The entities should have policies, procedures, and practices in place to assess and rectify impacts to the environment. This should cover the **whole life cycle of the product**.
- b) The entities have to make use of **natural and manmade resources in an optimum manner** to ensure their sustainability by taking feedback from the stakeholders.
- c) The entities have to **measure their performance** relating to the prevention of pollution, destruction of forests, waste generation, energy use, land use, etc.
- d) The entities have to contribute towards **climate change resilience** in line with India's commitment to various international mechanisms such as, Paris Agreement and National Action Plans for Climate Change.
- e) The entities should explore the comparison of its activities with **industry best practices** to reduce, reuse and recycle/ recover materials, resources.
- f) The companies have to look out for avenues by which they can improve their performance towards **various environmental responsibilities**.

Principle 7 – Influence on Public and Regulatory Policy:

The seventh principle of influencing the policy formulation positively recognizes that the businesses operate within the framework of statutory and legislative policies of the governing authority.

The principle further highlights that -

- a) The core elements of BRSR are to have met holistically when the organisation go ahead with their contributions to policy formulation and policy advocacy.
- b) The collective associations such as, the trade groups and industry chambers have to be utilized when moving ahead with the policy advocacy and formulation.
- c) The role in policy advocacy by the organisation should be in such a way that it encourages fair competition and prevents human rights abuses.

Principle 8 – Promote Inclusive Growth and equitable development:

This can work only with close participation and collaboration amongst the entities, authorities, the civil associations contributing to one another for a better livelihood, and assistance to the marginalized communities.

The core elements of the eighth principle are:

- a) The entities should have systems in place to identify and address impacts of their activities on the social, cultural, and economic aspects of the people. This includes business created issues like, land acquisition and use and construction activities for new facilities.
- b) The entities should **review, measure, and track the adverse impacts** of their activities on the society and environment and make action plans to mitigate them adequately.
- c) The entities should make efforts to **bring up creative products, technologies**, and business concerns that help the marginalized communities to have well-being and a better quality of life.
- d) Entities when designing their **CSR activities** should review the local and regional development priorities to help the marginalized groups and communities.
- e) The entities should take care to ensure that business induced displacement or relocation of communities does not happen, and in unavoidable cases, should make sure to have mutually agreed, participative, and informed negotiations to provide fair compensation to the affected people.
- f) All forms of intellectual property and traditional knowledge should get the deserved respect from the organisation, and efforts should be made to ensure that benefits derived from their knowledge are shared equitably.

Principle 9 – Provide value to the consumers in a responsible manner:

The primary purpose of any business is to create or provide useful products and services to the customer in exchange of reasonable profits.

The core elements associated with the principle are:

- a) Entities should put in their efforts to **reduce the negative impacts of their products** and services on consumers, natural environment, and society at large.
- b) When conceptualizing, designing, and marketing their products, the organisation should not in any manner prevent the **freedom of choice and fair competition**.
- c) The entities should transparently and accurately **disclose all kinds of adverse impacts** to the user, planet, society, on the biodiversity from their products.
- d) When handling customer data, **the right to privacy** of the customer needs to be maintained.
- e) Entities should inform the customers on the safe and responsible ways of usage, reuse, recycling, and disposal of their products, and ways **to eliminate over-consumption**.
- f) When advertising about their products, the organisations should ensure that **misleading and confusing information** is not exposed to the customers about their products or its usage.

1.6 Assurance on BRSR

SEBI has currently started with the top 1,000 listed companies. But very soon, remaining listed companies would also need to comply with the provisions of BRSR.

Further, BRSR is expected to be used as a single means for disclosing sustainability related information in India. This would be the main document which the stakeholders, investors would review and do industry analysis.

ESG audit would be a process that would help the companies to evaluate the environmental and social risks for the Company's products, services, operations etc. Conducting an ESG audit also helps businesses look at their supply-chain risks, risk management capabilities and transparency with shareholders.

1.6.1 Standard on Sustainability Assurance Engagements (SSAE) 3000

ICAI has recently issued **Standard on Sustainability Assurance Engagements (SSAE) 3000 Assurance Engagements on Sustainability Information**. This Standard deals with assurance engagements on an entity's sustainability information. This is an umbrella standard applicable to all assurance engagements on Sustainability information.

The intended users of this Standard include:

- ❖ **Assurance providers providing assurance on sustainability information.**
- ❖ **Entities seeking to engage a professional auditor.**
- ❖ **Regulators, investors, and other users of Sustainability Reporting data.**

This Standard applies for assurance engagements which pertain to providing reasonable or limited assurance on sustainability information.

The effective date of application of SSAE 3000 is as follows:

- ❖ Voluntary basis for assurance reports covering periods ending on 31st March 2023.
- ❖ Mandatory basis for assurance reports covering periods ending on or after 31st March 2024.

ICAI has also issued **SSAE 3410, Assurance Engagements on Greenhouse Gas Statements** which deal with assurance engagements on an entity's sustainability information including assurance of BRSR.

1.6.2 Methodology to provide assurance on BRSR

- ❖ **Preliminary Review of ESG report**, parameters
- ❖ **On-site Assessment** / Verification of ESG Report
- ❖ Issuance of Assessment Report
- ❖ Review of the **responses and clarifications** on the findings
- ❖ Submission of findings of the **on-site assessment and document review**
- ❖ Preparation of Assessment / Verification report including final results of Assessment / Recommendation

2. SUSTAINABLE DEVELOPMENT GOALS

- ❖ In 2015, Sustainable Development was adopted by all United Nations Members states to provide a blueprint, which mentioned the Sustainable Development Goals (SDGs).
- ❖ There were 17 SDGs which are considered as an urgent call for action by all countries, whether developed or developing countries.
- ❖ SDG plays a key role in the evaluation of UN systemwide implementation of the 2030 Agenda and on advocacy and outreach activities relating to the SDGs. In order to make the 2030 Agenda a reality, broad ownership of the SDGs must translate into a strong commitment by all stakeholders to implement the global goals.
- ❖ **Following are the 17 SDGs:**

1. No Poverty	10. Reduced Inequalities
2. Zero Hunger	11. Sustainable Cities & Communities
3. Good Health & Well Being	12. Responsible Consumption & Production
4. Quality Education	13. Climate Action
5. Gender Equality	14. Life Below Water
6. Clean Water & Sanitization	15. Life on Land
7. Affordable & Clean Energy	16. Peace, Justice & Strong Institutions
8. Decent Work & Economic Growth	17. Partnership for the Goals
9. Industry Innovation & Infrastructure	

3. GLOBAL TRENDS IN SUSTAINABLE REPORTING

The mandatory reporting requirements are mostly associated with the public sector or government-run companies, large corporations, multi-national business conglomerates, and listed companies in the stock exchanges. Various reporting frameworks are:

1. **Global Reporting Initiative (GRI-)** helps the organizations to report on economic, environmental, and social impacts. The general disclosures which are required to be reported under this standard are Economic, Environment and Social. This report is addressed to all the stakeholders of the entity.
2. **Carbon Disclosure Project (CDP-)** captures the environmental performance data which is related to GHG emissions, water, forests, and supply chain. Major details required to be reported are climate change, Forest, and Water security. This report is addressed to all the investors, buyers, and other stakeholders of the entity.
3. **International Integrated Reporting Framework (IIRC)** it is established as guiding principles and content elements in order to allow the companies to produce integrated reports. This report consists of Organisational overview, Governance structure, Business model, risks and opportunities, strategy, performance, outlook etc.

4. INTEGRATED REPORTING

There are 6 Cs of Integrated Reporting - also known as 6 capitals:

- (i) **Financial Capital:**
 - Pool of funds that is available to the organization for use in the production of goods or provision of services.
 - Obtained through financing, such as debt, equity, or grants, or generated through operations or investments.
- (ii) **Manufactured Capital:**
 - Seen as human-created, production-oriented equipment and tools.
 - Available to the organization for use in the production of goods or the provision of services, including buildings, equipment, infrastructure (such as roads, ports, bridges & waste, and water treatment plants).

(iii) **Natural Capital:**

- Is an input to the production of goods or the provision of services.
- An organization's activities also impact, positively or negatively, on natural capital.
- Includes water, land, minerals and forests, biodiversity, and ecosystem health.

(iv) **Human Capital:**

People's skills and experience, their capacity, and motivations to innovate, including their:

- Alignment with and support of the **organization's governance framework & ethical values** such as its recognition of human rights.
- Ability to understand and implement an organization's strategy.
- Loyalties and motivations for improving processes, goods, and services, including their ability to lead and to collaborate.

(v) **Social Capital:**

- Institutions and relationships established within and between each community, group of stakeholders and other networks to enhance individual and collective well-being.

- **Includes:**

- o Common values and behaviour.
- o key relationships, the trust and loyalty that an organization has developed and strives to build and protect with customers, suppliers, and business partners.
- o an organization's social license to operate.

(vi) **Intellectual Capital:**

Key element in an organization's future earning potential, with a tight link and contingency between investment in R&D, innovation, human resources, and external relationships, which can determine the organization's competitive advantage.

Asia Pacific region continues to dominate in presenting sustainability data in annual reports, approximately with 60% of Companies reporting in 2022. Integrated reporting is strong in the Middle East.

5. GLOBAL SCENARIO IN VARIOUS COUNTRIES

5.1 United States

In March 2022, the US Securities and Exchange Commission (SEC) proposed climate-risk disclosure requirements, which would expand the annual reporting requirements of publicly traded companies. In their SEC filings, companies would be required to discuss financially material, climate-related risks guided by the (TCFD) the **Task Force on Climate-Related Financial Disclosure** recommendations. Reporting would include:

- ❖ The company's climate risk management processes.
- ❖ How the risks identified would impact financial performance?
- ❖ How these risks are managed and mitigated?
- ❖ Any scenario analysis, transition plans, and publicly announced climate goals.

5.2 United Kingdom

In 2019, the UK passed a law targeting **net zero greenhouse gas (GHG) emissions by 2050**.

A key regulation for UK ESG disclosures is the Companies Act of 2006, which includes requirements for annual reporting. These rules apply to large companies that are either listed, exceed £500 million in annual turnover, or have more than 500 employees. Non-financial information has always been required in annual reports, but in 2022, the Act was expanded to include sustainability matters. The new requirements align with the recommendations from **the Task Force on Climate-Related Financial Disclosure (TCFD)**. As such, companies are required to discuss the strategy, processes, and due diligence regarding matters of:

- ❖ The environment (including the company's impact on the environment)

- ❖ The company's employees
- ❖ Social matters
- ❖ Respect for human rights
- ❖ Anti-corruption and anti-bribery

6. ROLE OF AUDITOR -CONSIDERATION OF CLIMATE RELATED RISKS IN AN AUDIT OF FINANCIAL STATEMENTS

- ❖ The role of the auditor is to obtain **reasonable assurance** about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.
- ❖ In developing the understanding of an entity, the auditor should include the consideration of **climate-related risks** and how these risks may be relevant to the audits. The climate-related risks could be more relevant in certain sectors or industries, e.g., banks and insurance, energy, transportation, materials and buildings, agriculture, food, and forestry products.
- ❖ Many investors and stakeholders are seeking information from auditor's reports about **how climate-related risks were addressed in the audit**. With this increased user focus on climate change, auditor need to be aware of, and may face, increasing pressure for transparency about climate matters in our auditor's reports.
- ❖ In some circumstances, it may **warrant inclusion of an Emphasis of matter paragraph** to draw attention to disclosures that are of fundamental importance to users' understanding of the financial statements. The auditor should also determine whether the entity has appropriately disclosed relevant **climate-related information** in the financial statements in accordance with the applicable financial reporting framework.
- ❖ The auditor should also read the other information for consistency with information disclosed in the financial statements and information that may be publicly communicated to stakeholders outside the financial statements, such as management report narratives in the annual report, press releases, or investor updates. This is a requirement under ISA 720 and SA 720, The Auditor's Responsibilities Relating to Other Information.