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SA 210 – AGREEING THE TERMS OF AUDIT ENGAGEMENT

1. MEANING AND DEFINITION OF AUDITING

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

1.1 ANALYSIS OF DEFINITION

- Audit is Independent examination of financial information.
- of any entity - that entity may be profit oriented or not and irrespective of its size or legal form. For example - Profit oriented - Audit of Listed Company engaged in business. On the other hand, Audit of NGO - not profit oriented.
- The objective of the audit is to express an opinion on the financial statements.

1.2 ORIGIN OF AUDITING

The reference to auditing is found in Kautilya's Arthshastra even in 4th century BC. It talks about fixed accounting year, a process for closure of accounts & audit. Even there are references in his monumental work to misstatements in financial statements due to abuse of power.

The word "audit" originates from Latin word "audire" meaning "to hear". In medieval times, auditors used to hear the accounts read out to them to check that employees were not careless and negligent.

The first Auditor General of India was appointed in British India in 1860. Presently, Comptroller and Auditor General of India is an independent constitutional authority responsible for auditing government receipts and expenditures.

1.3 WHO APPOINTS THE AUDITOR?

In case of companies: Appointed by members (shareholders) in Annual General Meeting (AGM).

In case of government companies: Appointed by Comptroller and Auditor General of India, an independent constitutional authority.

In case of firm: Appointed by partners of firm.

1.4 TO WHOM REPORT IS SUBMITTED BY AN AUDITOR?

The outcome of an audit is written audit report in which auditor expresses an opinion. The report is submitted to person making the appointment.

In case of companies, these are shareholders;

In case of a firm, to partners who have engaged him.

तरक्की होगी तो गिरने वाले भी होंगे
तुम तैयार रहना आजमाने वाले भी
होंगे !!!

2. FEATURES / CHARACTERISTICS OF AUDIT

2.1 SYSTEMATIC & INDEPENDENT

- Independence means that the judgement of a person is not subordinate to wishes of another person. It requires that he should not act under any influence. Thus, he can work in a complete unbiased manner.

Will Discuss in Detail SA 220

2.2 FINANCIAL STATEMENTS

- Auditor's opinion is on financial statements including Profit and loss account. Balance sheet & notes to accounts.
- The preparation of financial statements as per applicable Financial Reporting Framework (F.R.F) is the responsibility of management of entity

2.3 ENTITY

- His client can be any entity whatever is the legal form i.e. it may be proprietorship, partnership, trust or company etc.
- The entity may be profit oriented or a charitable one.

2.4 OPINION

- His opinion is on '**true & fair view**' of financial statements.
- For this, it is necessary that
 - (i) Financial statement have been prepared using acceptable **policies** which are consistently applied,
 - (ii) Financial statements have been prepared as per relevant **regulations**, &
 - (iii) There is appropriate **disclosure** of all material items

Note – We will Study different types of Opinion in SA 700 Series

In India, audit is to be conducted by a professional having good accounting & auditing background. A chartered accountant having certificate of practice is eligible to conduct audit.

The Auditor conducting Audit should take care to ensure that financial statements would not mislead anybody.

In doing so, he has to see that financial statements would not mislead anybody by ensuring that: -

- the accounts have been drawn up with reference to entries in the books of account;
- the entries in the books of account are adequately supported by sufficient and appropriate evidence;
- none of the entries in the books of account has been omitted in the process of compilation;
- the information conveyed by the statements is clear and unambiguous;
- the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards;
- the statement of accounts presents a true and fair picture of the operational results and of the assets and liabilities.

Auditing provides assurance. Its basic nature lies in providing assurance to users - providing confidence to users of financial statements. Such an assurance lends credibility to financial statements. Audited financial statements provide confidence to users that financial information reflected in financial statements can be relied upon.

3. AUDIT TEAM AND FLOW

BASIC FLOW FOR PRACTICAL KNOWLEDGE

- | | |
|--------------------------------|--------------------------|
| 1. Client Proposal | 10. Control Testing |
| 2. Risk Formalities | 11. Substantive Testing |
| 3. Acceptance of Audit | 12. Reporting/Conclusion |
| 4. Meeting with Management | 13. QRM Team |
| 5. Planning Meeting with Team | |
| 6. Process Understanding | |
| 7. Risk Understanding | |
| 8. Controls Understanding | |
| 9. 7 & 8 is covered under WT's | |



▪ Partner ▪ Senior Manager ▪ Manager
▪ Assistant Manager/ Seniors ▪ Staff

4. QUALITIES OF AN AUDITOR

An auditor is concerned with the reporting on financial matters of business and other institutions. Financial matters inherently are to be set with the problems of human fallibility; errors and frauds are frequent.

Tact, caution, firmness, good temper, integrity, discretion, industry, judgement, patience, clear headedness and reliability are some of qualities which an auditor should have. In short, all those personal qualities that go to make a good businessman contribute to the making of a good auditor.

In addition, he must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence.

The auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education. He is called upon constantly to critically review financial statements and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert.

An exhaustive knowledge of accounting in all its branches is the sine qua non of the practice of auditing. He must know thoroughly all accounting principles and techniques.

STUDENT NOTES



5. SA 200 OVERALL OBJECTIVES OF THE INDEPENDENT AUDITOR AND CONDUCT OF THE AUDIT IN ACCORDANCE WITH Sa's

- a) Overall Objective of Auditor
- b) Scope of Audit
- c) Aspects to be covered in Audit
- d) Reasonable Assurance
- e) Inherent Limitations of Audit
- f) Auditor Requirement/Responsibility of Auditor

5.1 OVERALL OBJECTIVES OF THE AUDITOR

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

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

In all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient, the SAs require that the auditor disclaim an opinion or withdraw from the engagement.



An analysis of above brings out following points clearly: -

- (1) Auditor's objective is to obtain a reasonable assurance whether financial statements as a whole are free from material misstatement whether due to fraud or error. Reasonable assurance is to be distinguished from absolute assurance. Absolute assurance is a complete assurance or a guarantee that financial statements are free from material misstatements. However, reasonable assurance is not a complete guarantee. Although it is a high-level of assurance but it is not complete assurance.

Audit of financial statements is carried out by the auditor with professional competence and skills in accordance with Standards on Auditing. Audit procedures are applied in accordance with SAs, audit evidence is obtained and evaluated. On basis of that, conclusions are drawn and opinion is formed. It leads to high level of assurance which is called as reasonable assurance but it is not absolute assurance.

- (2) Misstatements in financial statements can occur due to fraud or error or both. The auditor seeks to obtain reasonable assurance whether financial statements as a whole are free from material misstatements caused by fraud or error. He has to see effect of misstatements on financial statements as a whole, in totality.

IMP Notes : The user, however, should not assume that the auditor's opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise.

5.2 SCOPE OF AUDIT - WHAT IT INCLUDES”

Scope refers to range or reach of something. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. Users of financial statements may be shareholders, employees, customers, government and regulatory authorities, bankers etc. Enhancing of degree of confidence is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

The following points are included in scope of audit of financial statements: -

(1) Coverage of all aspects of entity

Audit of financial statements should be organized adequately to cover all aspects of the entity relevant to the financial statements being audited.

(2) Reliability & sufficiency of financial information

The auditor should be reasonably satisfied that information contained in underlying accounting records and other source data (like bills, vouchers, documents etc.) is reliable and sufficient basis for preparation of financial statements.

The auditor makes a judgment of reliability and sufficiency of financial information by studying & assessing of accounting systems & internal controls and by carrying out appropriate tests, enquiries and procedures.

(3) Proper disclosure of financial information

The **management responsible for preparation** & presentation of financial statements makes many judgments.

The auditor should also decide whether relevant **information is properly disclosed** in the financial statements. He should also keep in mind applicable statutory requirements in this regard. It is done by ensuring that financial statements properly summarize transactions & events & by considering judgments made by management in preparation of financial statements.

For example, choosing method of charging depreciation on fixed assets or choosing appropriate method for valuation of inventories.

The auditor evaluates **selection and consistent application of accounting policies** by management; whether such a selection is proper & whether chosen policy has been applied consistently on a period-to-period basis.

Understand that financial statements of an entity are prepared on historical financial information basis. "Historical financial information" means information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

For example, when purchases and sales are reflected in financial statements of an entity, these are examples of historical financial information. These are about transactions which have occurred in past.

STUDENT NOTES



5.3 SCOPE OF AUDIT - WHAT IT DOES NOT INCLUDE?

Auditor is not expected to perform duties which fall outside domain of his competence. For example, physical condition of certain assets like that of sophisticated machinery cannot be determined by him. Similarly, it is not expected from an auditor to determine suitability and life of civil structures like buildings. These require different skillsets which may be performed by qualified engineers in their respective fields.

An auditor is not an expert in authentication of documents. The genuineness of documents cannot be authenticated by him because he is not an expert in this field.

An audit is not an official investigation into alleged wrong doing. He does not have any specific legal powers of search or recording statements of witness on oath which may be necessary for carrying out an official investigation.

Audit is distinct from investigation. Investigation is a critical examination of the accounts with a special purpose. For example, if fraud is suspected and it is specifically called upon to check the accounts whether fraud really exists, it takes character of investigation.

The objective of audit, on the other hand, as has already been discussed, is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion.

Therefore, audit is never started with a pre-conceived notion about state of affairs; about wrong-doing some wrong having been committed. The auditor seeks to report what he finds in normal course of examination of accounts. However, it is quite possible that sometimes investigation results from the prima facie findings of the auditor. It may happen that auditor has given some findings of serious concern. Such finding may prompt for calling an investigation.

The scope of audit is general and broad whereas scope of investigation is specific and narrow.

An Overview of Scope of Audit

Check box	Scope of audit of financial statements
✓	Coverage of all aspects of entity relevant to the financial statements being audited.
✓	Reliability and Sufficiency of financial information
✓	Proper disclosure of financial information
✓	Expression of an opinion on financial statements
✗	Responsibility of preparation and presentation of financial statements
✗	Duties outside scope of competence of auditor
✗	Expertise in authentication of documents
✗	Investigation



STUDENT NOTES

Test Your Understanding

Lalji Bhai has purchased shares of a company listed on NSE. The audited financial statements of the company provide picture of healthy financial performance having robust turnover, low debt and good profits. On above basis, he is absolutely satisfied that money invested by him is safe and there is no chance of losing his money. Do audited results and audit reports of companies provide such assurance to investors like Lalji Bhai? Is thinking of Lalji Bhai correct?

Ans : An audit does not provide assurance to investor in shares regarding safety of his money. Share prices of securities are affected by range of factors. An audit only provides reasonable assurance that financial statements are free from material misstatement whether due to fraud or error. Hence, thinking of Lalji Bhai is not correct.

Test Your Understanding

Good deeds Limited is engaged in business of recycling of wastes from dumping grounds of municipal corporation of Indore to usable manure. It is, in this way, also, helping to make the city clean.

During course of audit by Zoha & Zoha, a firm of auditors, it is observed by auditors that company has received a notice from Central Bench of National Green Tribunal for not following certain environmental regulations involving imposition of hefty monetary penalty on the company. The company is yet to reply to the notice. The auditors point out that same is not stated in notes to accounts in financial statements. The company points out that auditors are going beyond scope of their work. Does such a matter fall within scope of audit?

Ans : Proper disclosure of financial information is well within scope of audit.

Test Your Understanding

A huge fire broke out in NOIDA plant of KT Limited. Plant assets comprising building, machinery and inventories were insured from branch of a public sector insurance company. Apart from an insurance surveyor who was deputed for assessing loss, the regional office of insurance PSU also appointed a CA for verification of books of accounts/ financial records of the company and circumstances surrounding the loss. He was also requested to submit an early report. Would the report by CA in nature of audit report?

Ans : Appointment of CA for verification of books of accounts/financial records and circumstances surrounding the loss is for a specific objective to determine genuineness of loss and any issue affecting liability of insurance company. It is an investigation and not in nature of audit report.

STUDENT NOTES



5.4 REASONABLE ASSURANCE W.R.T MISSTATEMENT

- Auditor is required to obtain **reasonable assurance** as to whether the financial statements are free from material misstatements
- Reasonable assurance is to be distinguished from absolute assurance. Absolute assurance is a complete assurance or a guarantee that financial statements are free from material misstatements. It is a high-level of assurance but it is not complete assurance.
- Thus, auditor obtains sufficient and appropriate audit evidence to reduce audit risk to an acceptable low level.
- However, reasonable assurance is not absolute assurance. This is due to inherent limitations of an audit.

5.5 INHERENT LIMITATIONS OF AUDIT

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

The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit. The inherent limitations of an audit arise from:

(1) Nature of financial reporting

Preparation of financial statements involves making many judgments by management. These judgments may involve subjective decisions or a degree of uncertainty. Therefore, auditor may not be able to obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.

Responsibility of preparation of F.S and design of Internal control- One of the premises for conducting an audit is that management acknowledges its responsibility of preparation of financial statements in accordance with applicable FRF & for devising suitable internal controls. However, such controls may not have operated to produce reliable financial information due to their own limitations.

For example, that management of a company has devised a control that all purchase bills should reflect stamp & signatures of an authorised person stating the date and time of receiving goods in premises. Now, what happens if concerned accountant & authorised person collude. It is a case of overriding of internal controls due to collusion between two persons.

(2) Nature of Audit procedures

Practical Limitation due to Sampling- The auditor carries out his work by obtaining audit evidence through performance of audit procedures. However, there are practical & 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.

Legal Limitation - Management may not provide complete information as requested by auditor. There is no way by which auditor can force management to provide complete information. In case he is not provided with required information, he can only report.

Fraud by Management - The management may consist of dishonest people & may be, itself, involved in fraud. It may be engaged in concealing fraud by designing sophisticated and carefully organized schemes which may be hard to detect by the auditor. It may produce fabricated documents to lead him to believe that audit evidence is valid.

Related Party Transaction (SA 550) - It is quite possible that entity may have entered into some transactions with related parties. Such transactions may be only paper transactions and may not have actually occurred. The auditor may not be aware of such related party relationships or audit procedures may not be able to detect probable wrong doings in such transactions.

(3) Not in nature of investigation

As already discussed, audit is not an official investigation. Hence, auditor cannot obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.

(4) Timeliness of financial reporting & decrease in relevance of information over time

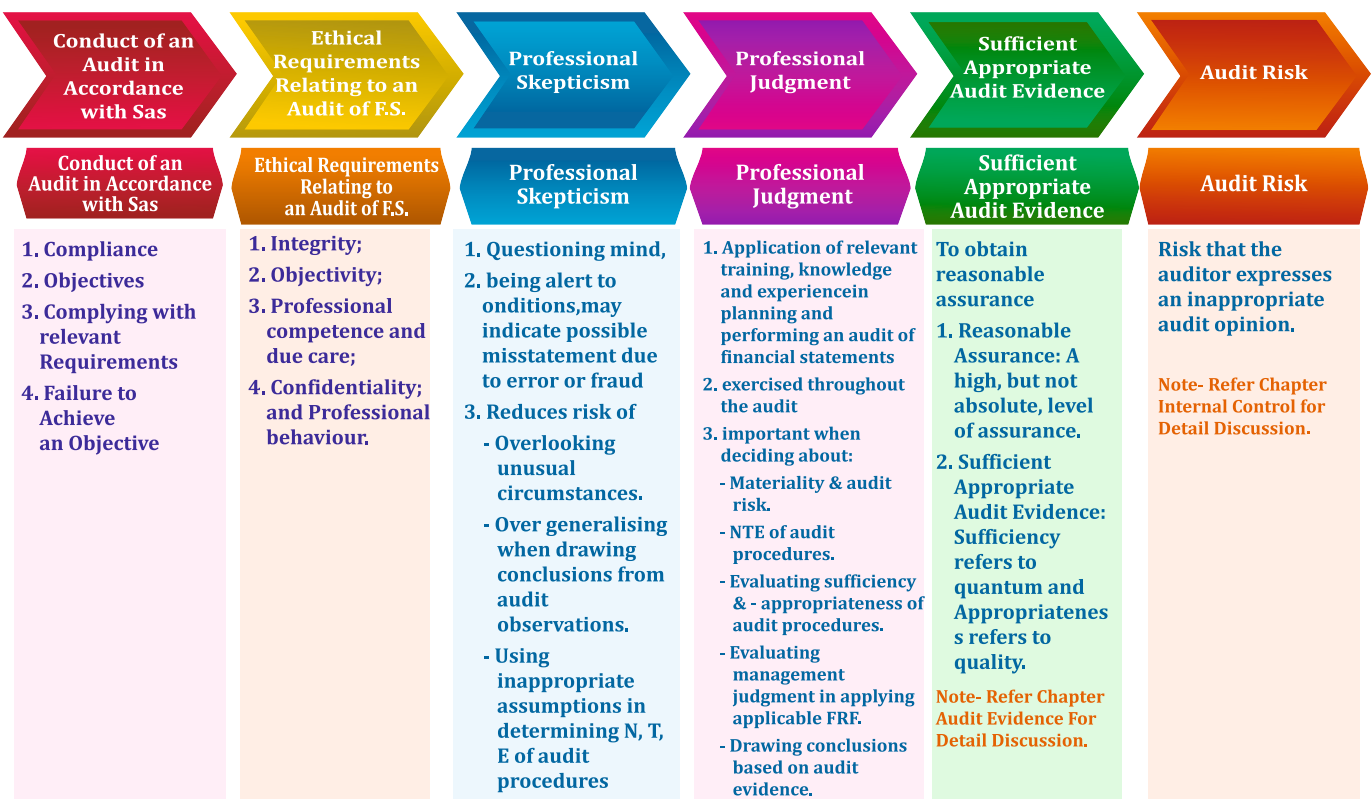
The relevance of information decreases over time & auditor cannot verify each and every matter. Therefore, a balance has to be struck between reliability of information and cost of obtaining it.

For example, an auditor who is conducting audit of a company since last two years. During these two years, he has sought detailed information from management of company regarding various matters. During his third- year, he chooses to rely upon some information obtained as part of audit procedures of second year. However, it could be possible that something new has happened & that information is not relevant.

(5) Future events- Detail Discussion in SA 560

Future events or conditions may affect an entity adversely. Adverse events may seriously affect ability of an entity to continue its business. The business may cease to exist in future due to change in market conditions, emergence of new business models or products or due to onset of some adverse events.

5.6 AUDITOR REQUIREMENT /RESPONSIBILITIES OF THE AUDITOR



1. Conduct of an Audit in Accordance with SAs

Compliance

The auditor shall comply with all SAs relevant to the audit.

- The auditor shall have an understanding of the entire text of an SA.
- The auditor shall not represent compliance with SAs in the auditor's report unless the auditor has complied with the requirements of this SA and all other SAs relevant to the audit.

Objectives-

Use this objective to achieve overall states in India- objectives.

- Having regard to interrelationship between SAs:
- Determine if any audit procedure in addition to that required by SAs is necessary.
- Evaluate whether sufficient appropriate audit evidence has been obtained.

Complying with relevant Requirements of SA

Auditor have to comply all the SA's unless,

- Entire SA is not relevant.
- Requirement is not relevant because it is conditional & condition does not exist.
- Departure form requirement in exceptional circumstances - perform alternative procedures to achieve aim of requirement.

Failure to Achieve an Objective

Auditor should evaluate if the failure Prevents auditor from achieving the overall objectives of the auditor, and Necessitates modified audit opinion. Auditor should withdraw from engagement if It is a significant matter for documentation.

2. Ethical Requirements Relating to an Audit of F.S.

The term "Ethics" means moral principles which govern a person's behaviour or his conducting of an activity. Ethics is something which comes from an individual intrinsically. Ethics is the science of morals in human conduct.

Need for Professional Ethics: Society in general, governments, clients, taxing authorities, employees, investors, the business and financial community in particular, have reposed **tremendous trust** in services rendered by Chartered Accountants.

The purpose of assurance engagements is to **enhance confidence** of the intended users. Therefore, users need to trust the person who is providing such services. Professional ethics seek to **protect the interests of the profession** as a whole and act as a shield that enables us to command respect.

Any **deviation from the ethical responsibilities brings the disciplinary mechanism** into action which may result into fines, suspension of membership, removal from membership or other disciplinary actions.

Principle based approach Vs Rule based approach (Ethical or legal): The essence of principles-based approach is that it requires compliance with spirit of ethics. It requires accountants to exercise professional judgment based upon their professional knowledge, skill and expertise.

However, rules-based approach to ethics strictly follows clearly established rules. It may lead to a narrow outlook and spirit of ethics may be overlooked while strictly adhering to rules. Rules- based approach is somewhat rigid as it may not be possible to deal with every practical situation relying upon rules.

The auditor shall comply with relevant ethical requirements, including independence. Relevant ethical requirements ordinarily comprise the Code of Ethics issued by the ICAI. The fundamental principles are:

1. Integrity

Integrity requires auditor to be straight forward and honest in all professional and business relationships. It implied fair dealing and truthfulness. it effectively means that he shall not be associated with reports, returns, communications or other information which he believes contains a materially false or misleading statements; contains statements or information provided recklessly or omits required information where such omission could be misleading.

2. Objectivity;

The principle of objectivity requires an auditor **not to compromise professional judgment** because of bias, conflict of interest or undue influence of others.

3. Professional competence and due care

It requires that auditor attains and maintains professional knowledge and skill at the level required to render competent professional service based on current technical and professional standards and legislation and also to act diligently and in accordance with technical and professional standards. Diligence includes responsibility to act carefully, thoroughly and on a timely basis in accordance with requirements of and assignment.

4. Confidentiality

Confidentiality principle requires a professional accountant to respect the confidentiality of information acquired as a result of professional or business relationships. Confidentiality serves the public interest because it facilitates the free flow of information from the professional accountant's client or employing organization to the accountant with the understanding that the information will not be disclosed to a third party.

However, such confidential information may be disclosed, for example, when it is required by law, when it is permitted by law and is authorised by the client or employer or there is a professional duty or right to disclose when not prohibited by law.

5. Professional behaviour

It requires an accountant to **comply with relevant laws and regulations** and avoid any conduct that the accountant knows or should know might discredit the profession. A professional accountant **shall not** knowingly engage in any employment, occupation or activity that **impairs or might impair** the integrity, objectivity or good reputation of the profession, and as a result would be incompatible with the fundamental principles.

6. Independence - Refer detail concept given at the end of this chapter.**Test Your Understanding**

CA P. Suryakantam has conducted audit of accounts of an entity for a particular year. ICAI has issued a letter to him relating to certain matters concerning audit. He didn't even bother to reply to the letter despite reminders. Discuss which fundamental principle governing professional ethics is disregarded by him.

Ans : Failure to reply to professional body smacks of lack of courtesy and professional responsibility. The principle of "Professional behaviour" is disregarded.

Test Your Understanding

A Chartered accountant in practice issued a certificate showing original cost of plant and machinery installed in premises of a client for Rs. 9 crores to save some regulatory fees for his client. However, original cost of plant and machinery was Rs.15 crore as per records of client. Which fundamental principle governing professional ethics is violated in this case?

Ans: "Integrity" requires that a professional accountant shall not knowingly be associated with reports, returns, communications or other information where the accountant believes that the information contains a materially false or misleading statement; contains statements or information provided negligently or omits or obscures required information where such omission or obscurity would be misleading. In the given case, a false certificate is knowingly issued showing misstated original cost of machinery. Therefore, fundamental principle of "integrity" is violated.

3. Professional Skepticism

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

Professional Skepticism Requirement and Auditor Expectation.

1. The auditor shall plan & perform an audit with professional skepticism.
2. **It Reduces risk of:**
 - Overlooking unusual circumstances.
 - Over generalizing when drawing conclusions from audit observations.
 - Using inappropriate assumptions in determining N, T, E of audit procedures & evaluating the results thereof.
3. **Professional skepticism includes being alert to:**
 - Contradictory audit evidence.
 - Questions on reliability of documents.
 - Conditions indicating possible frauds.
 - Circumstances suggesting need for audit procedures in addition to those suggested in SA's.

Professional skepticism is necessary to the **critical assessment of audit evidence**. It also includes consideration of the **sufficiency and appropriateness of audit evidence** obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the **reliability of information** to be used as audit evidence. In cases of **doubt about the reliability of information or indications of possible fraud**, the SAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.

The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism.

4. Professional Judgment

Meaning:

- The application of relevant training, knowledge and experience,
- Within the context provided by auditing, accounting & ethical standards,
- In making informed decisions about the courses of action.
- That are appropriate in the circumstances of the audit engagement.

Requirements:

- A. The auditor shall exercise professional judgment in planning and performing an audit of financial statements.
- B. Its exercise depends on facts & circumstances known to the auditor.
- C. Professional Judgment is to be exercised throughout the audit and to be appropriately documented.
- D. **Professional Judgment is important when deciding about:**
 - Materiality & audit risk.
 - NTE of audit procedures.
 - Evaluating sufficiency & appropriateness of audit procedures.
 - Evaluating management judgment in applying applicable FRF.
 - Drawing conclusions based on audit evidence.

6. AUDIT- MANDATORY OR VOLUNTARY?

It is not necessary that audit is always legally mandatory. There are entities like companies who are compulsorily required to get their accounts audited under law. Even non-corporate entities may be compulsorily requiring audit of their accounts under tax laws. For example, in India, every person is required to get accounts audited if turnover crosses certain threshold limit under income tax law.

It is also possible that some entities like schools may be required to get their accounts audited for the purpose of obtaining grant or assistance from the Government.

Audit is not always mandatory. Many entities may get their accounts audited voluntarily because of benefits from the process of audit. Many such concerns have their internal rules requiring audit due to advantages flowing from an audit

7. ADVANTAGES OF AUDIT OF FINANCIAL STATEMENTS

- a) Audited accounts provide **high quality information**. It gives confidence to users that information on which they are relying is qualitative and it is the outcome of an exercise carried out by following Auditing Standards recognized globally.
- b) **Shareholder interest is safeguarded by an audit**. In case of companies, shareholders may or may not be involved in daily affairs of the company. The financial statements are prepared by management As shareholders are owners of the company, they need an independent mechanism so that financial information is qualitative and reliable.
- c) An audit acts as a **moral check on employees** from committing frauds for the fear of being discovered by audit.
- d) Audited financial statements are **helpful to government authorities** for determining tax liabilities.
- e) Audited financial statements can be **relied upon by lenders**, bankers for making their credit decisions i.e. whether to lend or not to lend to a particular entity.
- f) An audit may also **detect fraud** or error or both.
- g) An audit **reviews existence and operations of various controls** operating in any entity. Hence, it is useful at pointing out deficiencies.



STUDENT NOTES

8. RELATIONSHIP OF AUDITING WITH OTHER DISCIPLINES

Auditing is interdisciplinary in nature. It draws from **diverse subjects** including accountancy, law, behavioural science, statistics, economics and financial management & makes use of these subjects. Since audit is concerned with financial information, a sound knowledge of accounting principles is a fundamental requirement for an auditor of financial statements to conduct audit & express an opinion. Similarly, good knowledge of business laws and various taxation laws helps auditor to understand financial statements in a better way in accordance with applicable laws.

Knowledge of subject like economics helps auditor to be familiar with overall economic environment in which specific business is operating. Financial management deals with issues such as funds flow, working capital management, ratio analysis etc. and an auditor is expected to be knowledgeable about these for applying some of audit procedures and carrying out audit effectively. Besides, knowledge of financial markets comprised in study of financial management is expected from a professional auditor.

During course of audit, auditor has to **interact with lot of persons for seeking information** and making inquiries. This can be done only if one has knowledge of human behaviour. Auditors use statistical methods to draw samples in a scientific manner. It is not possible for an auditor to check each and every transaction. So, use of statistical methods to draw samples for conducting audit is made.

Summary

Auditing and accounting- Auditing reviews the financial statements which are nothing but a result of the overall accounting process.

Auditing and law - An auditor should have a good knowledge of business laws affecting the entity.

Auditing and economics - Auditor is expected to be familiar with the overall economic environment of the client.

Auditing and behavioural science - Knowledge of human behaviour is essential for an auditor to effectively discharge his duties.

Auditing and data processing - EDP auditing in itself is developing as a discipline in itself.

Auditing and financial management - Auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc. Auditing

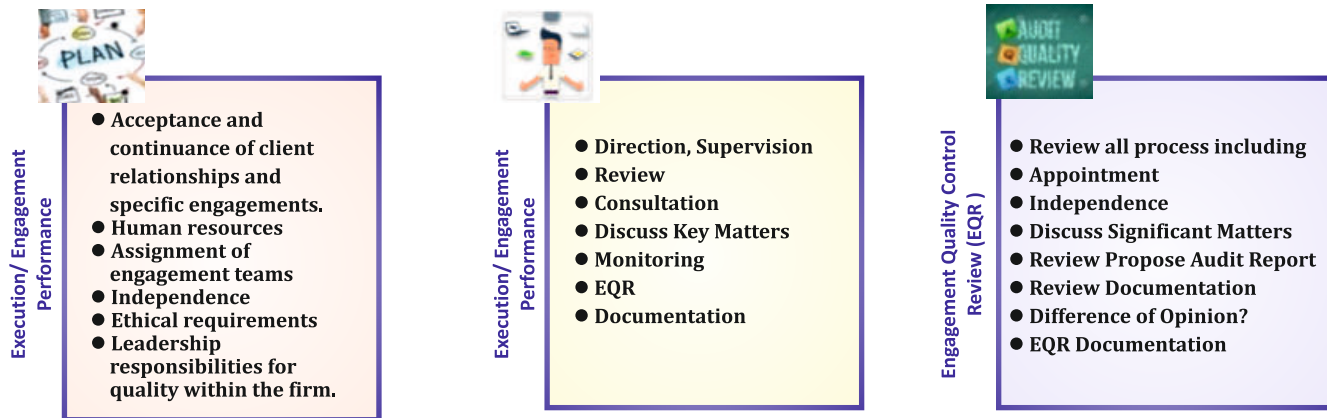
STUDENT NOTES



9. SA 220 QUALITY CONTROL FOR AN AUDIT OF FINANCIAL STATEMENTS

ELEMENTS OF A SYSTEM OF QUALITY CONTROL

As per SQC 1 "Quality Control for Firms that perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", the firm's system of quality control should include policies and procedures addressing each of the following elements:



Acceptance and continuance of client relationships and audit engagements

1. The engagements partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationship and audit engagements have been followed.
2. If the engagement partner obtains information that would have caused the firm to decline the audit engagement had that information been available earlier, the engagement partner shall communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action.

A firm before accepting an engagement should acquire vital information about client. Such an information should help firm to decide about:-

- ❖ The integrity of the principal owners, key management and TCWG of the entity;
- ❖ Competency of engagement team to perform the audit engagement and availability of necessary capabilities, including time and resources;
- ❖ Compliance with relevant ethical requirements by firm and the engagement team; and
- ❖ 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 & business reputation of client's principal owners, key management, related parties & TCWG.
- The nature of client's operations, including its business practices.
- Information concerning attitude of client's principal owners, key management & TCWG towards such matters as aggressive interpretation of accounting standards & internal control environment.

	<ul style="list-style-type: none"> • Whether 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. • The reasons for the proposed appointment of the firm and non-reappointment of the previous firm. <p>If there is any conflict of interest between the firm & client, it should be properly resolved before accepting the engagement.</p>
Human resources	<p>As per SQC1 "Quality Control for Firms that perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", 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 necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.</p> <p>Such policies and procedures address the following personnel issues:</p> <ul style="list-style-type: none"> ❖ Recruitment; ❖ Performance evaluation; ❖ Capabilities; ❖ Competence ❖ Career development; ❖ Promotion; ❖ Compensation; and ❖ Estimation of personnel needs. <p>Addressing these issues enables the firm to ascertain the number and characteristics of the individuals required for the firm's engagements. The firm's recruitment processes include procedures that help the firm select individuals of integrity as well as the capacity to develop the capabilities and competence necessary to perform the firm's work.</p>
Assignment of engagement teams	<p>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:</p> <ol style="list-style-type: none"> 1. Perform the audit engagement in accordance with professional standards & regulatory & legal requirements, & 2. Enable an auditor's report that is appropriate in the circumstances to be issued.
Independence	<p>The engagement partner shall form a conclusion on compliance with independence requirements. In doing so, the engagement partner shall:</p> <ol style="list-style-type: none"> 1 Obtain relevant information to identify circumstances and relationship that create threats to independence; 2 Evaluate information on identified breaches, of the firm's independence policies and procedures; and 3 Take appropriate action to eliminate such threats or reduce them to an acceptable level or to withdraw from the audit engagement.

<p>Relevant ethical requirements Note – Covered in SA 200</p>	<ol style="list-style-type: none"> Throughout the audit engagement, the engagement partner shall remain alert, for non-compliance with relevant ethical requirements by members of the engagement team. If matters come to the engagement partner's attention that indicate that members of the engagement team have not complied with relevant ethical requirements, the engagement partner, in consultation with others in the firm, shall determine the appropriate action. 	
<p>Leadership, responsibilities for quality on audits</p>	<p>As per SA 220 "Quality Control for an Audit of Financial Statements" the engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.</p> <p>As a part of this responsibility Engagement Partner should emphasize the following to the engagement Team (ET):</p> <ul style="list-style-type: none"> ❖ Compliance with professional Standards and legal requirements. ❖ Compliance with firm's Quality Control Policies. ❖ Issuance of appropriate audit report. ❖ Ability to raise concerns without fear. ❖ Quality is essential & indispensable in engagement performance. <p>Meaning of Engagement partner: The partner or other person in the firm who is a member of the Institute of Chartered Accountants of India and is in full time practice and is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.</p>	
<p>Engagement performance</p>	<p>Direction, supervision & performance</p>	<p>The engagement partner shall take responsibility for:</p> <ul style="list-style-type: none"> • The direction, supervision and performance of the audit engagement in compliance with professional standards & regulatory and legal requirements, and • The auditor's report being appropriate in the circumstances.
	<p>Reviews</p>	<ul style="list-style-type: none"> • The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures. • On or before the date of the auditor's report, the engagement partner shall, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions and the auditor's report.
	<p>Consultation</p>	<p>The engagement partner shall:</p> <ul style="list-style-type: none"> • Take responsibility for the engagement team undertaking appropriate consultation of difficult matters; • Be satisfied that engagement team have undertaken consultation both within the engagement team & between the engagement team and others; • Be satisfied that the nature and scope of and conclusions resulting from, such consultations are agreed with the party consulted; and • Determine that conclusions resulting from such consultations have been implemented.

<p>Policy and Procedure for Engagement Performance</p>	<p>Through its policies and procedures, the firm seeks to establish consistency in the quality of engagement performance. This is often accomplished through written or electronic manuals, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials.</p> <p>Matters addressed include the following:</p> <ul style="list-style-type: none"> ❖ How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work. ❖ Processes for complying with applicable engagement standards. ❖ Processes of engagement supervision, staff training and coaching. ❖ Methods of reviewing the work performed, the significant judgments made and the form of report being issued. ❖ Appropriate documentation of the work performed and of the timing and extent of the review. ❖ Processes to keep all policies and procedures current.
<p>Monitoring</p>	<ul style="list-style-type: none"> • The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. • Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements. • The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of: <ul style="list-style-type: none"> ○ Adherence to professional standards and regulatory and legal requirements; ○ Whether the quality control system has been appropriately designed and effectively implemented; and ○ Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances. • Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures. 
<p>Engagement quality control review</p>	<ol style="list-style-type: none"> 1. For audits of financial statements of listed entities and those other audit engagement for which the engagement quality control reviews is required, the engagement partner shall: <ol style="list-style-type: none"> a) Determine that an engagement quality control reviewer has been appointed, b) Discuss significant matters with the engagement quality control reviewer, and c) Not date the auditor report until the completion of the engagement quality control review, 2. The engagement quality control reviewer shall evaluate the following: <ol style="list-style-type: none"> (a) Discussion of significant matters with the engagement partner (b) Review of the financial statements and the proposed auditors report (c) Review of selected audit documentation and (d) Conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's report is appropriate.

	<p>3. For audits of financial statements of listed entities, the engagement quality control reviewer shall also consider the following:</p> <ul style="list-style-type: none"> (a) The engagement team's evaluation of the firm's independence (b) Whether appropriate consultations have taken place & the conclusions arising from those consultations (c) Whether audit documentation selected for reviews reflects the work performed and supports the conclusions reached
Differences of opinion	<p>If differences of opinion arise within the engagement team with those consulted or between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm's policies and procedures for dealing with and resolving differences of opinion.</p>
Documentation	<p>1. The auditors shall document:</p> <ul style="list-style-type: none"> a) Issues identified with respect to compliance with relevant ethical requirements & how they were resolved b) Conclusions on compliance with independence requirements c) Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements d) The consultations undertaken during the course of the audit engagement <p>2. The engagement quality control reviewer shall document, for the audit engagement reviewed that,</p> <ul style="list-style-type: none"> a) The procedures for engagement quality control review have been performed b) The engagement quality control review has been completed on or before the date of the auditors' reports and c) The reviewer is not aware of any unresolved matters.

Test Your Understanding

CA PK Nair is offered appointment as auditor of a company engaged in providing tourism services. While making due diligence of the proposed client, he comes to know that there have been raids on premises of the company and residences of its directors by National Investigation Agency (NIA) on suspicion of links with terror outfits. It has been followed up with searches by Enforcement Directorate hunting for illicit money trail. There is a strong suspicion of tourism services provided by company being facade of terror funds. Should proposed offer be accepted by him?

Ans : Integrity of principal owners has to be considered before accepting an audit engagement in accordance with SA 220. In this regard, SA 220 states requirements on lines of SQC 1. SQC 1 clearly states that in cases where there are indications that the client might be involved in money laundering or other criminal activities, appointment should not be accepted. In the instant case, there have been raids of NIA on suspected links with terror outfits which is a criminal activity. Further, raids by Enforcement Directorate also point towards money laundering. Therefore, proposed offer should not be accepted.

10. INDEPENDENCE OF AUDITORS

10.1 MEANING OF INDEPENDENCE

- ❖ To define "independence" precisely is not possible since independence is a state of mind and personal character.
- ❖ According to the Guidance Note of the ICAI on "Independence of Auditors" independence implies that the judgment of a person is not subordinate to the wishes or directions of another person who might have engaged him.
- ❖ It stipulates that the independence is a condition of mind and personal character and should not be confused with the visible standards of independence.

10.2 INDEPENDENCE IS:

- (a) **Independence of mind** - the state of mind that permits the provision of an opinion without being affected by influences allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and
- (b) **Independence in appearance** - the avoidance of facts and circumstances that are so significant that a third party would reasonably conclude an auditor's integrity, objectivity or professional skepticism had been compromised."

Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons.

- ❖ The auditor has to conduct himself in such a way that no reasonable person, can doubt his objectivity and integrity. In fact, the word independent as a prefix in audit proposition in itself enshrines the concept of independence of an auditor and it is thus, considered fundamental concept in the theory of auditing.
- ❖ The relationship between the auditor and the client should be such that firstly, he himself is satisfied about his client and then it is understood by others that the independence of the auditor is not affected.

10.3 REQUIREMENTS OF LAW ENSURING INDEPENDENCE

Law also makes an attempt to ensure auditor's independence. For instance:

- ❖ The Companies Act, 2013 contains specific provisions to ensure the independence of the auditor e.g.
 - ✓ the right of access given to the auditor to the books of account and other documents,
 - ✓ provisions disqualifying certain persons to act as auditor,
 - ✓ Provisions relating to appointment, removal, etc. are to ensure the independence of the auditor.
- ❖ Various provisions in the Schedules to the Chartered Accountants' Act, 1949 on misconduct are also an attempt to protect the independence of the auditor and to keep the professional competence.

STUDENT NOTES



10.4 THREATS TO INDEPENDENCE

1. **Self-interest threats-** It may occur as a result of the financial or other interests of a professional accountant or of a relative. Examples are:
 - ❖ Direct or indirect financial interest in a client,
 - ❖ Loan or guarantee to or from the concerned client,
 - ❖ Undue dependence on a client's fees,
 - ❖ Close business relationship with an audit client,
 - ❖ Potential employment with the client, and
 - ❖ Contingent fees for the audit engagement
2. **Self-review threats-** It may occur when a previous judgment needs to be re- evaluated by the professional accountant responsible for that judgment. Instances where such threats may arise are:
 - ❖ when an auditor having recently been a director or senior officer of the company, and
 - ❖ when auditors perform services that are themselves subject matters of audit.
3. **Advocacy threats-** It may occur when a professional accountant promotes a position or opinion to the point that subsequent objectivity may be compromised. For example, an auditor dealing with shares or securities of the audited company, or becomes the client's advocate in litigation and third-party disputes.
4. **Familiarity threats-** are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests. This can occur in many ways:
 - Close relative of the audit team working in a senior position in the client company,
 - Former partner of the audit firm being a director or senior employee of the client,
 - Long association between specific auditors and their specific client counterparts, and
 - Acceptance of significant gifts or hospitality from the client company, its directors or employees.
5. **Intimidation threats-** which occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.



10.5 SAFEGUARDS TO INDEPENDENCE

The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats.

The following are the guiding principles in this regard: -

1. Auditors should always be and appears to be independent of the entities that they are auditing.
2. Auditor should abide himself with the key fundamental principles are integrity, objectivity and professional skepticism.
3. Auditor should consider threats to independence before accepting any audit assignment.
4. In case of existence of any threats to independence, auditor should not accept the engagement or put in place safeguards that eliminate them. If necessary safeguards cannot be put in place due to circumstances, auditor should withdraw.
5. If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

Test Your Understanding

CA Raman Gupta is offered appointment as auditor of a company. One of his distant uncles held some shares in the same company. Holding of such shares, by a distant relative, is not prohibited under provisions of law nor does it affect his independence. Before he could accept appointment, he received unfortunate news of death of his uncle who had died without any children. He came to know that he was nominee of these shares having substantial value. It landed him in a tricky situation. What should be proper course of action for him?

Ans : When threats to independence exist, the auditor should either desist from the task or eliminate the threat or at the very least, put in place safeguards which reduce the threats to an acceptable level. Holding of shares involves financial interest in the company and is in nature of self-interest threat. He has come to hold shares due to nomination made by his distant relative before accepting the appointment. Considering above, he should take steps to eliminate the threat by selling shares immediately before accepting appointment. Holding of shares of the same company for which he is offered appointment as auditor constitutes threat to his independence.

Test Your Understanding

A Chartered accountant receives about 40% of his total audit fees from a single client. Discuss how it could affect independence of Chartered accountant as auditor of this client. What are such types of threats referred to as?

Ans : Undue dependence on fees of a client constitutes a threat as there is fear of losing the client. Such threats are referred to as self-interest threats.

Test Your Understanding

CA Murli Madhavan provides accounting and book keeping services to a leading NGO engaged in environmental protection work. He is also offered audit of the accounts of NGO. Identify and discuss what kind of threat to independence may be involved in accepting such an engagement.

Ans : In this case, Chartered Accountant is already rendering accounting and bookkeeping services to an NGO. If he accepts audit, he would be involved in reviewing own work. Therefore, the same constitutes “self-review” threat

Test Your Understanding

The auditors of a company have only relied upon management representation letter regarding treatment of certain tax matters under appeal by the company. The auditors have not carried out any other audit procedures to justify management's treatment of the said tax matters under appeal in the financial statements. What is lacking on part of auditors in such a situation?

Ans : In the given case, auditors have relied only upon management representation letter regarding treatment of certain tax matters under appeal by the company. No other audit procedures to verify management's treatment of such matters under appeal have been performed by auditors. It shows lack of “professional skepticism” on part of auditors.

Test Your Understanding

Zeeba Products is a partnership firm engaged in trading of designer dresses. The firm has appointed JJ & Co, Chartered accountants to audit their accounts for a year. The auditors were satisfied with control systems of firm, carried out required procedures and necessary verifications. In particular, they carried out sample checking of purchases, traced purchase bills to GST portal and also made confirmations from suppliers. They were satisfied with audit evidence obtained by them as part of audit exercise. An audit report was submitted to the firm giving an opinion that financial statements reflected true and fair view of state of affairs of the firm.

11. SA 210 – AGREEING THE TERMS OF AUDIT ENGAGEMENT

PRECONDITIONS FOR AN AUDIT

- Acknowledgment by management of its responsibility w.r.t
- Preparation of financial statement as per FRF
- I.C so that financial statement should be free from frauds and error
- They will provide auditor with :
 - #access to all information
 - #additional information
 - #unrestricted access to persons if necessary

AUDIT ENGAGEMENT TERMS

- Audit Engagements letter includes
- Objectives of the Audit
- Scope of Audit
- Responsibility of Mgt. and Auditor
- Identification of FRF
- Reference to expected form & content of reports to be issued by the auditors
- If Laws/Regulation prescribes terms, then no need for separate written terms except that management acknowledge the same.

11.1 WHAT IS AN ENGAGEMENT?

Engagement means an arrangement to do something. In the context of auditing, it means a formal agreement between auditor and client under which auditor agrees to provide auditing services. It takes the shape of engagement letter.

11.2 OBJECTIVE OF AUDITOR

The objective of the auditor is to **accept or continue** an audit engagement only when the basis upon which it is to be performed has been agreed, through:

- a) Establishing whether the **preconditions for an audit** are present; &
- b) Confirming that there is a **common understanding** between the auditor and management & TCWG, of the terms of the audit engagement.

11.3 PRECONDITIONS FOR AN AUDIT

The use by management of an acceptable FRF in the preparation of the financial statements & the agreement of management &, where appropriate, TCWG to the premise on which an audit is conducted. In order to establish whether the preconditions for an audit are present, the auditor shall:

- I. Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable; and
- II. Obtain the agreement of management that it acknowledges and understands its responsibilities for followings:
 - The preparation of the F.S. in accordance with the applicable FRF.
 - Exercising necessary internal control to enable the preparation of F.S. that are free from material misstatement, whether due to fraud or error.

➤ to provide the auditor with:

- Access to all relevant information such as records, documentation and other matters;
- Additional information that the auditor may request from management for the purpose of the audit and
- Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

11.4 WHAT HAPPENS IF PRECONDITIONS FOR AN AUDIT ARE NOT PRESENT?

If the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement:-

- (a) If the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable or
- (b) If the agreement of management is not obtained on matters relating to understanding of responsibility of management on preparation of financial statements, internal controls for preparation of financial statements, providing access to all information to auditor and unrestricted access to persons within the entity.

11.5 LIMITATION ON SCOPE PRIOR TO AUDIT ENGAGEMENT ACCEPTANCE

If management or TCWG impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the F.S., the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

11.6 OTHER FACTORS AFFECTING AUDIT ENGAGEMENT ACCEPTANCE

If the preconditions for an audit are not present, the auditor shall discuss the matter with management. The auditor shall not accept the proposed audit engagement:

- If the auditor has determined that the FRF to be applied in the preparation of the F.S. is unacceptable, or
- If the management does not agree with its responsibilities prescribed above.

11.7 AGREEMENT ON AUDIT ENGAGEMENT TERMS

- 1) The auditor shall agree the terms of the audit engagement with management or TCWG, as appropriate.
- 2) **The audit engagement letter is sent by auditor to his client. The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:**
 - The objective and scope of the audit of the F.S.;
 - The responsibilities of the auditor;
 - The responsibilities of management;
 - Identification of the applicable FRF for the preparation of the F.S. &
 - Reference to the expected form and content of any reports to be issued by the auditor & a statement that there may be circumstances in which a report may differ from its expected form and content.
- 3) If law or regulation prescribes in sufficient detail the terms of the audit engagement referred above, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities.

11.8 RECURRING AUDITS

In case of recurring audits, the auditor shall assess whether circumstances require revision in terms of the audit engagement and whether there is a need to remind the entity of the existing terms of the audit engagement. The auditor may decide not to send a new audit engagement letter or other written agreement each period.

However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

- ✓ Any indication that the entity misunderstands the objective and scope of the audit.
- ✓ Any revised or special terms of the audit engagement.
- ✓ A recent change of senior management.
- ✓ A significant change in ownership.
- ✓ A significant change in nature or size of the entity's business, legal or regulatory requirements or changes in other reporting requirements

11.9 ACCEPTANCE OF A CHANGE IN THE TERMS OF THE AUDIT ENGAGEMENT:

a) Request from Entity to change the Terms of Audit Engagement-When Reasonable Justification Exists?

A request from the entity for the auditor to change the terms of the audit engagement may result from a **change in circumstances** affecting the need for the service,

A misunderstanding as to the nature of an audit as originally requested or a restriction on the scope of the audit engagement, whether imposed by management or caused by other circumstances.

The auditor considers the justification given for the request, particularly the implications of a restriction on the scope of the audit engagement. A change may not be considered reasonable if it appears that change relates to information that is incorrect, incomplete or otherwise unsatisfactory.

An example might be where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the entity asks for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion.

b) What should auditor consider before agreeing to change the audit engagement to the engagement providing lower level of assurance?

If, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement that conveys a lower level of assurance, the auditor shall determine whether there is reasonable justification for doing so.

Before agreeing to change an audit engagement to a review or a related service, an auditor who was engaged to perform an audit in accordance with SAs may also need to assess any legal or contractual implications of the change.

If the auditor concludes that there is reasonable justification to change the audit engagement to a review or a related service, the audit work performed to the date of change may be relevant to the changed engagement. In order to avoid confusing the reader, the report on the related service would not include reference to:

- (a) The original audit engagement or
- (b) Any procedures that may have been performed in the original audit engagement, except where the audit engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.

c) Recourse available to auditor in situation of non-agreement to a change in terms of engagement and lack of permission from management to continue original audit engagement

If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:

- (a) Withdraw from the audit engagement where possible under applicable law or regulation and
- (b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

Test Your Understanding

Chirag, as part of articled training, is part of an engagement team conducting audit of a company. He has read somewhere that engagement letter issued by auditor to client also includes expected form and content of the auditor's report. He was at a loss to understand how could an auditor include form and content of the report before hand. Try to help Chirag by making things clear to him.

Ans

Engagement letter includes reference to expected form and content of audit report. It merely states that auditor would provide opinion in this form. However, engagement letter also includes statement that the form and content of report may need to be amended in the light of audit findings. Therefore, if in light of audit findings, auditor needs to give a modified opinion, he shall do so.

Test Your Understanding

The management of an entity feels that it is not necessary for it to give in writing explicitly to the auditor that it understands its responsibilities for preparation of financial statements in accordance with applicable financial reporting framework. Discuss, whether, it is necessary for the management to do so. In case management refuses, why should an auditor not accept the proposed engagement?

Ans

It is necessary for management to give in writing explicitly to the auditor that it understands its responsibilities for preparation of financial statements in accordance with applicable financial reporting framework. It is a necessary precondition for an audit in accordance with SA 210.

If the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement: -

- (a) If the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable or
- (b) If the agreement of management is not obtained on matters relating to understanding of responsibility of management on preparation of financial statements, internal controls for preparation of financial statements, providing access to all information to auditor and unrestricted access to persons within the entity.

Unless required by law or regulation to do so, such a refusal on the part of auditor is necessary as management is not willing to accept its responsibility for preparation of financial statements in accordance with applicable financial reporting framework. An audit is conducted on this basic premise according to SA 210. When basic premise on which audit is conducted is not fulfilled, refusal by auditor is necessary.

STUDENT NOTES

