EDU91

CA Inter Audit



Neeraj Arora

Seekhna Shuru toh Jeetna Shuru

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Teacher- Neeraj Arora

Website- www.edu91.org

Support Team-
Call: 9810113555
Chatbox: https://www.edu91.org/s/pages/chat-support

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Important Points to be kept in mind

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Abbreviations List

Abbreviation	Full Form
FS	Financial Statement
TCWG	Those Charged with Governance
RAP	Risk Assessment Procedures
FAP	Further Audit Procedures
TOD	Test of Details
SAAE	Sufficient and Appropriate Audit Evidence
CA	Chartered Accountant
ICAI	Institute of Chartered Accountants of India
SAP	Substantive Analytical Procedure
IC	Internal Control
ROMM	Risk of Material Misstatement
IAF	Internal Audit Function
RPRT	Related Party Relationships and Transactions
OB	Opening Balance
MGT.	Management
MMS	Material Mistatement(s)

Please be aware that the abbreviations presented in this book are applicable here. However, it is important to refrain from using any abbreviations in your examination.

Chapter 1 - Nature, Objective and Scope of Audit

Meaning and Nature of Auditing

Meaning of Audit

An audit is an

- *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

Analysis of the definition

- Audit is an independent examination of financial information.
  - Independence, here, implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him.
- Audit applies to various entities, including non-profits (e.g., NGOs, trusts), regardless of size or legal form (e.g., sole proprietorships, partnerships, LLPs, private/public companies, societies, trusts).
- The purpose of the audit is to express an opinion on the FSs.
- Historical financial information - relates to information expressed in financial terms of an entity about economic events, conditions or circumstances occurring in past periods.
- Financial statements – A structured representation of historical financial information, including related notes, intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework.

Objectives of Auditor

In conducting audit of FSs, objectives of auditor in accordance with *SA 200* "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing" are: -

a) To obtain *reasonable assurance* about whether the *FSs* 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 FSs are *prepared*, in all *material* respects, in accordance with an *applicable financial reporting framework*; and

b) To *report* on the FSs, and *communicate* as required by the SAs, in accordance with the auditor's findings.

Actual language used in audit report and industry

Whether the financial statements:

- Give a *true* and *fair* view (or present fairly in all material respects).
- Are prepared, in all material respects, in accordance with an applicable financial reporting framework.

True

Factually correct information which

- conforms with accounting standards and relevant legislation, and
- agrees with the underlying records.

Fair

Clear, impartial and unbiased information

- which reflects the commercial substance of the transactions of the entity.

For example - Security amount received from customers is your liability and not your income, if shown as income it is not clear, impartial and unbiased and therefore it is not fair.

Reasonable Assurance

A *high*, but *not absolute*, level of assurance.

Meaning of Assurance Engagement

What is Engagement?

Engagement means an arrangement to do something.

Assurance engagement

- An engagement in which a *practitioner* obtains sufficient appropriate *evidence* in order to express a *conclusion* designed to *enhance* the degree of *confidence* of the *intended users* other than the *responsible party* about the outcome of the evaluation or measurement of a *subject matter* against *criteria*.
- Giving assurance means offering an *opinion* about *specific information* so the *users* of that information are able to make *confident decisions* knowing that the *risk* of the information being *'incorrect'* is *reduced*.

Elements of an Assurance Engagement

Following elements comprise an assurance engagement: -

A three party relationship involving a practitioner, a responsible party, and intended users

- An assurance engagement involves above said three parties.
- A *practitioner* is a person who *provides assurance*.
- The term practitioner is broader than auditor.
- Audit is related to historical information whereas practitioner may provide assurance not necessarily related to historical financial information.
- A *responsible party* is the party *responsible* for *preparation* of *subject matter*.
- *Intended users* are the persons for *whom* an assurance *report* is *prepared*. These persons may use the report in making *decisions*.

An appropriate subject matter

- It refers to the information to be *examined* by the practitioner.
- In case of audit, financial information or we can say FS is the appropriate subject matter.
- Who is responsible for subject matter - Management / Those charged with governance is responsible for subject matter that is the financial information.

Suitable criteria

- These refer to *benchmarks* used to evaluate the subject matter like standards, guidance, laws, rules and regulations.
- In case of audit, accounting standards are the suitable criteria

Sufficient appropriate evidence

- The practitioner performs an assurance engagement to obtain sufficient appropriate evidence. It is on the basis of evidence that conclusions are arrived and an opinion is formed by auditor.

  (Details to be studied after Audit Evidence Chapter)
- "*Sufficient*" relates to *quantity* of evidence obtained by auditor.
- "*Appropriate*" relates to *quality* of evidence obtained by auditor.
- One evidence may be providing more comfort to auditor than the other evidence.
- The evidence providing more comfort is qualitative and, therefore, appropriate. Evidence should be both sufficient and appropriate.

A written assurance report in appropriate form

It is the *final outcome* of assurance engagement. It contains the *conclusion* that conveys the assurance about the subject matter.

Misstatement

A *difference* between

- the amount, classification, presentation, or disclosure
  - of a reported FS item
- and the amount, classification, presentation, or disclosure
  - that is required for the item to be in accordance with the applicable financial reporting framework.

Misstatements can arise from error or fraud

- The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the FSs is intentional or unintentional.
- 'Fraud' deals with intentional misrepresentation but, 'error', on the other hand, refers to unintentional mistakes in financial information.
- Few examples of misstatements could be: -
  - Charging of an item of capital expenditure to revenue or vice-versa
  - Difference in disclosure of a financial statement item vis-à-vis its requirement in applicable financial reporting framework
  - Selection or application of inappropriate accounting policies
  - Intentional booking of fake expenses in statement of profit and loss
  - Overstating of receivables in financial statements by not writing off irrecoverable debts
  - Overstating or understating inventories

When a misstatement will be considered as material

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 FSs;

Types of Opinion

- Clean Opinion
- Modified Opinion
  - Qualified Opinion
  - Adverse
  - Disclaimer of Opinion

Nature of Matter Giving Rise to the Modification	Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements	
	Material but Not Pervasive	Material and Pervasive
Financial statements Are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

Meaning of Pervasive

- The term pervasive is used to describe the effect of misstatements on the financial statement
- Whether the effect of material misstatement is pervasive or not it depends on auditors judgement.
- While deciding that the effect is pervasive or not auditor must keep the following things in mind
- Effect is pervasive when it is not confined to a specific element
- Even if it is confined to a specific element the effect can be considered as pervasive if it represent a substantial proportion of financial statements
- In relation to disclosures, The effect can be considered as pervasive if It is fundamental to users understanding of the financial statements.

Those charged with governance

The person(s) or organisation(s) with ***responsibility*** for

- overseeing the ***strategic direction*** of the entity and
- ***obligations*** related to the of the entity

Management

- The person(s) with ***executive responsibility*** for conduct of entity's operation

Pre- Conditions for an audit

In order to establish whether the preconditions for an audit are present, the auditor shall:

- Determine whether the financial reporting framework is ***acceptable***; and
- Obtain the ***agreement*** of ***management*** that it ***acknowledges*** (मानती है) and ***understands*** (जानती है) its responsibility:
    - For the preparation of the ***financial statements*** in accordance with the applicable financial reporting framework;
    - For the ***internal control*** as management considers necessary; and
    - To provide the auditor with:
        - ***Access*** to all ***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.

Internal Control

The Process ***d***esigned, ***i***mplemented and ***m***aintained by

- ➔ Those charged with governance
- ➔ Management
- ➔ Other personnel

To Provide Reasonable Assurance with regard to

- Reliability of ***financial reporting***
- Effectiveness & Efficiency of ***operations***
- Safeguarding of ***assets***
- Compliance with applicable ***law*** & ***regulations***

Test Checking

- Application of Audit Procedures to less than 100% of the Transaction. It is also known as Sampling.
- Should be done in such a way that every item must have an equal chance of selection.

Judgement

The ***application*** of relevant

- ➔ ***training***, ***knowledge*** & ***experience***, (TKE)
- ➔ in making ***informed decisions***
- ➔ about the courses of action that are appropriate in the circumstances of the audit engagement.

Professional judgement is ***essential*** to the proper conduct of an audit.

(Study this part while revising Chapter 1 For the first time after completion of syllabus)
Professional judgment is ***necessary*** in particular regarding ***decisions*** about:

- ***Materiality*** and ***audit risk***.
- The ***n***ature, ***t***iming, and ***e***xtent of audit ***procedures*** used to meet the requirements of the SAs and gather audit evidence.

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

Other Points
- May differ from person to person
- Can also be formed after consultation

Framework to conduct audit

→ Engagement / Appointment of the auditor
→ Planning
→ Materiality
→ Risk assessment (Risk assessment procedures) ; and
→ Response to the assessed risk (Further audit procedures)
  - ◆ Tests of controls, when required by the SAs or when the auditor has chosen to do so; and
  - ◆ Substantive procedures (Checking of Assertions), including
    - Tests of details and
    - Substantive analytical procedures.
→ Audit Evidence
→ Conclusions, Opinion and Reporting
→ Audit Documentation.

Risk Assessment and Risk Assessment Procedures

- Risk assessment is done to *assess* the risk of material misstatement. (ROMM)
- Risk of material misstatement is defined as 'the risk that the *financial statements* are *materially misstated prior* to *audit*
- Risk assessment procedures are
  - ○ used to
    - ■ obtain an *understanding* of the entity and its environment,
    - ■ including its *internal control*
  - ○ in order to
    - ■ assess the risk of material misstatement and
    - ■ determine the nature, extent and timing of further audit procedures.
- After RAP, the Auditor can assess the level of ROMM.
- Once the ROMM is assessed, we can decide NET of FAPs
  - ○ Nature - (Compliance or Substantive)
  - ○ Extent - (Sample size, Less work or more work)
  - ○ Timing - (Interim period and some transaction at the year end OR all year end in detail)
- Risk assessment procedures *alone do not provide audit evidence* sufficient to support audit opinion.
- They are required in all financial statement audits.

Further Audit Procedures

Compliance Procedure or Test of control

- Auditor will test internal control to assure that his initial understanding of IC was right or not.
- We will (For testing IC)
  - ○ Check Design (SoD, Approvals, Reconciliations etc)
    - ■ No - Leave it go for SP
    - ■ Yes test efficiency (Operation and Continuity)

- Test of *Efficiency* (Operation and Continuity) If internal controls are efficient then it is going to have a direct impact on the nature, extent and timing of substantive procedures.

Substantive Procedure

- Auditor will check transactions, account balance presentation and disclosure
  - Analytical Procedures
  - Test of Details (Vouching and Verification)

Assertions

- Assertions refer to *representations by management*, explicit or otherwise, that are embodied in the financial statements.
- By stating that the financial statements are in compliance with the relevant financial reporting framework, management is making certain assertions about the proper recognition, measurement, presentation, and disclosure of the various components of the financial statements and any accompanying disclosures.
- Auditor will check those claims (assertions).
- The assertions used by the auditor to identify potential errors or inaccuracies in financial statements can be divided into three categories and may take the following forms.

Transactions	Account balance	Presentation and Disclosure
Occurrence	*E*xistence	*Occurence* and rights and obligations
*C*ompleteness	*R*ights and obligations	*C*ompleteness
*A*ccuracy	*C*ompleteness	*Classification* and understandability
*C*ut-off	*V*aluation and allocation	*A*ccuracy and valuation
*C*lassification		

Assertions related to transactions

Occurrence

Transactions that are recognized in the financial records as having occurred, i.e., did it really happen? and such transactions and events *pertain* to the *entity*.

Completeness

All transactions and events that should have been recorded have been *recorded*.

Accuracy

Amounts and other data relating to recorded transactions and events have been recorded *appropriately*.

Cut-off

Transactions and events have been recorded in the correct *accounting period*.

Classification

Transactions and events have been recorded in the *proper accounts*.

Assertions related to Account Balance

Existence

Assets, liabilities, and equity interests *exist*.

Rights and obligation
the entity *holds* or *controls* the *rights* to assets, and *liabilities* are the *obligations* of the entity.

Completeness
All assets, liabilities and equity interests that should have been *recorded* have been recorded.

Valuation and allocation
Assets, liabilities, and equity interests are included in the financial statements at *appropriate amounts* and any resulting *valuation* or *allocation* adjustments are appropriately recorded.

Assertions related to Presentation and Disclosure
Occurrence and rights and obligations
Disclosed events, transactions, and other matters have occurred and *pertain* to the *entity*.

Completeness
All disclosures that should have been included in the financial statements have been *included*.

Classification and understandability
Financial information is *appropriately presented* and *described*, and disclosures are clearly expressed.

Accuracy and valuation
Financial and other information are disclosed *fairly* and at *appropriate amounts*.

Example on Assertion

		₹
Plant & Machinery (at Cost)		4,00,000
Less: Depreciation till the end of previous year	1,40,000	
For the year	26,000	1,66,000
		2,34,000

The assertions are as follows:
- the firm owns the plant and machinery;
- the historical cost of plant and machinery is ₹ 4 lacs;
- the plant and machinery physically exists;
- the asset is being utilised in the business of the company productively;
- total charge of depreciation on this asset is ₹ 1,66,000 to date on which ₹ 26,000 relates to the year in respect of which the accounts are drawn up; and
- the amount of depreciation has been calculated on a recognised basis and the calculation is correct.
- The above assertions are *implicit*

Explicit assertions are made when otherwise the reader will be left with an incomplete picture; it may even be misleading.
- Secured Loans ₹ 4,00,000
- The description does not give us a complete picture. We do not know:
  - the name of the lender, if it is relevant;
  - the nature of security provided; and
  - the rate at which interest is payable.
- Negative assertions are also encountered in the financial statements and the same may be expressed or implied. For example, if it is stated that there is *no contingent liability* it would be an expressed *negative assertion*;

On the other hand, if in the balance sheet there is no item as "building", it would be an ***implied negative assertion*** that the entity did not own any building on the balance sheet date.

Audit evidence

Information used by the auditor in arriving at the ***conclusions*** on which the auditor's ***opinion*** is based. Audit evidence includes both information contained in the ***accounting records*** underlying the financial statements and ***other information***.

Information contained in the accounting records

Accounting records include

- the records of initial accounting entries and supporting records such records of fund transfer
- Invoices;
- Contracts
- the ledgers, journal entries and other adjustments to the financial statements.
- records such as worksheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

Other information

Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements:

Other information which the auditor may use as audit evidence includes, for example

- ***minutes*** of the meetings,
- written ***confirmations*** from trade receivables and trade payables,
- ***manuals*** containing details of internal control etc.

Audit Risk

The risk that the auditor expresses an ***inappropriate opinion*** when the ***FSs*** are ***materially misstated***. Audit risk can be divided into two part

- Risk of material misstatement.
  - Inherent risk
  - Control risk
- Detection Risk

What is not included in Audit Risk ?

- Risk that the auditor might ***express*** an ***opinion*** that the ***FSs are materially misstated when they are not.***
- Audit risk is a technical term related to the process of auditing; it does ***not*** refer to the ***auditor's business risks*** such as loss from litigation, adverse publicity, or other events arising in connection with the audit of FSs.

Inherent Limitations of Audit - SA 200

- 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 objectives of an audit, is to enable an auditor to express an opinion on such FSs.
- The auditor is ***not expected*** to, and ***cannot, reduce audit risk to zero*** and ***cannot*** therefore ***obtain absolute assurance*** that the FSs are free from material misstatement due to fraud or error.
- This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being ***persuasive rather than conclusive***.

- The process of auditing, however, is such that it suffers from certain limitations, i.e. the limitation which cannot be overcome irrespective of the nature and extent of audit procedures. The limitations of an audit arise from

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 FS 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:

Nature of financial reporting

- Preparation of FSs involves making many *judgments* by management.
  - These judgments may involve *subjective* decisions or a degree of *uncertainty*. \
  - Therefore, the auditor may not be able to obtain absolute assurance that FSs are free from material misstatements due to frauds or errors.
- One of the premises for conducting an audit is that management acknowledges its responsibility of preparation of FSs in accordance with the applicable financial reporting framework and for devising suitable internal controls. However, such controls may not have operated to produce reliable financial information due to their own limitations.

Nature of Audit procedures

- There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example,
  - 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.
  - Management may *not provide complete information* as requested by auditor. There is no way by which auditor can force management to provide complete information as may be requested. In case he is not provided with required information, he can only report. It is an example of legal limitation on an auditor's ability to obtain audit evidence.
- The management may consist of dishonest and unscrupulous people and 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 before auditor to lead him to believe that audit evidence is valid. However, in reality, such documents could be fake or non-genuine.
- An auditor is *not* an *expert* in *authentication* of *documents*. Therefore, he may be led to accept invalid audit evidence on the basis of unauthentic documents.
- It is quite possible that the 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.

Not in nature of investigation

- An 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

Timeliness of financial reporting and decrease in relevance of information over time

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

Future events

- Future events or conditions may affect an entity adversely.
- *Adverse events* may seriously affect the entity's ability 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.

Because of the limitations of an audit, there is an unavoidable risk that some material misstatements of the FSs may not be detected, even though the audit is properly planned and performed in accordance with SAs.

However, the inherent limitations of an audit are *not a justification* for the auditor to be satisfied with less-than persuasive audit evidence.

Who Appoints an Auditor?

Auditors are appointed by the entity's owners, members in AGMs for companies, or by government authorities as per law. In India, the CAG appoints auditors for government companies, while partners appoint auditors for firms. Sometimes, auditors may also be appointed by government authorities under specific laws or regulations, such as tax laws.

To Whom Report is submitted by an Auditor?

The result of an audit is a written report with the auditor's opinion, submitted to the *appointing party*: shareholders for companies, and partners for firms.

Different Type of Assurance Engagements

1. Audit
2. Review
3. Other Assurance Engagements.

Meaning of Review; Audit Vs. Review

- A review engagement is an example of a limited assurance engagement. Entities not legally bound may opt for financial reviews. Reviews provide assurance, cost less, cause less disruption.
- Both "audit" and "review" are related to FSs prepared on the basis of historical financial information. The differences are as follows

Reasonable assurance	Limited assurance
Thorough Procedures - Test of Controls, Substantive Procedures - MORE DEPTH	*Less* detailed *procedures* - Enquiries, Analytical Procedure. - LESS DEPTH
High Level *Assurance*	*Moderate* or *lower assurance*
Subject matters confirms with *Suitable criteria* in all material aspects. (Reasonable Conclusions)	Subject matter is *plausible* in the circumstance. The language signifies that level of assurance is moderate or lower. (Limited Conclusions)
Positively worded opinion.	Negatively worded opinion.
More regulations / standards.	Less.
In our opinion, the FSs give a true and fair view of (or present fairly, in all material respects) the financial position of X Company as at 31st March, 20X4, and of its financial performance and its cash flows for the year then ended in accordance with Applicable Financial Reporting Framework	Nothing has come to our attention that causes us to believe that the FSs of Y Company as of 31st March, 20X4 are not prepared, in all material respects, in accordance with an applicable financial reporting framework.
Example - Audit	Example - Review engagements

Other assurance engagements

Assurance can also be related to matters other than historical financial information. Such an assurance may relate to prospective financial information. It may relate to providing assurance on internal controls in an entity.

Assurance on Prospective Financial Information,

- "*Prospective financial information*" means *financial information based* on *assumptions* about *events* that may occur in the *future* and *possible actions* by an entity. It can be in the *form* of a *forecast* or *projection* or *combination* of both.
- In assurance reports involving prospective financial information, the practitioner obtains sufficient appropriate evidence to the effect that
  - *management's assumptions* on which the prospective financial information is based are not unreasonable,
  - the prospective financial information is *properly prepared* on the basis of the assumptions and
  - it is *properly presented* and *all material* assumptions are *adequately disclosed*.
- Evidence may be available to support the assumptions on which the prospective financial information is based, such evidence is itself generally future- oriented. The auditor is, therefore, not in a position to express an opinion as to whether the results shown in the prospective financial information will be achieved.
- In such assurance engagements, practitioner provides a report assuring that nothing has come to practitioner's attention to suggest that these assumptions do not provide a reasonable basis for the projection.
- Hence, such type of assurance engagement provides only a "*moderate*" level of assurance.

Quality Control and Engagement Standards

Why are Standards needed?

- Standards ensure carrying out of audit against established *benchmarks* at par with global practices.
- Standards improve *quality* of *financial reporting* thereby helping users to make diligent decisions.
- Standards promote *uniformity* as audit of FSs is carried out following these Standards.
- Standards equip professional accountants with professional *knowledge* and skill.
- Standards ensure audit *quality*.

Standards on Quality Control

- *SQC 1 - "Quality Control for Firms that Perform Audit and Reviews of Historical Financial Information, and other Assurance and Related Services Engagements"*
- Standards on Quality Control (SQCs) have been issued to establish standards and provide guidance regarding a *firm's responsibilities* for its system of quality control for the conduct of audit and review of historical financial information and for other assurance and related service engagements.
- SQC 1 has been issued in this regard. It requires auditors/practitioners to establish system of quality control so that firm and its personnel *comply* with professional *standards* and *regulatory* & legal *requirements* and reports issued are appropriate.

Engagement Standards

The following Standards issued under authority of ICAI Council are collectively known as Engagement Standards: -

1. Standards on auditing (SAs) which apply in *audit* of *historical financial information.*
2. Standards on review engagements (SREs) which apply in *review* of *historical financial information*.
3. Standards on Assurance engagements (SAEs) which apply in assurance engagements *other than audits* and *review* of historical financial information.
4. Standards on Related Services (SRSs) which apply in agreed upon procedures to *information*, *compilation engagements* and other related service engagements.

The purpose of issue of these standards is to establish high quality standards and guidance in the areas of FS audits and in other types of assurance services.

Standards on Auditing

- Standards on Auditing apply in the context of an audit of FSs by an independent auditor. It is important to remember that Standards on Auditing apply in *audit* of *historical information*. They can also be termed as performance benchmarks for the auditors.
- The main purpose is to bring as much *uniformity* as possible in work performed by auditors.

- Standards on Auditing cover a broad range of topics including the auditor's objectives, documentation, audit planning, risk assessment, sampling, evidence, and the formation and reporting of opinions on financial statements (FSs), encompassing all key areas of FS audit.
- Some examples of Standards on Auditing are: -
    - SA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing
    - SA 230 Audit Documentation
    - SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
    - SA 500 Audit Evidence
    - Revised SA 700 Forming an Opinion and Reporting on Financial Statements

Numbering of Standards

Standard on Quality Control (SQC)	01-99
Standard on Auditing (SA)	100-999
Standard on Review Engagement (SRE)	2000-2699
Standard on Assurance Engagement (SAE)	3000-3699
Related Services (SRS)	4000-4699

Classification of SAs

Introductory matters	100-199
General Principles and Responsibilities	200-299
Risk Assessment and Response to Assessed Risk	300-499
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List of Standards

General Principles and Responsibilities		
1	SA 200	Overall objectives of the Independent Auditor and the conduct of the Audit in Accordance with Standard on Auditing
2	SA 210	Agreeing the Terms of Audit Engagements
3	SA 220	Quality Control for an Audit of financial statements
4	SA 230	Audit Documentation
5	SA 240	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements.
6	SA 250	Consideration of Laws and Regulations in an Audit of Financial Statements
7	SA 260	Communication with those Charged with Governance
8	SA 265	Communicating Deficiencies in Internal control to those Charged with Governance and Management
9	SA 299	Joint Audit of financial statements
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10	SA 300	Planning an Audit of Financial Statements
11	SA 315	Identifying and Assessing the Risk of material Misstatements through understating the Entity and Its Environment

12	SA 320	Materiality in Planning and Performing an Audit
13	SA 330	Response to Assessed Risks
14	SA 402	Audit consideration Relating to an Entity using a Service Organisation
15	SA 450	Evaluation of Misstatements Identified during the Audit
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16	SA 500	Audit Evidence
17	SA 501	Audit Evidence-Specific Consideration for selected Items
18	SA 505	External Confirmations
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20	SA 520	Analytical Procedures
21	SA 530	Audit Sampling
22	SA 540	Auditing Accounting Estimates, Including fair value Accounting Estimates and Related Disclosures
23	SA 550	Related Parties
24	SA 560	Subsequent Events
25	SA 570	Going Concern
26	SA 580 (	Written Representation
Using Work of Others		
27	SA 600	Using the work of Other Auditors
28	SA 610	Using the Work of Internal Auditors
29	SA 620	Using the Work of an Auditor's Expert
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30	SA 700	Forming an Opinion and Reporting on Financial Statements
31	SA 701	Communicating key Audit Matters in the Independent Auditor's Report
32	SA 705	Modifications to the opinion in the independent Auditor's Report
33	SA 706	Emphasis of Matter Paragraphs and other Matter Paragraphs in the Independent Auditor's Report
34	SA 710	Comparative Information -Corresponding Figures and Comparative Financial Statements
35	SA 720	The Auditor's responsibilities relating to Other Information
Standards on Quality Control		
36	SQC 1	"Quality Control for Firms that Perform Audit and Reviews of Historical Financial Information, and other Assurance and Related Services Engagements"

Standards on Review Engagements

- Standards on review engagements apply in the context of *review of FSs.*
- Review is a *limited assurance engagement* and it provides assurance which is lower than that provided by audit. It is due to the fact that review involves fewer procedures as compared to audit.
- Since a review also provides assurance to users, it also involves obtaining sufficient appropriate evidence. For example, when an auditor performs review of interim financial information of an entity.
- Examples of Standards on Review engagements are:
  - *SRE 2400* (Revised) Engagements to Review Historical FSs
  - *SRE 2410* Review of Interim Financial Information Performed by the Independent Auditor of the Entity
- It is to be noted that both Standards on auditing and Standards on review engagements apply to engagements involving historical financial information.

Standards on Assurance Engagements

- Standards on Assurance Engagements apply to *non-historical financial information* and include various assurance services beyond audits or reviews of historical data, such as examining prospective financial information or assessing non-financial aspects like internal controls.
- Examples of Standards on Assurance Engagements are:
  - *SAE 3400* The Examination of Prospective Financial Information
  - *SAE 3420* Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus

Standards on Related Services

- Standards on Related Services govern engagements for agreed-upon *procedures* on *financial information* and *compilation* engagements where *no assurance* is *provided*. They outline the practitioner's duties in such services, which can include specific financial data checks or assisting in the preparation of financial statements without expressing an opinion.
- 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 FS, say, a balance sheet or even a complete set of FSs.
- An engagement in which practitioner may be called upon to *assist management* with the *preparation* and *presentation* of historical *financial information* without obtaining assurance on that information.
- Examples of Standards on related services are:
  - *SRS 4400* Engagements to perform agreed-upon procedures regarding financial information
  - *SRS 4410* (Revised) Compilation engagements

Duties in relation to Engagement and Quality Control Standards

- It is the duty of professional accountants to see that Standards are followed in engagements undertaken by them. Ordinarily, these are to be followed by professional accountants.
- However, a situation may arise when a specific procedure as required in Standards would be ineffective in a particular engagement. In such a case, he is required to
  - *document* how alternative procedures performed achieve the purpose of required procedure
  - *reason* for *departure* has also to be documented unless it is clear.
  - his *report* should draw attention to such departures.
- Disclosure in a report does not exempt accountants from complying to relevant Standards.

Scope of Audit-What It Includes

Scope refers to the coverage of something.

Scope of Audit

The following points are included in scope of audit of FSs: -

Coverage of all aspects of entity

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

Reliability and sufficiency of financial information

- Auditors must ensure the *reliability* of accounting *records* and *source data* (e.g., bills, vouchers, documents) as a sufficient foundation for the FSs.
- Auditors *assess* the *reliability* and *sufficiency* of *financial information* through analysis of accounting systems, internal controls, and execution of relevant tests, inquiries, and procedures.

Proper disclosure of financial information

- The auditor must ensure FSs adequately disclose relevant information and comply with statutory requirements, verifying that they accurately summarize recorded transactions and considering management's judgments in their preparation.
- The auditor evaluates management's judgments in FS preparation, including the selection and consistent application of accounting policies, such as depreciation methods for fixed assets and inventory valuation, ensuring proper choice and period-to-period consistency.
- FSs are based on historical financial information, which includes financial data on past economic events and conditions from an entity's accounting system, like past purchases and sales transactions.

Scope of audit-What it does not include

- Auditors are not required to assess matters beyond their expertise, such as the physical condition of complex machinery or the suitability and lifespan of buildings, which are better evaluated by qualified engineers.
- Auditors are not document authentication experts and cannot verify the genuineness of documents.
- An audit is not a formal inquiry into misconduct and does not grant the auditor legal authority for searches or sworn witness statements necessary for official investigations.
- Audit differs from investigation; the latter is a detailed examination for a specific purpose, such as fraud detection. Audit has a broad scope, while investigation is focused and narrow.

Benefits of Audit-Why Audit is Needed

- 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.
- In case of companies, shareholders may or may not be involved in daily affairs of the company. The FSs are prepared by management consisting of directors. As shareholders are owners of the company, they need an independent mechanism so that financial information is qualitative and reliable. Hence, their interest is safeguarded by an audit.
- An audit acts as a moral check on employees from committing frauds for the fear of being discovered by audit.
- Audited FSs are helpful to government authorities for determining tax liabilities.
- Audited FSs 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.
- An audit may also detect fraud or error or both.
- An audit reviews the existence and operations of various controls operating in any entity. Hence, it is useful at pointing out deficiencies.

Audit- Mandatory Or Voluntary?

- Audit may not be legally mandatory for all entities; however, companies and certain non-corporate entities are required by law to undergo audits, such as when turnovers exceed thresholds specified by tax laws, like in India under income tax law.
- Entities like schools may need audits to qualify for government grants or assistance.
- Audit isn't always compulsory; many organizations opt for voluntary audits due to the benefits and internal governance that favor the auditing process.

Qualities of Auditor

- Tact, caution, firmness, good temper, integrity, discretion, industrious, 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.
- 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.

- *Knowledge* of an *expert*. He is called upon constantly to critically review FSs 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*.

Person conducting an audit should take care to ensure that financial statements would not mislead anybody

In doing so, he has to see that FSs 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 FS *amounts* are properly *classified*, *described* and *disclosed* in conformity with accounting standards; and
- 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 FSs. Such an assurance lends credibility to FSs. Audited FSs provide confidence to users that financial information reflected in FSs can be relied upon.

Relationship of Auditing with other Subjects

- Auditing is interdisciplinary in nature, utilizing accountancy, law, behavioural science, statistics, economics, and financial management. For effective FS audits, an auditor needs a strong grasp of accounting principles, business, and tax laws.
- Auditors engage with various individuals for information and inquiries, requiring understanding of human behavior. They also employ statistical methods for sample selection, as auditing every transaction is impractical.
- Economics knowledge aids auditors in understanding the economic context of a business. Familiarity with financial management, including funds flow, working capital, and ratio analysis, is crucial for effective audit procedures and overall financial market understanding.

Auditing and Accounting

Auditing reviews the FSs 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 Statistics & Mathematics

Auditor is also expected to have the knowledge of statistical sampling for meaningful conclusions and mathematics for verification of inventories.

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 and Production

Good auditor is one who understands the client and his business functions such as production, cost system, marketing etc.

Chapter 2 - Audit Strategy, Audit Planning and Audit Programme

SA 300 "Planning an Audit of Financial Statements"

Scope

This Standard on Auditing (SA) deals with the auditor's responsibility to plan an audit of financial statements.

Objective

The objective of the auditor is to ***plan*** the ***audit*** so that it will be performed in ***an effective manner.***

Involvement of Key Engagement Team Members

- 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 involvement of the engagement partner and other key members of the engagement team in planning the audit draws on their experience and insight, thereby enhancing the effectiveness and efficiency of the planning process.

Discussion of elements of planning with entity's management

The auditor ***may*** decide to ***discuss elements*** of ***planning*** with the entity's ***management*** to facilitate the conduct and management of the audit engagement. When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit. The overall audit strategy and the audit plan remain the ***auditor's responsibility***.

Benefits of Planning in the Audit of Financial Statements

Planning an audit involves

- ***establishing*** the ***overall audit strategy*** for the engagement and
- ***developing*** an ***audit plan***.

Adequate planning benefits the audit of financial statements in several ways, including the following:

1. Helping the auditor to devote appropriate ***attention*** to ***important areas*** of the audit
2. Helping the auditor identify and ***resolve*** potential ***problems*** on a ***timely*** basis.
3. Helping the auditor properly ***organize*** and ***manage*** the audit ***engagement*** so that it is performed in an ***effective*** and ***efficient*** manner.
4. ***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.
5. Facilitating the ***direction*** and ***supervision*** of engagement team members and the review of their work.
6. Assisting, where applicable, in ***coordination*** of work done by auditors of components and experts.

Planning Process- Elements of Planning

The elements of planning can be categorized as under: -

I. Preliminary engagement activities
II. Planning activities

Preliminary Activities

The auditor shall undertake the following activities at the beginning of the current audit engagement

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

Performing the preliminary engagement activities at the beginning of the current audit engagement assists the auditor in identifying and evaluating events or circumstances that may adversely affect the auditor's ability to plan and perform the audit engagement.

Performing these preliminary engagement activities enables the auditor to plan an audit engagement for which, for example:

- The auditor maintains the necessary ***independence*** and ability to perform the engagement.
- There are ***no*** issues with ***management integrity*** that may affect the auditor's willingness to continue the engagement.
- There is ***no misunderstanding*** with the client as to the terms of the engagement.

Planning activities

Planning activities involve: -

a. ***Establishing*** the overall audit ***strategy***
b. ***Developing*** an audit ***plan***
c. The auditor shall ***update*** and ***change*** the overall audit ***strategy*** and the audit ***plan*** as necessary during the course of the audit.
d. The auditor shall plan the ***n***ature, ***t***iming and ***e***xtent of ***direction*** and ***supervision*** of engagement team members and the review of their work.

Nature and extent of planning activities

The nature and extent of planning activities will vary according to the

- ***size*** and ***complexity*** of the entity,
- the key engagement team members' ***previous experience*** with the entity, and
- ***changes*** in ***circumstances*** that occur during the audit engagement.

Audit Strategy

What is Audit Strategy

Overall audit strategy sets the ***scope***, ***timing*** and ***direction*** of the audit, and guides the ***development*** of the more ***detailed audit plan***.

How would the audit strategy be helpful to the auditor?

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.

Establishment of Overall Audit Strategy

In establishing the overall audit strategy, the auditor shall (POINTS TO BE KEPT IN MIND WHILE DEVELOPING OVERALL AUDIT STRATEGY)

a. ***Identify*** the ***characteristics*** of the engagement that define its scope;
b. ***Ascertain*** the ***reporting objectives*** of the engagement to plan the timing of the audit and the nature of the communications required.

c. Consider the factors that, in the auditor's professional judgement, are significant in directing the engagement team's efforts;
d. Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
e. Ascertain the nature, timing and extent of resources necessary to perform the engagement.

The auditor shall take following factors into consideration while establishing audit strategy: -

Identify the characteristics of the engagement that define its scope

It is important for auditor to identify scope of the engagement. Only a well identified scope can lead to establishment of a sound audit strategy. There are many characteristics of engagement defining 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

Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required.

The ascertaining of reporting objectives of engagement helps the auditor to plan timing of different audit procedures and also the 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.

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

Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant

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

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.

Audit Plan

Description of Audit Plan

As per SA 300 "Planning an Audit of Financial Statement" the audit plan shall be include a description of

- The nature, timing and extent of planned ***risk assessment procedures***, as determined under SA 315.
- The nature , timing and extent of planned ***further audit procedures*** at the assertion level, as determined under SA 330.
- ***Other planned audit procedures*** that are required to be carried out so that the engagement complies with SAs. (Obtaining written representations from management)

- Planning of the auditor's risk assessment procedures occurs early in the audit process.
- However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures.

Relationship between Audit Strategy and Audit Plan

- Audit strategy sets the broad overall approach to the audit whereas audit plan addresses the various matters identified in the overall audit strategy. Audit strategy determines scope, timing and direction of audit. Audit plan describes how strategy is going to be implemented.
- 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.
- The establishment of the overall audit strategy and the detailed audit plan are ***not necessarily discrete or sequential processes***, but are ***closely inter-related*** since changes in one may result in consequential changes to the other

For Understanding Purpose Only

- SCOPE - Coverage (Consolidate financial statement or otherwise, branches are included or not, etc) (regulatory or statutory reporting requirements)
- TIMING - Setting milestones for completion of audit work. (Deadlines) (Time Budgets)
- DIRECTION - How we are going to use the information / knowledge gained from other engagements, Effect of preliminary evaluations of materiality, audit risk and internal control.

Other points for understanding

- The audit strategy relates to the ***overall approach*** you will take to the audit, it decides the scope of the audit.
- The audit plan is the detailed procedures you will use in your audit depending on what the strategy is.
- For example- if you decide the organisation is new and doesn't have proper controls in place, you will decide not to rely on any controls and perform only substantive testing- This is Audit Strategy.
- Audit plan is then deciding the ***substantive audit tests you will perform (AEIOU. Reperformance. External Confirmation)***.
- This includes the nature, timing and extent of audit tests you will undertake to gain comfort over the financial statement balances.
- An audit plan is more detailed.

Changes to planning decisions During the Audit

- The auditor shall ***update*** and ***change*** the overall audit ***strategy*** and the audit ***plan*** as necessary during the course of the audit.
  - As a result of ***unexpected events***,
  - ***changes*** in ***conditions***, or
  - the audit ***evidence obtained*** from the results of audit procedures,
- the auditor may need to ***modify*** the audit plan & planned nature, timing and extent of ***further audit procedures***, based on the revised consideration of assessed risks.
- This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures.
- For example, audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls.

Direction, Supervision and Review

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:

- The ***size*** and ***complexity*** of the entity.
- The ***area*** of the audit.
- The ***assessed risks of material misstatement***
- The ***capabilities*** and ***competence*** of the individual team members performing the audit work.

Documentation of Audit plan

The auditor shall ***document***:

a. the overall ***audit strategy***;
b. the ***audit plan***; and
c. any ***significant changes*** made during the audit engagement to the overall audit strategy or the audit plan, and the ***reasons*** for such changes.

Record of the key decisions

The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team.

Record of the proper planning

It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance.

Record of change in strategy and procedures explains reasons for change and response to changes

A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

Planning is a Continuous Process

Planning is not a discrete phase of an audit, but rather a continual and iterative 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 procedures*** 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***.

Additional Considerations in Initial Audit Engagements

Purpose and Objective remains same

The purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement.

Planning activities will be expanded

However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not ordinarily have the previous experience with the entity that is considered when planning recurring engagements.

For initial audits, additional matters the auditor may consider in establishing the overall audit strategy and audit plan include the following:

- Performing procedures required by *SA 220* regarding the acceptance of the client relationship and specific audit engagement.
- *Unless prohibited* by *law* or regulation, *arrangements* to be made with the *predecessor auditor*, for example, to review the predecessor auditor's working papers.
- *Other procedures* required by the *firm's system of quality control* for initial audit engagements (for example, review of the overall strategy by senior partner before starting the audit)

Audit Programme

Meaning

An audit programme consists of

- a *series* of *verification procedures*
- to be applied to the financial statements and accounts of a given company
- for the purpose of *obtaining sufficient evidence*
- to enable the auditor to *express* an *informed opinion* on such statements.

One Audit Programme – Not Practicable For All Businesses

- All businesses are not same
- They vary in *nature, size, capital raised* and on other parameters also
- Some might have a formal and working *internal control*, while some may not have internal control at all.
- Applicability of *different laws* and *regulation* also differentiate the scope of services to be given by auditor
- Because of the reasons for variations mentioned above it is not possible to develop one audit program applicable to all businesses under all circumstances.
- Every audit programme must have *details* of the *nature* of *work* to be *done* as per the nature, size and other parameters of the business. .This will help in saving time and special matters and situations will not be overlooked.

Framing an Audit Programme

- To start with, an auditor having regard to the nature, size and composition of the business and the dependability of the internal control and the given scope of work, should frame a programme which should aim at providing for a *minimum essential work* which may be termed as a standard programme.
- As experience is gained by actually carrying out the work, the programme may be altered to take care of situations which were left out originally, but are found relevant for the particular concern.
- Similarly, if any work originally provided for proves beyond doubt to be unnecessary or irrelevant, it may be dropped.
- The *assistant* engaged in the job should be encouraged to keep an *open mind* beyond the programme given to him.
- He should be instructed to note and *report significant matters* coming to his notice, to his seniors or to the partners or proprietor of the firm engaged for doing the audit.

Periodic Review of The Audit Programme

Audit programme *must be periodically reviewed*, to check its effectiveness in the light of changing circumstances.

Objective of review - Cover new aspects and remove not required one, keep AP up-to-date.

- The ultimate objective of periodic review is to cover the *new aspects* of the client's business and *remove* the *not required* or non-value adding part so as to keep the audit programme up-to-date.

If not reviewed- Obsolete | Negligence on the part of the auditor | May face legal consequences

- If it is not reviewed, it may become *obsolete* and as a result entire *audit* may become *ineffective* also this will be considered as *negligence* on the part of the auditor and they may have to face *legal* and regulatory *consequences* for the same

Constructing an Audit Programme

- While developing an audit programme, the auditor may conclude that relying on certain internal controls is an effective and efficient way to conduct his audit.
- However, the auditor may decide not to rely on internal controls when there are other more efficient ways of obtaining sufficient appropriate audit evidence.

The auditor should also consider

- the *timing* of the procedures,
- the *coordination* of any assistance expected from the client,
- the *availability* of *assistants*, and the involvement of other auditors or experts.

Further, the auditor normally has flexibility in deciding when to perform audit procedures.

However, in some cases, the auditor may have no discretion as to timing,

- for example, when observing the taking of inventories by client personnel or verifying the securities and cash balances at the year-end.

For the purpose of programme construction, the following points should be kept in mind:

1. Stay within the *scope* and *limitation* of the assignment.
2. Prepare a *written audit programme* setting forth the *procedures* that are needed to implement the audit plan.
3. Determine the *evidence reasonably available* and *identify* the *best evidence* for deriving the necessary satisfaction.
4. Apply only those *steps* and *procedures* which are *useful* in accomplishing the verification purpose in the specific situation.
5. Include the audit *objectives* for *each area* and *sufficient details* which serve as a set of instructions for the assistants involved in audit and help in controlling the proper execution of the work.
6. Consider all *possibilities* of *error*.
7. *Co-ordinate* the *procedures* to be applied to related items.

Audit Programme To provide Audit Evidence

- Audit programme is designed to provide for Audit evidence by prescribing procedures and technique.
- The best evidence for testing accuracy of an assertion is a matter of *professional judgement* of the auditor.
- Auditor through his training, knowledge and experience Will design the audit program in such a manner that it will provide the best possible audit evidence for the given assertions.
- For example the best evidence for cash in hand can be obtained through counting the cash.
- For something which is pledged with the bank the banker's certificate will be the best audit evidence.

Advantages of Audit Programme

The advantages of an audit programme are:

a. It provides the assistant carrying out the audit with a total and *clear set* of *instructions* of the work generally to be done.
b. It is essential, particularly for major audits, to provide a *total perspective* of the work to be performed.

c. Selection of assistants for the jobs on the basis of capability becomes easier when the work is rationally planned, defined and segregated.
d. Auditing without a written programme risks overlooking records; a structured programme reduces this danger.
e. The assistants, by putting their signature on programme, accept the responsibility for the work carried out by them individually and, if necessary, the work done may be traced back to the assistant.
f. The principal can control the progress of the various audits in hand by examination of audit programmes initiated by the assistants deputed to the jobs for completed work.
g. It serves as a guide for audits to be carried out in the succeeding year.
h. A properly drawn up audit programme serves as evidence in the event of any charge of negligence being brought against the auditor. It may be of considerable value in establishing that he exercised reasonable skill and care that was expected of a professional auditor.

Disadvantage

a. The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.
b. The programme often tends to become rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on. Changes in staff or internal control may render precaution necessary at points different from those originally decided upon.
c. Inefficient assistants may take shelter behind the programme i.e. defend deficiencies in their work on the ground that no instruction in the matter is contained therein.
d. A hard and fast audit programme may kill the initiative of efficient and enterprising assistants.

Quality Control For Audit Work Delegation and Supervision of Audit Work

An audit is a complex task involving number of people at different levels.
Auditor will have to depend on

- Assistants
- Technical Experts
- Other auditors

In the case of assistants, the auditor has to direct, supervise and review the work delegated to them.
In the case of other auditors and experts, the auditor has to obtain reasonable assurance that the work performed by them is adequate for the purpose of the auditor.
The objective of the auditor is to implement quality control procedures at the engagement level that provides the auditor with reasonable assurance that

- The audit complies with the professional standards and the regulatory and legal requirements
- The Auditor's report is issued as appropriate in the circumstance.

The responsibility to express an opinion on financial statements and it's accountability will always be of the auditor

Variety of fields for Audit Evidence (While studying cover it with Audit Evidence Chapter)

An auditor picks up evidence from a variety of fields and it is generally of the following broad types:

a. Documentary examination,
b. Physical examination,
c. Statements and explanation of management, officials and employees,
d. Statements and explanations of third parties,
e. Arithmetical calculations by the auditor,
f. State of internal controls and internal checks,
g. Inter-relationship of the various accounting data,
h. Subsidiary and memorandum records,
i. Minutes,
j. Subsequent action by the client and by others.

Chapter 3 - Audit Risk and Risk Assessment

Audit Risk

The risk that the auditor expresses an *inappropriate opinion* when the *FSs* are *materially misstated*. Audit risk can be divided into two part

- Risk of material misstatement.
  - Inherent risk
  - Control risk
- Detection Risk

What is not included in Audit Risk ?

- Risk that the auditor might *express* an *opinion* that the *FSs are materially misstated when they are not.*
- Audit risk is a technical term related to the process of auditing; it does *not* refer to the *auditor's business risks* such as loss from litigation, adverse publicity, or other events arising in connection with the audit of FSs.

Components

Risk of material misstatement

- **Inherent risk**
  - Inherent Risk is the *susceptibility* of an *account balance* or *class of transaction* to a material misstatements, *assuming* that there were *no internal controls*
  - Risk of misstatement in an assertion because of its nature
  - Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations.
  - Inherent risk factors are considered while designing tests of controls and substantive procedures.
  - External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete. Factors in the entity and its environment may also influence the inherent risk related to a specific assertion.
  - Examples
    - Inherent risk arises when management misunderstands complex accounting guidance, potentially leading to misstatements in financial reporting.
    - High business failure rates in a particular industry increase the inherent risk of misstatement in financial assertions of entities within that industry.
- **Control risk**
  - The risk that a *material misstatement* that could occur in an assertion and that will *not be prevented, or detected and corrected*, on a *timely* basis by the entity's *internal control*
  - Either IC is Missing or IC is not operating effectively or there is a flaw in designing of IC
  - there exists an *inverse relation* between *control risk and efficiency of internal control* of an entity.
  - Example
    - Control risk exists if a company's protocol to secure cash and cheque books in a locked safe by authorized personnel only is not adhered to.
    - There's a control risk if fire safety measures, like functional fire extinguishers and smoke detectors, are not maintained, jeopardizing inventory safety.
    - Control risk is present when the petty cash system's rule of limiting expenditures to under ₹ 10000 is not followed.

Both inherent risk and control risk are the *entity's risks* and they exist independently of the audit of FSs. Inherent risk and control risk are influenced by the client. These are the entity's risks and are not influenced by the auditor.

Risks of material misstatement exist at two levels

The auditor must consider whether the risks of material misstatement identified exist at:

- the *FS level* (i.e. affecting the FSs overall or as a whole); or
- the *assertion level* for classes of transactions, account balances and disclosures (i.e. existence, completeness, occurrence, valuation, presentation, etc of line items in the FSs).
- Risks at the FS level are *pervasive* and therefore affect many assertions. For example, if there is a risk that the going concern basis of preparation is inappropriate, this could result in overvalued assets, omitted liabilities and omitted disclosures.
- Risks at the assertion level are *assessed* to determine the *n*ature, *t*iming and *e*xtent of *further audit procedures* necessary to obtain sufficient appropriate audit evidence.

Detection risk

- It is the risk that the *procedures performed* by the *auditor* to reduce audit risk to an acceptably low level will *not detect a misstatement*.
- Detection risk, which relates to the nature, timing and extent of audit procedures, has two elements:
    1. Sampling risk; and
    2. non-sampling risk.

Sampling Risk

This arises from the possibility that the auditor's *conclusion*, based on a *sample*, may be *different* from the *conclusion* reached if the *entire population* was *subjected* to the *same audit procedure.*

- If the auditor concludes that CR is lower than it is or that a material misstatement does not exist when in fact, it does, there is a higher risk of an inappropriate audit opinion. This affects *audit effectiveness.*
- If he concludes that CR is higher than it is or that a material misstatement exists when it does not, this affects *audit efficiency*, as more work than necessary will be carried out.

Non-sampling Risk

Non-sampling risk arises from factors that cause the auditor to reach an erroneous conclusion for any reason *not related to sampling*, for example:

- failure to adequately understand the entity or carry out the risk assessment; inadequate audit strategy, planning and work programme;
- misapplication of an audit procedure by the audit team (e.g. through lack of training);
- misinterpretation of test results (e.g. not recognising the significance of an error or nor recognising that there is an error); and • poor quality management (e.g. lack of briefing, supervision and review).

Non-sampling risk can be minimised through, for example, adequate planning, assigning appropriate staff (e.g. experienced, professional and technically competent), the application of professional judgment, supervision and review of audit work.

Example

1. Auditor doesn't attend inventory count for significant work-in-progress inventories, relying on alternative procedures instead.
2. Auditor audits company's revenue based on a sample which may not represent the total revenue, risking oversight of anomalies.

Relationship

- Audit risk = Risks of material misstatement X Detection risk
- Since risks of material misstatement is a function of inherent risk and control risk, it can also be shown as:
    - *Audit risk = Inherent risk X Control risk X Detection risk*

Assessment of risks- A matter of professional Judgment

The assessment of risks is a matter of *professional judgment, rather than a matter capable of precise measurement.*

Combined Assessment of the Risk of Material Misstatement

- Auditing standards usually address inherent and control risks together as the "risks of material misstatement."
- Auditors may assess inherent and control risks separately or combined, based on their audit approach and practicality.
- Risk assessments can be *quantified* (e.g., percentages) or *non-quantitative* (High, medium, low).
- The crucial point is the auditor's need to conduct suitable risk assessments, regardless of the method used.

Risks that require special audit consideration

As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. 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 transactions
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, especially those measurements involving a wide range of measurement uncertainty and
f. Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be *unusual*.

Identifying Significant Risks

- Significant risks often relate to significant *non-routine transactions* or *judgmental matters*.
  - Non-routine transactions are transactions that are unusual, due to either *size* or *nature*, and that therefore occur infrequently.
  - Judgmental matters may include the *development* of *accounting estimates* for which there is significant measurement uncertainty.
- Significant risks are inherent risks with both a higher likelihood of occurrence and a higher magnitude of potential misstatement.
- The auditor assesses assertions affected by a significant risk as higher inherent risk. The following are always significant risks:
  - Risks of material misstatement due to fraud
  - Significant transactions with related parties that are outside the normal course of business for the entity

Risks of Material Misstatement – Greater for Significant Non-Routine Transactions

Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

- Greater *management intervention* to specify the accounting treatment.
- Greater *manual intervention* for data collection and processing.
- *Complex* calculations or accounting principles.
- The *nature* of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

Risks of material misstatement– Greater for Significant Judgmental Matters

Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:

- Accounting principles for accounting estimates or revenue recognition may be subject to *differing interpretations*.
- Required judgment may be *subjective* or *complex*, or require assumptions about the effects of future events, for example, judgment about fair value.

SA 315 Identifying and assessing the risk of material misstatement through understanding the entity and its environment

The objective of the auditor is to

- identify and assess the risks of material misstatement,
- whether due to fraud or error,
- at the FS and assertion levels,
  - through understanding the entity and its environment, including the entity's internal control,
  - thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

This will help the auditor to reduce the risk of material misstatement to an acceptably low level.

For the purpose of Identifying and assessing the risk of material misstatement, the auditor shall:

a. Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and 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 assertions;
c. Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and
d. Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Risk assessment procedures

The audit procedures are performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement at the FS and assertion levels.

Risk assessment procedures includes

Risk assessment procedures include inquiries, observation and inspection and analytical procedures. Observation and inspection are required to support, corroborate or contradict inquiries and provide information.

Inquiries of management, and of others within the entity

- Information obtained through inquiry from
  - management and
  - from those who are responsible for financial reporting and
  - from others within the entity and
  - other employees with different levels of authority
    - help in identifying risks of material misstatement.
  - Inquiry alone is not sufficient.

Example of Inquiries

Auditors gather information mainly from management and financial reporting heads. Inquiries with different authority levels within the entity can offer diverse perspectives on risks of material misstatement.

- Internal audit personnel can inform about internal control design effectiveness and management's response to internal audit findings.
- Inquiries to employees handling complex transactions can clarify the suitability of accounting policies applied.
- Legal counsel can provide insights into litigation, compliance, fraud, warranties, and contractual meanings.
- Marketing/sales personnel can shed light on marketing strategy shifts, sales trends, and customer contracts.
- Risk management can highlight operational and regulatory risks impacting financial reporting.
- Information systems personnel can detail system changes, failures, and related risks.

Analytical procedures

- Analytical procedures may help identify the ***existence*** of
  - ***unusual transactions*** or
  - ***events*** and ***amounts***,
  - ***ratio*** and ***trends***
    - that might indicate matters that have audit implications.
- Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatements due to fraud.
- Analytical procedures using high-level aggregated data, often employed in risk assessment, offer a general initial indication of potential material misstatements
- In such cases combining these results with other gathered information aids auditors in evaluating and understanding these initial findings.

Observation and inspection

Observation and inspection are required to support, corroborate or contradict inquiries and provide information. Examples of such audit procedures include observation or inspection of the following:

- The ***entity's operations.***
- ***Documents*** (such as business plans and strategies), records, and internal control manuals.
- ***Reports*** prepared by management (such as quarterly management reports and interim FSs) and those charged with governance (such as minutes of board of director's meetings)
- The entity's ***premises*** and plant facilities

RAPs and SAAE

- Risk assessment procedures by themselves, however, ***do not provide sufficient appropriate audit evidence*** on which to base the audit opinion.
- The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.
- The risks to be assessed include both those due to error and those due to fraud,

Understanding the Entity and its Environment

SA 315 Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment states that the auditor shall obtain an understanding of the following:

1. ***Relevant industry, regulatory*** and ***other external factors*** including applicable financial reporting framework.
2. The ***nature*** of the entity
3. The entity's ***selection*** and ***application*** of ***accounting policies***, including the reasons for changes thereto.
4. The entity's ***objectives*** and ***strategies***, and those related ***Business risks*** that may result in risks of material Misstatement.
5. The ***measurement*** and ***review*** of the ***entity's financial performance***

Relevant industry, regulatory and other external factors including applicable financial reporting framework.

Industry Factors

Examine industry dynamics like competition, supplier/customer relations, and tech progress. Consider market status, seasonal operations, and product technology.

Regulatory Factors

Assess regulatory framework, financial reporting standards, and legal/political climate. Review industry-specific practices, laws impacting operations, taxes, government policies, and environmental mandates.

External Factors

Evaluate economic climate, interest rates, financing availability, and inflation trends.

The nature of the entity

- 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
  - the way that the entity is *structured* and how it is *financed*; to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the FSs.
- An understanding of nature of entity enables the auditor to understand whether entity has a complex structure for example, whether it has subsidiaries.
- Understanding complex structures helps to *identify potential material misstatement* risks. Understand ownership and inter-entity/personnel relationships to ensure related party transactions are properly identified and recorded.

Examples of matters that the auditor may consider while obtaining understanding of nature of entity

- **Business Operations:** Investigate revenue origins, offerings, operational practices, production locales, and principal trade associates.
- **Investment Activities:** Capital investments and recent or forthcoming acquisitions.
- **Financing Activities:** The structure of major subsidiaries and debt arrangements.
- **Financial Reporting:** Understand the appropriateness of accounting policies and the application of revenue recognition standards.

The entity's selection and application of accounting policies, including the reasons for changes thereto.

Assess if the entity's accounting policies suit its business, align with the financial reporting framework, and match industry norms.

The entity's objectives and strategies, and those related Business risks that may result in risks of material misstatement.

- The entity operates within various factors, setting objectives and strategies to navigate changes and risks, including material misstatement risks.
- Business risk is broader than the risk of material misstatement of the FSs, though it includes the latter. Business risk may arise from change or complexity.
- Understanding the entity's business risks enhances the *detection* of *material misstatement* risks due to their financial impact, yet not all such risks are the auditor's responsibility.

Examples of matters that the auditor may consider when obtaining an understanding of the entity's objectives, strategies and related business risks that may result in a risk of material misstatement of the FSs

Industry changes may risk the entity's capacity to adapt without adequate expertise; new offerings could raise product liability; business growth risks misjudging demand.

The measurement and review of the entity's financial performance

Understanding the entity's performance measures helps auditors assess if the pressure to meet targets could lead to actions heightening the risk of material misstatement.

Examples for measuring and reviewing financial performance which may be used by an auditor

Auditors may assess financial performance through key indicators, ratios, trends, comparative analyses, budgets, forecasts, variances, department reports, and credit ratings.

Why understanding the entity and its environment is significant?

It helps the auditor in planning the audit and in identifying areas requiring special attention. Gaining knowledge about client's business is one of the important principles in developing an overall audit plan. In fact, without adequate knowledge of client's business, a proper audit is not possible.

Understanding the entity-a continuous process

Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an "understanding of the entity"), is a ***continuous, dynamic process*** of gathering, updating and analysing information throughout the audit. The understanding establishes a ***frame of reference*** within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

- Assessing ***ROMM*** of the FSs
- Determining ***materiality*** in accordance with SA 320
- Considering the ***appropriateness*** of the selection and application of ***accounting policies***
- Identifying ***areas*** where ***special audit consideration*** may be ***necessary***, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions
- Developing ***expectations*** for use when performing ***analytical procedures***
- Evaluating the ***sufficiency*** and ***appropriateness*** of audit ***evidence*** obtained such as the appropriateness of assumptions and of management's oral and written representations.

Chapter 3A - Internal Control

Internal Control

Meaning of Internal Control

- As per SA-315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", the internal control may be defined as
  - the process ***d***esigned, ***i***mplemented and ***m***aintained by
    - those charged with governance,
    - management and
    - other personnel
  - (Purpose of Internal control) - to provide ***reasonable*** assurance about the achievement of an entity's objectives with regard to
    - reliability of ***financial reporting,***
    - effectiveness and efficiency of ***operations,***
    - safeguarding of ***assets***, and
    - compliance with applicable ***laws*** and ***regulations***.
- The term "controls" refers to any aspects of one or more of the components of internal control.
- The way in which internal control is designed, implemented and maintained varies with an entity's size and complexity.

Benefits of Understanding of Internal Control

An understanding of internal control assists the auditor in: -

i) Identifying types of potential misstatements;
ii) Identifying factors that affect the risks of material misstatement, and
iii) Designing the nature, timing, and extent of further audit procedures.

Inherent Limitations of I.C.

Limitations which are inseparable from the system of I.C.

Effect

- Due to Limitations of I.C. System,
- it can provide only reasonable,
- not absolute assurance,
- that its objectives are achieved.

Question (Internal Control) (★★★★★)
Briefly discuss the limitations of Internal Control.

Answer

Limitations of Internal Control:

(i) Internal control can provide only reasonable assurance: Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control.

(ii) Human judgement in decision-making: Realities that human judgement in decision- making can be faulty and that breakdowns in internal control can occur because of human error.

(iii) Lack of understanding the purpose: Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

(iv) Collusion among People: Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. **For example**, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

(v) Judgements by Management: Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

(vi) Limitations in case of Small Entities: Smaller entities often have fewer employees due to which segregation of duties is not practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

Components of IC

The division of internal control into the following five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:

1. The *control environment*;
2. The *entity's risk assessment process*
3. The *information system*, including the related business processes, relevant to financial reporting, and communication
4. *Control activities*
5. *Monitoring of controls*.

The Control Environment

Question

The auditor of XYZ Ltd, engaged in FMCG (Fast Moving Consumable Goods) obtains an understanding of the control environment. As part of obtaining this understanding, the auditor evaluates whether:

- **Management has created and maintained a culture of honesty and ethical behavior; and**
- **The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.**

Advise what is included in the control environment. Also explain the elements of control environment.

Answer

Control Environment – Component of Internal Control: The auditor shall obtain an *understanding* of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

- Management has created and maintained a culture of *honesty* and *ethical behavior*; and
- The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

What is included in Control Environment?

The control environment includes:

- The *governance* and *management functions* and
- The *attitudes*, *awareness*, and *actions* of those charged with governance and management.

The control environment sets the tone of an organization, influencing the control consciousness of its people.

Elements of the Control Environment: Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

a. **Communication and enforcement of integrity and ethical values** – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.
b. **Commitment to competence** – Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.
c. **Participation by those charged with governance** – Attributes of those charged with governance such as:
   i. Their independence from management.
   ii. Their experience and stature.
   iii. The extent of their involvement and the information they receive, and the scrutiny of activities.
   iv. The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.
d. **Management's philosophy and operating style** – Characteristics such as management's:
   i. Approach to taking and managing business risks.
   ii. Attitudes and actions toward financial reporting.
   iii. Attitudes toward information processing and accounting functions and personnel.
e. **Organisational structure** – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.
f. **Assignment of authority and responsibility** - Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.
g. **Human resource policies and practices** -- Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counseling, promotion, compensation, and remedial actions.

Satisfactory Control Environment – not an absolute deterrent to fraud

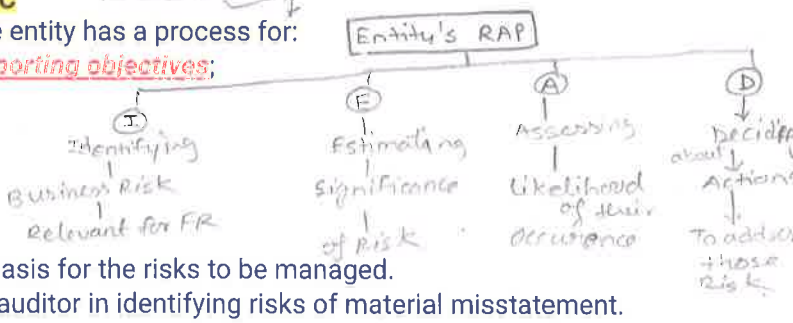
The existence of a satisfactory control environment can be a *positive factor* when the auditor assesses the risks of material misstatement. However, although it may help *reduce* the *risk of fraud*, a satisfactory control environment is *not an absolute deterrent to fraud*. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. The control environment also influences the nature, timing, and extent of the auditor's *further procedures*.

The control environment in itself *does not prevent, or detect and correct, a material misstatement*. It may, however, influence the auditor's evaluation of the *effectiveness* of *other controls* (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

The Entity's Risk Assessment Process– Component of IC

The auditor shall obtain an understanding of whether the entity has a process for:

a. *Identifying* business *risks relevant* to *financial reporting objectives*;
b. *Estimating* the *significance* of the risks;
c. Assessing the *likelihood* of their occurrence; and
d. Deciding about *actions* to address those risks.



NOTES

- The entity's risk assessment process forms the basis for the risks to be managed.
- If that process is appropriate, it would assist the auditor in identifying risks of material misstatement.
- Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgement.

Information System - Component of IC

The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following are as:

a. The classes of *transactions* in the entity's operations that are significant to the financial statements
b. The *procedures* by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
c. The related *accounting records*, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions;
d. How the *information system captures events* and *conditions* that are significant to the financial statements;
e. The *financial reporting process* used to prepare the entity's financial statements;
f. Controls surrounding *journal entries*.

Control Activities - Component of IC

The auditor of PQR Ltd, a company engaged in the manufacturing of Auto parts obtains an understanding of control activities relevant to the audit, which the auditor considers necessary to assess the risks of material misstatement.

Auditor is of the view that he requires an understanding of only those control activities related to significant class of transactions, account balance, and disclosure in the financial statements and the assertions which the auditor finds relevant in his risk assessment process.

Advise explaining the meaning of control activities. Also identify and explain the control activities which are relevant to the audit.

Answer

Control Activities - Component of Internal Control

The auditor shall obtain an *understanding* of control activities relevant to the audit, which the auditor considers *necessary* to *assess* the *risks* of material misstatement. An audit requires an understanding of only those control activities related to significant class of transactions, account balance, and disclosure in the financial statements and the assertions which the auditor finds relevant in his risk assessment process.

Control activities are the policies and procedures that help ensure that management directives are carried out.

Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels.

Control activities that are relevant to the audit are:

- Control activities that relate to *significant risks* and those that relate to risks for which *substantive procedures alone do not provide sufficient appropriate audit evidence*.; or
- Those that are considered to be relevant in the judgement of the auditor.
- As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgement, a significant risk.

Monitoring of Control - Component of IC

Knowledge

- This is the client's process of assessing the effectiveness of controls over time and taking necessary remedial action.
- Monitoring can be either ongoing or performed on a separate evaluation basis (or a combination of both).
- Monitoring of internal controls is often the key role of internal auditors.

The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting.

Monitoring of controls Defined: Monitoring of controls is a process to assess the effectiveness of internal control performance over time.

1. **Helps in assessing the effectiveness of controls on a timely basis:** It involves assessing the *effectiveness* of *controls* on a timely basis and taking necessary *remedial* actions.
2. **Management accomplishes through ongoing activities, separate evaluations etc.:** Management accomplishes monitoring of controls through *ongoing activities, separate evaluations, or a combination of the two*. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.
3. **Management's monitoring activities include:** Management's monitoring activities may include using information from *communications* from *external parties* such as customer complaints and regulator comments that may indicate *problems* or highlight areas in need of *improvement*.
4. **In case of Small Entities:** Management's monitoring of control is often accomplished by *management's or the owner-manager's close involvement* in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.

Examples of Components of Internal Control

Examples of Components of Internal Control (Read them for knowledge purpose, not for exams)

1. Control environment - communication of ethical values to personnel through policy statements and codes of conduct.
2. Risk assessment process – management monitors changes in the operating environment to plan for the future.
3. Information system - quarterly management accounts are presented to the board of directors for their consideration.
4. Control activities - an annual inventory count is held to confirm the quantities of inventories physically held.
5. Monitoring of controls – Internal audit conducts a regular review of sales personnel's compliance with the company's terms of sales contracts

Are all Controls Relevant to the audit?

- There is a *direct* relationship between an entity's *objectives* and the *control* it implements to provide reasonable assurance about their achievement. However, *not all* of these objectives and controls are *relevant* to the auditor's risk assessment.
- Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:
    - *Materiality*.
    - The significance of the related *risk*.
    - The *size* of the entity.
    - The *nature* of the entity's business, including its organisation and ownership characteristics.
    - The diversity and *complexity* of the entity's operations.
    - Applicable *legal* and *regulatory* requirements.
    - The circumstances and the applicable *component* of internal *control*.
    - The *nature* and *complexity* of the *systems* that are part of the entity's internal control, including the use of service organisations.
    - Whether, and how, a specific control, *individually* or in *combination* with others, *prevents*, or *detects* and *corrects*, material misstatement.

Miscellaneous topics related to IC

Controls over the completeness and accuracy of information

- Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures.
- For example, in auditing revenue by applying standard prices to records of sales volume, the auditor considers the accuracy of the price information and the completeness and accuracy of the sales volume data.

- Controls relating to operations and compliance objectives may also be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures.

Controls relating to objectives that are not relevant to an audit -

- An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered.
- For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit.
- Further, although internal control applies to the entire entity or to any of its operating units or business processes, an understanding of internal control relating to each of the entity's operating units and business processes may not be relevant to the audit.
- The statute may require the auditor to report on compliance with certain internal controls
- In certain circumstances, the statute or the regulation governing the entity may require the auditor to report on compliance with certain specific aspects of internal controls as a result, the auditor's review of internal control may be broader and more detailed.

Internal control over safeguarding of assets

- Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to *both financial reporting and operations objectives.*
- The auditor's consideration is generally limited to those relevant to the reliability of financial reporting.
- For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a FS audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a FS audit.

Nature and Extent of the Understanding of Relevant Controls

Design

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

Implementation of a control means that the control exists and that the entity is using it. Auditor Prioritize evaluating the design of a control before its implementation; an ineffective control is not worth assessing.

An improperly designed control may represent a significant deficiency in internal control. Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include-

- *Inquiring* of entity personnel.
- *Observing* the application of specific controls.
- *Inspecting* documents and reports.
- *Tracing transactions* through the information system relevant to financial reporting

Inquiry alone, however, is not sufficient for such purposes.

Understanding an entity's controls is not equivalent to testing their effectiveness. Manual controls require evidence across different periods for effectiveness, unlike automated controls where consistency due to IT processing may suffice, contingent on evaluation and testing of related IT controls.

Evaluation of Internal Control By Auditor

The examination and evaluation of the internal control system is an indispensable part of the overall audit programme. The auditor needs reasonable assurance that the accounting system is adequate and that all the

accounting information which should be recorded has in fact been recorded. Internal control normally contributes to such assurance.

Role/Advantages of Review

It enables the auditor to ascertain whether

1. Internal control system is adequate & operating effectively.
2. I.C. is able to prevent, detect & correct material misstatement.
3. I.C. Properly safeguards the assets.
4. I.C. ensures correct recording of transactions.
5. Reports & Certificates provided by management are reliable.
6. I.C. are weak / excessive in a particular area.
7. Effective internal audit department is in operation.
8. Suggestions can be given to management to improve the I.C. system.
9. Extensive Substantive procedures are required.
10. Audit procedures or techniques need to be changed from planned ones.

Evaluation of Internal Control System

So far as the auditor is concerned, the examination and evaluation of the internal control system is an indispensable part of the overall audit programme. The auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal control normally contributes to such assurance.

Formulate Audit Program after understanding Internal Control

The auditor can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operation.

It would be better if the auditor can undertake the review of the internal control system of client. He will also be in a position to bring to the notice of the management the weaknesses of the system and to suggest measures for improvement. At a further interim date or in the course of the audit, he may ascertain how far the weaknesses have been removed.

A proper understanding of the internal control system in its content and working also enables an auditor to decide upon the appropriate audit procedure to be applied in different areas to be covered in the audit programme.

For example - If confident in sales and receivables control, the auditor may verify balances near the balance sheet date; if not, he'll seek exact date confirmations to prevent errors or fraud.

Evaluation of Internal Control– Methods



There are four major methods to review IC

1. Narrative Records
2. Check List
3. Questionnaire
4. Flow Chart

Narrative records

This is a complete and exhaustive description of the system as found in operation by the auditor. Actual testing and observation are necessary before such a record can be developed. It may be recommended in cases where no formal control system is in operation and would be more suited to small business.

The basic disadvantages of narrative records are:

- To comprehend the system in operation is quite difficult.
- To identify weaknesses or gaps in the system.
- To incorporate changes arising on account of reshuffling of manpower, etc.

Check List

This is a *series* of *instructions* and/or *questions* which a member of the auditing staff must follow and/or answer. When he completes instruction, he marks his initials in the space against the instruction. Answers to the checklist instructions are usually Yes,No or Not Applicable. This is again an on the job requirement and instructions are framed having regard to the desirable elements of control.

Example A few examples of checklist instructions are given hereunder:

1. Are tenders called before placing orders?
2. Are the purchases made on the basis of a written order?
3. Is the purchase order form standardised?
4. Are purchase order forms pre-numbered?
5. Are the inventory control accounts maintained by persons who have nothing to do with custody of work, receipt of inventory, inspection of inventory and purchase of inventory?

The complete checklist is studied by the Principal/Manager/Senior to ascertain existence of internal control and evaluate its implementation and efficiency.

Internal Control Questionnaire

- This is a *comprehensive* series of questions concerning internal control.
- It is most widely used form for collecting information about the *existence*, *operation* and *efficiency* of internal control.
- An important advantage of the questionnaire approach is that oversight or omission of significant internal control review procedures is less likely to occur with this method.
- With a proper questionnaire, all internal control evaluation can be completed at one time or in sections. The review can more easily be made on an interim basis.
- In the questionnaire, generally questions are so framed that a *'Yes'* answer denotes satisfactory position and a *'No'* answer suggests weakness. Provision is made for an explanation or further details of 'No' answers. In respect of questions not relevant to the business, 'Not Applicable' reply is given.
- The auditor sends a questionnaire to the client for *completion by relevant staff*; any inconsistencies found are clarified through discussion, leading to a report on deficiencies and improvement recommendations.

Few illustrative examples of Internal Control Questionnaire in different areas of an entity

Examples of Extracts of Internal Control Questionnaire in respect of purchases, creditors, inventories and fixed assets

Purchases

1. Are purchases centralised in the Purchase Department?
2. Are purchases made only from approved suppliers?
3. Are the purchase orders based on valid purchase requisitions duly signed by authorised persons in this behalf?
4. Are purchases based on competitive quotations from two or more suppliers?
5. Are purchase orders pre-numbered?
6. Are purchase orders signed only by employees authorized in this behalf?
7. Are all materials received only in the Receiving Department?
8. Are persons connected with receipt of materials and the keeping of receiving records denied authority to issue purchase orders or to approve invoices?
9. Are materials inspected and counted, weighed or measured in the Receiving Department?

Creditors

1. Are suppliers' invoices routed direct to the Accounts Department?
2. In respect of raw material and supplies, are reconciliations made of quantities and/or values received as shown by purchase invoices with receipt into stock records?
3. Does the Accounts Department match the invoices of supplies with Goods Received Notes and purchase orders?

4. Do all invoices bear evidence of being checked for prices, freight, terms etc.?
5. Are all advance payments duly authorized by persons competent to authorize such payments?
6. Are duplicate invoices marked immediately on receipt to avoid payment against them?
7. Are all supplier's statements compared with ledger accounts?
8. Is there any follow-up action to investigate difference, if any, between the suppliers' statements and the ledger accounts?
9. Is a list of unpaid creditors prepared and reconciled periodically?

Inventories

1. Are stocks stored in assigned areas?
2. Are stocks insured comprehensively against different risks? If some risk is not insured, whether it is due to specific decision taken by a senior official?
3. Is a record maintained for the insurance policies?
4. Is the record reviewed periodically?
5. Is there an official who decides on the value for which stocks are to be insured?
6. Is the adequacy of insurance cover reviewed periodically?
7. Are perpetual stock records kept for raw materials, work-in-progress, finished goods and stores?
8. Are stock records periodically reconciled with accounting records?
9. Where there is a system of perpetual inventory count:
    a. Is there a periodical report of shortages/excess?
    b. If so, are these differences investigated?
    c. Are these differences adjusted in the stock records and in the financial accounts?
    d. Is written approval obtained from a responsible official to adjust these differences?
10. Are there norms for stock levels to be held?

Fixed Assets

1. Are budgets for capital expenditure approved?
2. Is the authority to incur capital expenditure restricted to specified officials?
3. Are purchases of capital expenditure subject to same controls as applicable to purchases of raw materials, stores etc.?
4. Is there proper check to see that amounts expended do not exceed the amount authorized?
5. Are fixed assets verified periodically?
6. Is there a written procedure for such verification?
7. Are reports prepared on such verification?
8. Do such reports indicate damaged/obsolete items of fixed assets?
9. Are discrepancies disclosed by such reports investigated?
10. Are the records and financial accounts corrected with appropriate authority?

Flow Chart

- It is a ***graphic presentation*** of each part of the company's system of internal control.
- It is the most ***concise*** way of recording the auditor's review of the system.
- It ***minimises*** the amount of ***narrative explanation*** and thereby achieves a presentation not possible in any other form.
- It gives ***bird's eye view*** of the system and the flow of transactions.
- This will help him to ***understand*** and ***evaluate*** the internal ***controls*** in the correct perspective and identify deficiencies

Chapter 3B - Response to the Assessed Risk

SA 330 - The Auditor's Responses to Assessed Risks

Objective of Auditor

The objective of the auditor is

- to obtain sufficient appropriate audit evidence (What - Kya karna hai)
- about the assessed risks of material misstatement, (Why - Kis liye)
- through designing and implementing appropriate responses to those risks. (How - Kaise)

Responsibility of auditor

SA 330 states that: -

- The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the FS level.
- The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.
- In designing the further audit procedures to be performed, the auditor shall consider risk of material misstatement

Testing of Internal Control

Meaning

An audit procedure

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

Why and When (Circumstances)?

The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when:

a) He expects that the controls are operating effectively, or

b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control.

A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular, where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

While obtaining audit evidence about the effective operation of internal controls, the auditor considers how they were applied, the consistency with which they were applied during the period and by whom they were applied. The concept of effective operation recognises that some deviations may have occurred.
Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error.

When deviations are detected the auditor makes specific inquiries regarding these matters, particularly, the timing of staff changes in key internal control functions. The auditor then ensures that the tests of control appropriately cover such a period of change or fluctuation.

Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk.

The evaluation of deviations may result in the auditor concluding that the assessed level of control risk needs to be revised. In such cases, the auditor would modify the nature, timing and extent of planned substantive procedures.

Before the conclusion of the audit, based on the results of substantive procedures and other audit evidence obtained by the auditor, the auditor should consider whether the assessment of control risk is confirmed.

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

Nature and Extent of Test of Controls

In designing and performing test of controls, the auditor shall:

a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:
   i) ***How*** the controls were applied at ***relevant times*** during the period under audit.
   ii) The ***consistency*** with which they were applied.
   iii) By ***whom*** or by ***what*** means they were applied.

b) Determine whether the controls to be tested depend upon ***other controls*** (indirect controls), and if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls.

Inquiry alone is not sufficient to test the operating effectiveness of controls. Accordingly, other audit procedures are performed in combination with inquiry. In this regard, inquiry combined with inspection or reperformance may provide more assurance than inquiry and observation, since an observation is pertinent only at the point in time at which it is made.

The nature of the particular control influences the type of procedure required to obtain audit evidence about whether the control was operating effectively. For example, if operating effectiveness is evidenced by documentation, the auditor may decide to inspect it to obtain audit evidence about operating effectiveness.

Matters to be considered in determining the extent of tests of controls.

1. The ***frequency*** of the performance of the control by the entity during the period.
2. The ***length of time*** during the audit period that the auditor is relying on the operating effectiveness of the control. (Hum kitney period ki checking kar rahey hai agar period kam hai toh TOC ka extent _____)
3. The ***expected rate of deviation*** from a control.
4. The ***relevance and reliability*** of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level. (How much effect the operating effectiveness of control will have on assertion, if the operating effectiveness of the control is going to have an high level impact on assertions, then the extent of testing for that particular controls needs to be increased)
5. The ***extent to which audit evidence is obtained*** from tests of other control related to the assertion. (For a particular assertion there might be multiple controls, if audit evidence is obtained from other internal controls for a particular assertion is sufficient, then extent of testing can be reduced for other controls for the same assertion)

Timing of Test of Controls

The auditor shall test controls for

- the ***particular*** time, or
- ***throughout*** the period,

in order to provide an appropriate basis for the auditor's intended reliance.

Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose, for example, when testing controls over the entity's physical inventory counting at the period end.

If, on the other hand, the auditor intends to rely on a control over a period, tests that are capable of providing audit evidence that the control operated effectively at relevant times during that period are appropriate.

Such tests may include tests of the entity's monitoring of controls.

Using audit evidence obtained in previous audits

In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:

a) The effectiveness of ***other elements of internal control***, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process
b) The risks arising from the ***characteristics*** of the ***control***, including whether it is manual or automated
c) The effectiveness of ***general IT-controls***
d) The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in ***previous audits***, and whether there have been personnel changes that significantly affect the application of the control
e) Whether the lack of a change in a particular control poses a risk due to changing circumstances and
f) The ***risks*** of material misstatement and the extent of ***reliance*** on the control

If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit.

Evaluating the Operating Effectiveness of Controls

- Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk.
- In case of deviations, the auditor will evaluate the deviations.
- The evaluation of deviations may result in the auditor concluding that the assessed level of control risk needs to be revised. In such cases, the auditor would modify the nature, timing and extent of planned substantive procedures.
- When evaluating the operating effectiveness of relevant controls, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively.
- The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective.
- A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control.

Specific inquiries by the auditor when deviations from controls are detected.

When deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether

- The tests of controls that have been performed provide an ***appropriate*** ***basis*** for reliance on the controls
- ***Additional*** tests of controls are necessary
- The ***potential*** ***risks*** of misstatement need to be addressed using substantive procedures.

Tests of Details

Substantive procedures comprise:

a. Tests of details (of classes of transactions, account balances, and disclosures), and
   i. tests of transactions i.e., vouching and
   ii. tests of balances i.e., verification.
b. Substantive analytical procedures. (SAP)

Substantive analytical procedures

The term "analytical procedures" means

- evaluations of financial information
- through analysis of plausible relationships
- among both financial and non-financial data.

Analytical procedures also includes

- such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.

Examples

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 tests of details on the payroll.

In case of Room Rental Income of Hotel, different types of analytical procedures provide different levels of assurance. Analytical procedures involving 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 for further verification by means of tests of details, provided the elements are appropriately verified.

Designing and Performing Substantive Procedures

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

Depending on the circumstances, the auditor may determine that

1. Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.
2. Only tests of details are appropriate.
3. A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

The nature of the risk and assertion is relevant to the design of tests of details.

1. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence.
2. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.

Because the assessment of the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from test of controls are unsatisfactory.

In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing.

Internal Financial Controls as per Regulatory Requirements

Meaning

The term Internal Financial Controls (IFC) basically refers to the policies and procedures put in place by companies for ensuring:

- Reliability of financial reporting

- *Effectiveness* and *efficiency* of *operations*
- *Compliance* with applicable *laws* and *regulations*
- Safeguarding of *assets*
- *Prevention* and *detection* of *frauds*

Reporting Requirements

Relevant provision of Companies Act,2013	Nature of Responsibility
Section 134 (5)(e)	In case of *listed* Companies, the Directors' responsibility statement shall state that the *Directors* had laid down Internal financial controls to be followed by the company and that such Internal financial controls are adequate and were operating effectively.
Section 143(3)(i) of the Act	The auditor's report shall state whether the company has adequate Internal financial controls system in place and also on the operating effectiveness of such controls. This requirement shall not apply to a private company which – i) is One Person Company or a small company; or ii) has *turnover less than ₹ 50 crore* as per latest audited FSs; and which has aggregate *borrowings* from banks or financial institutions or any body corporate at *any* point of time during the financial Year for *less than ₹ 25 crore*
Section 177(4)(vii) of the Act	Every audit Committee shall act in accordance with the terms of reference specified in writing by the Board which shall, inter alia, include - evaluation of internal financial controls and risk management systems
As per Section 149(8) of the Act	The company and independent directors shall abide by the provisions specified in Schedule IV which lays down the Code for *independent Directors*. As per this code, the role and functions of independent directors include that they shall satisfy themselves on the integrity of financial information and that financial controls and the systems of risk management are robust and defensible.

The directors and management have primary responsibility of implementing and maintaining an effective internal controls framework and auditors are expected to evaluate, validate and report on the design and operating effectiveness of internal financial controls.

Chapter 3C - Materiality

SA 320 – Materiality in planning & performing an audit

What is meant by materiality?

SA 320 deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements.

Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements they generally explain that:

- ***Misstatements***, including omissions, are considered to be material if they, individually or in the aggregate, could ***reasonably*** be ***expected*** to ***influence*** the ***economic decisions*** of users taken on the basis of the ***financial statements***;
- Judgments about materiality are made in the light of ***surrounding circumstances***, and are affected by the ***size*** or ***nature*** of a misstatement, or a combination of both; and
- Judgments about matters that are material to users of the financial statements are based on a consideration of the ***common financial information needs of users*** as a ***group***.

Such a discussion, if present in the applicable financial reporting framework, provides a ***frame*** of ***reference*** to the auditor in determining materiality for the audit.

If the applicable financial reporting framework ***does not*** include a ***discussion*** of the concept of materiality, the characteristics referred above provide the auditor with such a frame of reference.

Application of concept of Materiality

The concept of materiality is applied by the auditor ***both*** in ***planning*** and ***performing*** the ***audit***, and in ***evaluating*** the effect of ***identified misstatements*** on the audit and of ***uncorrected misstatements***, if any, on the financial statements and in forming the opinion in the auditor's report.

Materiality is not always a matter of relative size

Materiality is ***not always a matter of relative size***. For example, a small amount lost by fraudulent practices of certain employees can indicate a serious flaw in the enterprise's internal control system requiring immediate attention to avoid greater losses in future.

Does not necessarily establish an amount below which uncorrected misstatements, will always be evaluated as immaterial.

The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality.

Statutory requirement of disclosure

If there is any statutory requirement of disclosure, it is to be considered material irrespective of the value of amount. Examples are given below: -

- As per Division I of schedule III of Companies Act, 2013, any item of income or expenditure which ***exceeds 1% of the revenue from operations or ₹ 1,00,000, whichever is higher***, needs to be ***disclosed separately***.
- A company should disclose in notes to accounts, shares in the company held by each shareholder holding ***more than 5% shares*** specifying the number of shares held as per requirements of Division I of Schedule III of Companies Act,2013.

Determining materiality helps in

In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:

- Determining the nature, timing and extent of *risk assessment procedures*;
- *Identifying* and *assessing* the *risks* of material misstatement; and
- Determining the nature, timing and extent of *further audit procedures*.

Determination of materiality- a matter of professional judgment

The auditor's determination of materiality is a matter of *professional judgment*, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:

a. Have a *reasonable knowledge* of *business* and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
b. *Understand* that financial statements are *prepared*, *presented* and *audited* to *levels of materiality*;
c. Recognize the *uncertainties* inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
d. Make *reasonable economic decisions* on the basis of the information in the financial statements.

Determining Materiality and Performance Materiality

Materiality for the financial statements as a whole.

When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole.

Performance Materiality

Performance materiality means

- The amount or amounts set by the auditor
- at *less than materiality*
- for the *financial statements* as a whole
- to *reduce* to an *appropriately* low level
- the *probability*
- that the aggregate of misstatements exceed materiality for the financial statements as a whole.

If, in the specific circumstances of the entity,

- there is one or more particular *classes* of *transactions*, *account balances* or *disclosures*
- for which *misstatements* of *lesser amounts* than the materiality for the financial statements as a whole
  - could *reasonably* be *expected*
  - to *influence* the *economic decisions* of users taken on the basis of the financial statements,

the auditor shall also determine the (PERFORMANCE) materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures"

- Performance materiality is also known as *Tolerable misstatements*
- A percentage based on risk at the financial statement level is multiplied by planning materiality to determine tolerable misstatement, or performance materiality.

Factors giving indications to determine performance materiality.

- Requirement of law or regulation (Example remuneration of management, Related party transactions)
- Disclosures depending on Industry (For example,research and development costs for a pharmaceutical company).
- Specific item important for users in a particular case (Purchase price of new acquired business)

Benchmarking

Benchmarking is one recognized method through which an Auditor determines the materiality level. Under this method, a percentage is often applied to a chosen benchmark, as a starting point in determining materiality for the Financial Statements as a whole.

The auditor has to apply his professional judgement in determining materiality, choosing appropriate benchmark and determining level of benchmark.

Factors that may affect the identification of an appropriate benchmark

Factors that may affect the identification of an appropriate benchmark include –

a. *Elements* of the *Financial Statement* (e.g., Assets, Liabilities, Equity, Revenue, Expenses)
b. Whether there are items on which the *attention* of the *users* of the particulars Entity's Financial Statement tends to be focused (e.g., profit, revenue or net assets)
c. *Nature* of the Entity, where the Entity is at in its *life cycle*, and the industry and economic environment in which the Entity operates
d. *Ownership Structure* and Financial Pattern (e.g., if an entity is financed more by Debt rather than Equity, users may put more emphasis on Assets, and claims on them, than on the Entity's Earning) and
e. The relative *volatility* of the *benchmark*.

Some examples of suitable benchmark depending upon various circumstances

Examples of benchmarks that may be appropriate, include categories of *reported income* such as *PBT*, Total *Revenue*, *Gross Profit* and Total *Expenses*, Total *Equity* or Net Asset Value.

a. *Profit Before Tax* from continuing operations is often used for profit-oriented entities. In this regard if Profit Before Tax from continuing operations is volatile, other benchmark may be more appropriate.
b. In an audit of the entities doing *public utility programs*/projects, Total Cost or Net Cost (Expenses less Revenues) may be appropriate benchmarks for that particular program/project activity.
c. Where an entity has *custody* of the *assets*, assets may be an *appropriate benchmark*.

Percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue.

Chosen Benchmark – Relevant financial data

For chosen benchmark, relevant financial data ordinarily includes:

- Prior periods' financial results and financial positions,
- The period to-date financial results and financial position, and
- Budgets or forecasts for the current period,
- Adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates

Use of Professional Judgment

- Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment.
- There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue.
- The auditor may consider 5% of profit before tax from continuing operations to be appropriate for a profit-oriented entity in a manufacturing industry, while the auditor may consider 1% of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in different circumstances.

Revision as the Audit Progresses

- Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a
  - change in *circumstances* that occurred during the audit (for example, a decision to dispose of a major part of the entity's business),
  - new *information*, or
  - a *change* in the *auditor's understanding* of the entity and its operations as a result of performing further audit procedures.
- For example, if during the audit it appears that actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.
- If materiality assessment lowers, the auditor must review performance materiality and audit procedures.

Documenting the Materiality

The audit documentation shall include the following amounts and the factors considered in their determination:

a. *Materiality* for the financial statements as a whole
b. If applicable, the *materiality level* or levels for *particular classes* of transactions, account balances or disclosures
c. *Performance materiality* and
d. Any *revision* of (a)-(c) as the audit progressed

Materiality and Audit Risk

Objective

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

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

The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level .

Audit Risk

- Audit risk is the risk that the auditor expresses an *inappropriate audit opinion* when the financial statements are *materially misstated*.
- Audit risk is a *function* of the *risks* of *material misstatement* and *detection risk* .

Materiality and audit risk

Materiality and audit risk are considered throughout the audit, in particular, when

- *Identifying* and *assessing* the *risks* of material misstatement.
- Determining the *n*ature, *t*iming and *e*xtent of *further audit procedures*; and
- 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 the degree of audit risk. Accordingly, if we have high risk in an organisation we should keep our materiality level low.
- Audit Risk has three components – Inherent risk (IR), Control Risk (CR) & Detection Risk.
- If a company is having low IR & CR then the chances are material misstatement are also low.
- Auditor will keep his materiality level high.
- If Risk is high the auditor will keep his materiality level low so that he can detect a greater number of misstatements.

Chapter 3D - Automated Environment

What is an automated environment?

- An automated environment basically refers to a business environment where the
  - Processes,
  - Operations,
  - Accounting and
  - Even Decisions are carried out by using computer systems – also known as Information Systems (IS) or Information Technology (IT) systems.
- The fundamental principle of an automated environment is the ability to ***carry out business with less manual intervention and more system driven***.
- The ***complexity*** of a business environment ***depends*** on the level of automation i.e., if a business environment is more automated, it is likely to be more complex.
- Entity uses different softwares to initiate, execute, process and record the transaction, these systems can be in the form of Enterprise Resource Planning Packages (ERPs) or simple accounting softwares.
- ERPs are comparatively more automated and hence more complex.

Key features of an Automated Environment

The key features of an automated environment are as follows.

- Enables ***faster*** business operation.
- ***Accuracy*** in data processing and computation
- Ability to process large ***volumes*** of transactions
- ***Integration*** between business operations
- Better ***security*** and ***controls***
- Less prone to ***human errors***
- Provides ***latest*** information
- ***Connectivity*** and ***Networking*** capability

Understanding and documenting automated environment

For conducting an Audit, an auditor is required to identify and assess the risk of material misstatements. For this auditor conducts risk assessment procedures.

The auditor assesses the risk of material misstatement through understanding the entity, it's environment and it's internal control.

When an entity's business environment is automated, the auditor also needs to understand the IT used in such an automated environment and the risks related to the same, in order to properly identify and assess the risk of material misstatement.

Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment

- ***Information systems*** being used (one or more application systems and what they are)
- Their ***purpose*** (financial and non-financial)
- ***Location*** of IT systems - local vs global
- ***Architecture*** (desktop based, client-server, web application, cloud based)
- ***Version*** (functions and risks could vary in different versions of same application)
- ***Interfaces*** within systems (in case multiple systems exist)
- ***In-house vs Packaged***
- ***Outsourced activities*** (IT maintenance and support)
- ***Key persons*** (CIO, CISO, Administrators)

The understanding of a company's IT environment that is obtained should be documented.

Understanding the Risks that arise from the use of IT and IT Systems

Having obtained an understanding of the IT systems and the automated environment of a company, the auditor should now understand the risks that arise from the use of IT systems. Given below are some such risks that should be considered:

- *Inaccurate processing* of *data*, *processing inaccurate data*, or both.
- *Unauthorized access* to data.
- *Direct data changes* (backend changes).
- Excessive access / *Privileged access* (super users).
- *Lack* of adequate segregation of duties.
- *Unauthorized changes* to systems or programs.
- *Failure* to make *necessary changes* to systems or programs.
- *Loss of data*.

Impact of IT related risks

The auditor should apply professional judgement in determining and assessing IT related risks and plan the audit response appropriately. IT related risks will have the following impact on Substantive Audit, Controls and Reporting.

SUBSTANTIVE AUDIT - Thorough Testing of Data ETC

First, we may *not* be able

- to *rely* on the *data* obtained from systems where such risks exist.
    - This means,
        - *all* forms of data, information or reports
        - that we obtain from systems for the purpose of audit
        - has to be thoroughly tested and corroborated for *completeness* and *accuracy*.

CONTROLS - Non-Reliance on Controls

Second, we will *not* be able

- to *rely* on automated
    - *controls*,
    - *calculations*,
    - accounting *procedures*
        - that are built into the applications.
            - *Additional* audit *work* may be required in this case.

REPORT - Modification in Report

Third, due to the *regulatory requirement* of auditors to *report* on *internal financial controls* of a company, the audit report also may have to be *modified* in some instances.

In all the above scenarios, it is likely that the auditor will be required to obtain more audit evidence and perform additional audit work.

The auditor should also be able to demonstrate

- how the risks were *identified* and
- what audit *evidence* was *obtained* and
- how IT risks were *addressed*.

As the complexity, automation and dependence of business operations on IT systems increases, the severity and impact of IT risks too increases accordingly.

Types of Controls in an Automated Environment

- General IT Controls
- Application Controls
- IT-Dependant Controls.

General IT Controls

General Controls are

- *pervasive controls* and
- apply to *all systems components*, *processes*, and *data* for a given enterprise or systems environment.
- For example- Information security policy.

General IT controls are policies and procedures that relate to

- many applications and
- support the effective functioning of application controls.

They apply to mainframe, miniframe, and end-user environments.

General IT-controls that maintain the integrity of information and security of data commonly include controls over the following:

- Data centre and network operations
- Program change
- Access security
- Application system acquisition, development, and maintenance.

Controls over Data centre and network operations

- The objective of controls over Data centre and network operations is to
  - ensure that *production systems* are *processed* to *meet financial reporting objectives*.
- These include activities such as
  - overall management of computer operation activities,
  - preparing, scheduling and executing of batch jobs,
  - monitoring, storage and retention of backups.
  - Such controls also help in performance monitoring of operating system, database and networks.
  - Matters such as BCP (Business continuity plan) and DRP (Disaster recovery plan) which deal with recovery from failures are also taken care of by such type of controls.

Program Change

- The objective of program change controls is to
  - ensure that *modified systems continue* to *meet financial reporting objectives.*
- It includes activities such as
  - change management process,
  - recording, managing and tracking change requests,
  - making and testing changes

Access Security

- The objective of controls over access security is to
  - ensure that *access* to programs and data is *authenticated* and *authorized* to meet financial reporting objectives.
- It includes activities such as
  - security organization & management,
  - security policies & procedures,
  - application security,
  - data security,

- operating system security,
- network security,
- physical security

Application system acquisition, development, and maintenance

- The objective of such controls is to
  - ensure that systems are *developed, configured and implemented* to *meet financial reporting objectives*.
- It includes
  - overall management of development activities,
  - project initiation,
  - analysis & design,
  - construction,
  - testing & quality assurance.

Application Controls

Application controls include *both automated or manual controls* that operate at a business process level. Automated Application controls are embedded into IT applications like ERPs and help in ensuring the *completeness*, *accuracy* and *integrity* of data in those systems.

Examples of automated applications include

- edit checks and validation of input data,
- sequence number checks,
- user limit checks,
- reasonableness checks,
- mandatory data fields.

IT dependent Controls

- IT dependent controls are basically *manual controls* that make use of some form of data or information or report produced from IT systems and applications.
- In this case, even though the control is performed manually, the design and effectiveness of such controls depends on the reliability of source data.
- Example - A system-generated report lists users that have not accessed a particular system within the past 60 days. The internal control may require an administrator to review such reports and disable certain users out of it.
- Due to the inherent dependency on IT, the effectiveness and reliability of Automated application controls and IT dependent controls require the General IT Controls to be effective.

General IT Controls vs. Application Controls

- These two categories of control over IT systems are *interrelated*.
- The relationship between the application controls and the General IT Controls is such that *General IT Controls are needed to support the functioning of application controls*, and both are needed to ensure complete and accurate information processing through IT systems.

Testing methods in an automated environment.

Testing General Note

There are basically four types of audit tests that should be used. They are *inquiry, observation, inspection and reperformance*. Inquiry is the most efficient audit test but it also gives the least audit evidence.

Hence, inquiry should always be used in combination with any one of the other audit testing methods. *Inquiry alone is not sufficient.*

Reperformance is most effective as an audit test and gives the best audit evidence. However, testing by reperformance could be very time consuming and least efficient most of the time.

Generally, applying ***inquiry in combination with inspection gives the most effective and efficient audit evidence***.

Which audit test to use, when and in what combination is a matter of professional judgement and will vary depending on several factors including

- Risk assessment,
- Control environment,
- Desired level of evidence required,
- History of errors/misstatements,
- Complexity of business, assertions being addressed, etc.

When testing in an automated environment, some of the more common methods are as follows:

- Obtain an ***understanding*** of how an automated ***transaction*** is ***processed*** by doing a ***walkthrough*** of one end-to-end transaction using a combination of inquiry, observation and inspection.
- Observe how a ***user processes*** transactions under ***different scenarios***.
- Inspect the ***configuration*** defined in an application.

The auditor should document the nature of the test (or combination of tests) applied along with the judgements in the audit file as required by SA 230.

Manual and Automated Elements of Internal Control Relevant to the Auditor's Risk Assessment

The auditor's risk assessment is influenced by the manual or automated nature of internal controls, which also affects the manner in which transactions are initiated, recorded, processed, and reported

Manual controls are considered to be less effective

In general, manual controls are considered to be less effective than IT controls because

- manual controls are performed by people who are ***less predictable*** than IT applications and ***more error-prone*** (e.g. they are human, after all);
- manual controls are more easily bypassed, ***ignored*** or ***overridden*** than IT controls (as IT controls are programmed - the applications run them automatically); and
- manual controls are ***subject to*** random, simple ***errors*** and mistakes.

Suitability of manual controls

Manual controls may be more suitable where judgment and discretion are required, for example:

- for large, ***unusual*** or non-recurring transactions;
- where errors are ***non-routine*** and challenging to define, anticipate or predict;
- where a control response is required ***outside*** of the routine automated control; and
- in monitoring the ***effectiveness*** of ***information processing controls*** that use IT.

However, using judgment and discretion in internal control may mean high control risk (e.g. where the control environment is weak).

Circumstances in which Manual Elements are less suitable

- High volume or recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented, or detected and corrected, by control parameters that are automated.
- Control activities where the specific ways to perform the control can be adequately designed and automated.

Audit Approach in an Automated Environment

Risk Assessment

- Identify ***significant accounts*** and ***disclosures***

- *Qualitative* and *Quantitative* considerations
- Relevant Financial Statement *Assertions*
- Identify likely *sources* of misstatement
- Consider *risk* arising from use of IT systems

Understand and Evaluate

- *Document* understanding of business processes using Flowcharts/ Narratives
- Prepare *Risk* and *Control Matrices*.
- *Understand* design of *controls* by performing *walkthroughs* of end-to-end process
- Process wide considerations for Entity Level Controls, *S*egregation *o*f *D*uties
- IT *General Controls, Application Controls*

Test for Operating Effectiveness

- Assess *N*ature, *T*iming and *E*xtent (NTE) of *controls testing*
- Assess *reliability* of *source data*; completeness of population
- *Testing* of key *reports* and *spreadsheets*
- *Sample testing*
- Consider *competence* and *independence* of staff/team performing controls testing.

Reporting

- *Evaluate* Control *Deficiencies*
- *Significant deficiencies*, Material Weaknesses
- *Remediation* of control weaknesses
- *Internal Controls Memo* (ICM) or Management Letter
- *Auditor's report*

Data Analytics for Audit

- The *combination* of *processes, tools* and *techniques* that are used to *tap vast amounts* of electronic *data* to *obtain meaningful information* is called data analytics.
- Auditors can make use of similar tools and techniques in the audit process and obtain good results.
- The tools and techniques that auditors use in applying the principles of data analytics are known as *Computer Assisted Auditing Techniques* or CAATs in short.

Application of Data Analytics

Data analytics can be used in testing of electronic records and data residing in IT systems

- using spreadsheets and
- specialised audit tools viz., IDEA and ACL to perform the following,
    - Check *completeness* of data and population that is used in either test of controls or substantive audit tests
    - *Selection* of *audit samples* – random sampling, systematic sampling
    - *Re-computation* of balances – reconstruction of trial balance from transaction data
    - *Reperformance* of mathematical calculations – depreciation, bank interest calculation
    - *Analysis* of journal entries as required by SA 240
    - *Fraud investigation*
    - Evaluating impact of *control deficiencies*.

Digital Audit

What is a Digital Audit?

Digital Audit is placing *assurance* on the *effectiveness of the IT systems* implemented in an organization.

The Impact of Digitization and Technology

- Companies are digitizing operations with new tech to modernize and restructure business models. Automation is key to digitization.
- In such a business environment, use of digital technology is being made by auditors right from planning to expression of final opinion.
- Auditors are making use of artificial intelligence, data analytics and other latest technologies to help understand business processes in a better way. By using such tools, auditors can conduct audit in a better way and devote more attention to areas requiring greater focus.
- Digital audit is helping auditors to better *identify risks making use of technology*

Chapter 4 - Audit Evidence

SA 500 Audit Evidence

Meaning of Audit Evidence

Audit evidence – *Information used* by the *auditor* in arriving at the *conclusions* on which the auditor's *opinion* is based. Audit evidence includes both information contained in the *accounting records* underlying the FSs and *other information*.

Information contained in the accounting records

Accounting records include

- the records of initial accounting *entries* and supporting records, such as checks and records of electronic fund transfers;
- *Invoices*;
- *Contracts*
- the *ledgers*, *journal* entries and other *adjustments* to the financial statements.
- *records* such as *worksheets* and *spreadsheets* supporting cost allocations, computations, reconciliations and disclosures.

Other information

Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements:

Other information which the auditor may use as audit evidence includes, for example

- *minutes* of the meetings,
- written *confirmations* from trade receivables and trade payables,
- *manuals* containing details of internal control etc

A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

Other Points related to Audit Evidence and Its Nature.

- It is *cumulative* in *nature*
- *Primarily obtained* from audit procedures performed during the course of the audit.
- It may, however, also *include information* obtained from *other sources* such as *previous audits.*
- Audit evidence comprises both
    - information that supports and corroborates management's assertions, and
    - any information that contradicts such assertions.
- The *absence* of *information* (for example, management's refusal to provide a requested representation) also constitutes audit evidence.

Relation of Audit Evidence and Opinion of the Auditor

- There exists a very important relationship between Audit Evidence and the opinion of the Auditor.
- While conducting an audit of a company,
    - the auditor obtains audit evidence and
    - With the help of that audit evidence obtained, the auditor forms an audit opinion on the FSs of that company.
    - Audit evidence is necessary to support the auditor's opinion and report.

As explained in SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", *reasonable assurance* is obtained when the auditor has obtained *sufficient appropriate audit evidence* to *reduce audit risk* to an *acceptably low level*.

Sufficient and Appropriate Audit Evidence

Sufficiency of Audit Evidence

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

Factors to determine Sufficiency

Materiality

- It may be defined as the ***significance*** of ***classes*** of transactions, account balances and presentation and disclosures to the ***users*** of the financial statements.
- ***Less evidence*** would be required in case assertions are ***less material*** to users of the financial statements.
- But on the other hand if assertions are more material to the users of the financial statements, more evidence would be required.

Risk of material misstatement

It may be defined as the risk that the financial statements are materially misstated prior to audit.
Less evidence would be required in case assertions that have a ***lower risk*** of material misstatement.
But on the other hand, if assertions have a higher risk of material misstatement, more evidence would be required.

Size of a population

It refers to the ***number*** of ***items*** included in the population.
Less evidence would be required in case of ***smaller***, ***more homogeneous*** population but on the other hand in case of larger, more heterogeneous populations, more evidence would be required.

Appropriateness of Audit Evidence

Appropriateness is the measure of the ***quality*** of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

Relevance

Relevance means the ***relationship*** of the evidence with ***audit procedure*** and the ***assertion*** being checked.

A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others.

For example, ***confirmation*** of ***balance*** from a customer is a relevant evidence as regards existence of receivable, but it may ***not*** be ***relevant*** as regards ***collectability*** of the balance due from customer.

Also, ***physical observation*** of inventories is relevant ***evidence*** relating to ***existence***, but is ***not*** appropriate evidence to ensure that the entity ***owns*** the inventories.

On the other hand, audit evidence from different sources or of a different nature may often be relevant to the same assertion. For example Checking the terms of the agreement and confirming the same from the third party.

The term ***competence*** is also used in place of ***relevance***.
One more example of relevance: To Check if a purchase is complete you don't look at the Purchase contract. For checking the completeness of purchase we will check that goods or services were received. For this we will check various documents and records related to receiving goods like stock registers .

Reliability of Audit Evidence

- You measure reliability by deciding whether the evidence is credible.
- As an auditor, you should adopt an attitude of professional skepticism.

- In order to obtain reliable audit evidence, information produced by the entity that is used for performing audit procedures needs to be sufficiently complete and accurate.

As per SA 500 "Audit Evidence", the reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its

- *source* and
- its *nature*, (Direct, indirect, oral, written or original, photocopies) and
- the *circumstances* under which it is obtained,
- including the *controls* over its preparation and maintenance where relevant.

Generalisations about the reliability of various kinds of audit evidence are subject to important exceptions.
Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability.

For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity.

While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful

1. The reliability of audit evidence is increased when it is obtained from *independent sources* outside the entity.
2. The reliability of audit evidence that is generated *internally* is *increased* when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
3. 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).
4. 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).
5. 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.
6. Circumstances prevailing in the organisation can have a severe impact on the reliability of the audit evidence..

Sources of Audit Evidence

- Some audit evidence is obtained by performing audit procedures to test the accounting records.
- Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements.
- More assurance is ordinarily obtained from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually.
- Information from sources independent of the entity that the auditor may use as audit evidence may include confirmations from third parties, analysts' reports, and comparable data about competitors.

Audit Procedures to Obtain Audit Evidence

Audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing

- ➔ Risk assessment procedures; and
- ➔ Further audit procedures, which comprise:
  - ◆ Tests of controls, when required by the SAs or when the auditor has chosen to do so; and
  - ◆ Substantive procedures, including tests of details and substantive analytical procedures.
- ➔ The audit procedures described below may be used as
  - ◆ risk assessment procedures,

- tests of controls or
- substantive procedures,
    - Depending on the context in which they are applied by the auditor.

Audit procedures to obtain audit evidence can include

1. Inspection
2. Observation
3. External Confirmation
4. Recalculation
5. Reperformance
6. Analytical Procedure
7. Enquiry

Inspection

- ***examining records*** or ***documents***,
    - whether internal or external,
    - in paper form, electronic form, or other media, or
- a ***physical examination*** of an asset.
- Inspection of records and documents provides audit evidence
    - of varying degrees of reliability,
    - depending on their nature and source and,
- Example - Documentation related to authorisation

Observation

- Observation consists of ***witnessing*** a ***process*** or procedure being performed by others.
- For example, the auditor may observe the counting of inventories being performed by client's personnel.

External Confirmation

An external confirmation represents audit evidence obtained by the auditor as a ***direct written response*** to the auditor from a ***third party*** (the confirming party), in paper form, or by electronic or other medium.

External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only.

External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions.

Recalculation

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

Re-performance

Re-performance involves the auditor's ***independent execution*** of ***procedures*** or controls that were originally performed as part of the entity's internal control.

Analytical Procedures

- Analytical procedures consist of ***evaluations*** of ***financial information*** by a study of ***relationships*** among both ***financial*** and ***non- financial data***.
- Analytical Procedures refers to studying significant ratios and trends and investigating unusual fluctuations.

Inquiry

- ***Seeking information*** of ***knowledgeable persons***, both financial and non- financial, ***within*** the entity or ***outside*** the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures.

- Inquiries may range from *formal* written inquiries to *informal* oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.
- Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.
- Corroboration is crucial for inquiry evidence, especially on management intent. Auditor should Assess management's history, reasons, and ability to support inquiry evidence.
- Auditor may need written representations from management or TCWG to confirm oral inquiry responses in certain matters.
- Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

Types of Audit Evidence

Depending upon nature

Visual

- For example, observing physical verification of inventory conducted by the client's staff.

Oral

- For example, discussion with the management and various officers of the client.

Documentary

- For example, fixed deposit certificate, loan agreement, sales bill etc.

Depending upon source

Internal Evidence

- Evidence which originates *within* the *organisation* being audited is internal evidence.
- Examples, Sales invoice, Copies of sales challan and forwarding notes, goods received note, inspection report, copies of cash memo, debit and credit notes, etc.

External evidence

- The evidence that originates *outside* the client's *organization* is external evidence
- Examples, Purchase invoice, supplier's challan and forwarding note, debit notes and credit notes coming from parties, quotations, confirmations, etc.

Auditors receive mostly internal evidence; external evidence also plays a significant role. As clients control internal evidence, auditors must cautiously rely on it, being aware of potential manipulations. It is not suggested that they are to be suspected.

External evidence is often *more reliable*, coming from unbiased third parties. But, auditors should be vigilant if they doubt a third party's independence, like with associated concern invoices.

As an ordinary rule, the auditor should try to match internal and external evidence as far as practicable. Where external evidence is not readily available to match, the auditor should see as to what extent the various internal evidences corroborate one another.

Auditors should ideally match internal and external evidence when possible. If external evidence is scarce, they must assess how well internal evidences corroborate each other.

Inconsistency in or Doubts over Reliability of Audit Evidence

If:

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

the auditor shall determine what *modifications* or additions to audit procedures are necessary to resolve the matter, and shall consider the *effect* of the matter, if any, on other aspects of the audit

Management's expert

An individual or organisation possessing expertise in a field *other than accounting or auditing*, whose work in that field is used by the entity to *assist* the entity in preparing the *FSs.*

Relying on the work of a management's expert

If the entity has employed or engaged experts, the auditor may rely on the works of experts, provided he is satisfied that sufficient and appropriate audit evidence is obtained with reasonable assurance to form an opinion on the FSs. 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,:

- Evaluate the *competence*, *capabilities* and *objectivity* of that expert;
- Obtain an *understanding* of the work of that expert; and
- Evaluate the *appropriateness* of that expert's work as audit evidence for the relevant assertion.

When information to be used as audit evidence has been prepared using the work of a management's expert, the nature, timing and extent of audit procedures may be affected by such matters;

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

Audit Trail

- An audit trail is a *documented flow* of a transaction.
- It is used to investigate how a *source* document was *translated* into an account *entry* and from there it was inserted into FS of an entity.
- It is used as audit evidence to establish *authentication* and *integrity* of a transaction.
- Audit trails help in maintaining *record* of system and user activity.
- Like, in case of *banks*, there is an audit trail keeping *track* of *log-on activity* detailing record of log-on attempts and device used.
- Audit trails help to *enhance* internal *controls* and data security.
- Audit trails assist in *assigning* responsibility, reconstructing events, and analyzing issues
- Audit trails incur costs, both in system expenses and time spent analyzing data. Automated tools can *efficiently* analyze the *large volume* of data from audit trails.
- Audit trails boost auditor *confidence* by verifying if management's controls work effectively and if authorized personnel performed transactions. They *enhance* data *security*, increasing the *reliability* of audit evidence obtained.

Evaluation of Audit Evidence

- SA 500 "Audit Evidence" is applicable to all the audit evidence obtained during the course of the audit to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.
- Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.
- The auditor has to conclude whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of ***professional judgment***.

Selecting Items for Testing to Obtain Audit Evidence

- When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure.
- The means available to the auditor for selecting items for testing are:
  - Selecting ***all*** items (100% examination);
  - Selecting ***specific*** items; and
  - Audit ***sampling***.
- The application of any one or combination of these means may be appropriate depending on the auditors' judgement to obtain audit evidence.

Selecting All Items

- The auditor ***may decide*** that it will be ***most appropriate*** to ***examine*** the ***entire population*** of items that make up a class of transactions or account balance (or a stratum within that population).
- 100% examination is unlikely in the case of tests of controls; however, it is more common for tests of details.
- 100% examination may be appropriate when
- For example
  - The population constitutes a small number of large value items;
  - There is a significant risk and other means do not provide sufficient appropriate audit evidence; or
  - The repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective.

Selecting Specific Items

- The auditor may decide to select specific items from a population.
- In making this decision, factors that may be relevant include the auditor's ***understanding*** of the entity, the ***assessed risks*** of material misstatement, and the ***characteristics*** of the ***population*** being tested.
- The judgmental selection of specific items is subject to non-sampling risk.
- Specific items selected may include:
  - High value or key items.
    - The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic.
    - For example, items that are suspicious, unusual, particularly risk-prone or that have a history of error
  - All items over a certain amount.
    - The auditor may decide to examine items whose recorded values exceed a certain amount so as to verify a large proportion of the total amount of a class of transactions or account balance.
  - Items to obtain information.
    - The auditor may examine items to obtain information about matters such as the nature of the entity or the nature of transactions.

Audit Sampling

Audit sampling is designed to enable *conclusions* to be drawn about an entire population on the basis of testing a sample drawn from it.

Using the work of Internal Auditors (SA 610)

Relationship between SA 315 and SA 610

- Knowledge and experience of the internal audit function can affect the external auditor's understanding of the entity and its environment and identification and assessment of risks of material misstatement.
- This SA addresses the external auditor's responsibilities when, based on the external auditor's preliminary understanding of the internal audit function obtained as a result of procedures performed under SA 315, the external auditor expects to use the work of the internal audit function or using internal auditor to provide direct assistance.

Internal audit function - Meaning

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

Objectives and scope of internal audit functions

The objectives and scope of internal audit functions typically include *assurance and consulting activities* designed to evaluate and improve the effectiveness of the entity's *governance* processes, *risk management* and internal *control* such as the following:

Activities Relating to Governance

- Internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, accountability.

Activities Relating to Risk Management

- Internal audit function may assist the entity by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and internal control

Activities Relating to Internal Control

- *Evaluation* of internal *control*.
  - Reviewing controls, evaluating their operation and recommending improvements thereto
- *Examination* of *financial* and *operating* information.
  - Review the means used to identify, recognise, measure, and to make specific inquiry classify and report financial into individual items. and operating informations.
- *Review* of *operating activities*.
  - Review the economy, efficiency including non-financial activities and effectiveness of operating of an entity. activities,
- *Review* of *compliance* with *laws* and *regulations*.
  - Review compliance with laws, and with management policies regulations and other and directives and other external requirements, internal requirements.

Ways in which the external auditor may make use of the function for purposes of the audit.

While the objectives of an entity's internal audit function and the external auditor differ, the function may perform audit procedures similar to those performed by the external auditor in an audit of FSs. If so, the external auditor may make use of the function for purposes of the audit in one or more of the following ways:

i) to obtain information that is relevant to the external auditor's assessments of the risks of material misstatement due to error or fraud.

ii) Unless prohibited, or restricted to some extent, by law or regulation, the external auditor, after appropriate evaluation, may decide to use work that has been performed by the internal audit function during the period in partial substitution for audit evidence to be obtained directly by the external auditor

iii) Unless prohibited, or restricted to some extent, by law or regulation, the external auditor may use internal auditors to perform audit procedures under the direction, supervision and review of the external auditor (referred to as "direct assistance")

Scope of SA 610

- Standard on Auditing (SA) 610 deals with the external auditor's responsibilities if using the work of internal auditors. This includes
  - *using* the *work* of the *internal audit function* in obtaining audit evidence and
  - using internal auditors to provide *direct assistance* under the direction, supervision and review of the external auditor.
- Nothing in this SA requires the external auditor to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor; it remains a decision of the external auditor in establishing the overall audit strategy

Using the work of IAF

Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used

1. *Evaluating* the internal audit function
2. *Determining* the *nature* and *extent* of the work of the internal audit function that can be used
3. *Using* the *work* of internal audit function

Evaluating the internal audit function

The external auditor shall determine whether the work of the internal audit function can be used for purposes of the audit by evaluating the following

- The extent to which the internal audit function's organizational status and relevant policies and procedures support the *objectivity* of the internal auditors;
- The level of *competence* of the internal audit function; and
- Whether the internal audit function applies a *systematic* and *disciplined* approach, including quality control.

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

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

Determining the nature and extent of the work of the internal audit function that can be used

The external auditor shall consider the

- *nature* and *scope* of the work that has been performed, or is planned to be performed, by the internal audit function and
- its *relevance* to the external auditor's overall audit strategy and audit plan

The external auditor shall make all *significant judgments* in the audit engagement and, to prevent undue use of the work of the internal audit function, shall plan to use *less* of the work of the function and perform *more* of the work *directly*.

The external auditor shall also evaluate whether, in aggregate, using the work of the internal audit function to the extent planned would still result in the external auditor being *sufficiently involved* in the audit, given the external auditor's sole responsibility for the audit opinion expressed.

The external auditor shall, in communicating with TCWG an overview of the planned scope and timing of the audit in accordance with *SA 260*, *communicate how* the *external auditor* has planned to use the *work* of the internal audit function

Using the Work of the Internal Audit Function

- If the external auditor plans to use the work of the internal audit function, the external auditor shall ***discuss*** the ***planned use*** of its work with the function as a basis for coordinating their respective activities.
- The external auditor shall ***read*** the ***reports*** of the internal audit function relating to the work of the function that the external auditor plans to use to obtain an understanding of the nature and extent of audit procedures it performed and the related findings.
- The external auditor shall perform ***sufficient audit procedures*** on the work of the internal audit function as a whole that the external auditor plans to use to determine its ***adequacy*** for purposes of the audit, including evaluating whether:
    - The ***work*** of the function had been ***properly*** planned, performed, supervised, reviewed and documented
    - Sufficient appropriate ***evidence*** had been obtained to enable the function to draw ***reasonable*** conclusions; and
    - ***Conclusions*** reached are ***appropriate*** in the circumstances and the reports prepared by the function are ***consistent*** with the results of the work performed

Using IA to provide DA under DSR of EA

Determining Whether, in Which Areas, and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance

1. Determining Whether Internal Auditors Can Be Used to Provide Direct Assistance for Purposes of the Audit
2. Determining the Nature and Extent of Work that Can Be Assigned to Internal Auditors Providing Direct Assistance
3. Using Internal Auditors to Provide Direct Assistance

Direct assistance

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

Determining Whether Internal Auditors Can Be Used to Provide Direct Assistance for Purposes of the Audit

- Using internal auditors to provide direct assistance must not be ***prohibited*** by ***law*** or ***regulation***.
- The external auditor shall evaluate the
    - existence and significance of ***threats*** to ***objectivity*** and
    - the ***level*** of ***competence*** of the internal auditors who will be providing such assistance.

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

- There are significant threats to the objectivity of the internal auditor; or
- The internal auditor lacks sufficient competence to perform the proposed work

Determining the Nature and Extent of Work that Can Be Assigned to Internal Auditors Providing Direct Assistance

Areas where direct assistance shall not be taken.

The external auditor shall not use internal auditors to provide direct assistance to perform procedures that:

- Involve making ***significant judgments*** in the audit
- Relate to ***higher assessed risks*** of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited;
- Relate to ***work*** with which the ***internal auditors*** have been ***involved*** and which has already been, or will be, ***reported*** to ***management*** or TCWG by the internal audit function
- Relate to ***decisions*** the ***external auditor*** makes in accordance with this SA ***regarding*** the ***internal audit*** function and the use of its work or direct assistance.

In communicating with TCWG an overview of the planned scope and timing of the audit in accordance with SA 260, communicate the nature and extent of the planned use of internal auditors to provide direct assistance so as to reach a mutual understanding that such use is not excessive in the circumstances of the engagement.

Areas where significant judgment is involved and hence The external auditor shall not use internal auditors to provide direct assistance.

- 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 FSs, and other matters affecting the auditor's report.

Since the external auditor has sole responsibility for the audit opinion expressed, the external auditor needs to make the significant judgments in the audit engagement.

Using Internal Auditors to Provide Direct Assistance

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.
- The *external auditor* shall *direct*, *supervise* and *review* the work performed by internal auditors on the engagement in accordance with SA 220.
- The direction, supervision and review by the external auditor of the work performed by the internal auditors shall be *sufficient* in order for the external auditor to be satisfied that the internal auditors have obtained *sufficient appropriate audit evidence* to *support* the *conclusions* based on that work.

Documentation

If the external auditor uses the work of the internal audit function, the external auditor shall include in the audit documentation:

- The *evaluation* of:
  - Whether the function's organizational status and relevant policies and procedures adequately support the *objectivity* of the internal auditors.
  - The level of *competence* of the function; and
  - Whether the function applies a systematic and disciplined *approach*, including quality control;
- The *nature* and *extent* of the *work used* and the *basis* for that decision; and
- The audit *procedures* performed by the external auditor to *evaluate* the *adequacy* of the work used.

If the external auditor uses internal auditors to provide *direct assistance* on the audit, the external auditor shall Include in the audit documentation:

- 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;
- The basis for the *decision* regarding the *nature* and *extent* of the work performed by the internal auditors;
- Who *reviewed* the work performed and the *date* and *extent* of that review in accordance with SA 230
- The *written agreements* obtained from an *authorized representative* of the entity and the *internal auditors*; and
- The *working papers* prepared by the internal auditors who provided direct assistance on the audit engagement

Factors to be considered while determining objectivity

Objectivity refers to the ability to perform those tasks without allowing bias, conflict of interest or undue influence of others to override professional judgments. Factors that may affect the external auditor's evaluation include the following:

- 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. For example, whether the internal audit function reports to TCWG or an officer with appropriate authority, or if the function reports to management, whether it has direct access to TCWG.

- 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.
- Whether TCWG ***oversee employment decisions*** related to the internal audit function, for example, determining the appropriate remuneration policy.
- Whether there are any ***constraints*** or ***restrictions*** placed on the internal audit function by management or TCWG, for example, in communicating the internal audit function's findings to the external auditor.
- Whether the internal auditors are ***members*** of ***relevant professional bodies*** and their memberships obligate their compliance with relevant professional standards relating to objectivity, or whether their internal policies achieve the same objectives.

Factors to be considered while determining competence

Competence of the internal audit function refers to the attainment and maintenance of knowledge and skills of the function as a whole at the level required to enable assigned tasks to be performed diligently and in accordance with applicable professional standards. Factors that may affect the external auditor's determination include the following

- Whether the internal audit function is adequately and appropriately ***resourced*** relative to the size of the entity and the nature of its operations.
- Whether there are ***established policies*** for hiring, training and assigning internal auditors to internal audit engagements.
- Whether the internal auditors have adequate ***technical training*** and proficiency in auditing. Relevant criteria that may be considered by the external auditor in making the assessment may include, for example, the internal auditors' possession of a relevant professional designation and experience.
- Whether the internal auditors possess the ***required knowledge*** relating to the entity's financial reporting and the applicable financial reporting framework and whether the internal audit function possesses the necessary skills (for example, industry-specific knowledge) to perform work related to the entity's FSs.
- Whether the internal auditors are ***members*** of relevant ***professional bodies*** that oblige them to comply with the relevant professional standards including continuing professional development requirements.

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

- 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.
- Whether the internal audit function has ***appropriate quality control policies*** and procedures, for example, such as those policies and procedures in SQC 1 that would be applicable to an internal audit function (such as those relating to leadership, human resources and engagement performance) or ***quality control requirements*** in standards set by the relevant ***professional bodies*** for internal auditors. Such bodies may also establish other appropriate requirements such as conducting periodic external ***quality assessments***.

External Auditor's Responsibility for the audit

- The external auditor has ***sole*** responsibility for the audit ***opinion*** expressed, and that responsibility is ***not reduced*** by the external auditor's use of the work of the internal audit function or internal auditors to provide direct assistance on the engagement.
- Although they may perform audit procedures similar to those performed by the external auditor, neither the internal audit function nor the internal auditors are independent of the entity as is required of the external auditor in an audit of FSs in accordance with SA 200.
- This SA, therefore, defines the conditions that are necessary for the external auditor to be able to use the work of internal auditors. It also defines the necessary work effort to obtain sufficient appropriate evidence

that the work of the internal audit function, or internal auditors providing direct assistance, is adequate for the purposes of the audit.

- The requirements are designed to provide a framework for the external auditor's judgments regarding the use of the work of internal auditors to prevent over or undue use of such work.

Basics of Internal Financial Control and Reporting Requirements

Distinction between Internal Financial Control and Internal Control over financial reporting

- The term Internal Financial Controls (IFC) refers to the *policies* and *procedures* put in place by companies for ensuring *reliability* of financial *reporting*, *effectiveness* and *efficiency* of *operations*, *compliance* with applicable *laws* and *regulations*, *safeguarding* of *assets* and *prevention* and *detection* of *frauds*.
- On the other hand, Internal controls over financial reporting is required where auditors are required to express an *opinion* on the *effectiveness* of an *entity's internal controls over financial reporting*, such opinion is in addition to and distinct from the opinion expressed by the auditor on the FSs.
- Therefore, "internal financial control" is a wider term whereas "internal controls over financial reporting" is a narrower term restricted to entity's internal controls over financial reporting only

SA 530 "Audit sampling"

Meaning of Sampling

According to SA 530 - Audit sampling (sampling)

- The application of audit procedures
- to *less than 100% of items* within a population of audit relevance
- such that all sampling units have a chance of selection in order
- to provide the auditor with a
  - *reasonable basis*
  - on which to *draw conclusions* about the *entire population*.

This Standard on Auditing (SA) applies when the auditor has

- decided to use audit sampling in performing audit procedures.

It deals with the auditor's

- use of statistical and non-statistical sampling when
  - *designing* and *selecting* the audit sample,
  - *performing* tests of controls and tests of details, and
  - *evaluating* the results from the sample

We can also say that sampling is one of the means to select samples for testing.Sampling is also known as test check

Precautions to be taken while applying test check techniques.

- Thorough study of *accounting system* should be done before adopting sampling
- Proper study of internal *control systems*.
- *Areas* which are *not suitable* for *sampling* should be carefully considered. Eg: compliance with statutory provisions, transactions of unusual nature etc.
- Proper *planning* for Sampling methods to be used and explaining the staff,
- Transactions and balances have to be properly *classified* (stratified)
- Sample *size* should be appropriately determined.
- Sample should be chosen in *unbiased* way,
- *Errors* located in the sample should be analysed properly.

Population

Meaning

Population refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

Characteristics

Appropriateness

- Appropriate means the population from which the samples are drawn shall be *relevant* for the specific *objective*. Auditor will choose the sample and test it and then will project the results on the entire population.
- Appropriateness will include consideration of the direction of testing.
- For example, if the auditor's objective is to test for overstatement of accounts payable, the population could be defined as the accounts payable listing.
- On the other hand, when testing for understatement of accounts payable, the population is not the accounts payable listing but rather subsequent disbursements, unpaid invoices, suppliers' statements, unmatched receiving reports or other populations that provide audit evidence of understatement of accounts payable;

Completeness.

- *Conclusion* about the entire population can be *drawn only* when the *population* is *complete*
- For example, if the auditor intends to select payment vouchers from a file, conclusions cannot be drawn about all vouchers for the period unless the auditor is satisfied that all vouchers have in fact been filed.

Reliable

Auditors should obtain *evidence* about the *reliability* of the population. If the population is *not reliable* with respect to accuracy and source, the sample drawn will definitely *not* be *relevant* for the specific audit objective.

Sampling Unit

- The individual items constitute a population.
- For example checks listed on deposit slips, credit entries on bank statements, sales invoices or debtors' balances, or a monetary unit.
- The conclusion on the population is based on the audit procedures applied on the sampling unit.

Sample Design, Size And Selection of Items For Testing

Sample Design

While designing an audit sample auditor should consider the

- *purpose* of audit *procedure* and
- *characteristic* of *population* from which the sample will be drawn
- The auditor first considers
    - the specific objectives to be achieved and
    - the combination of audit procedures which is likely to best achieve those objectives.
- Auditor has to clearly define what will be considered as a misstatement. It will help the auditor in projecting the misstatement in the population.
- For example - In a test of details relating to the existence of accounts receivable, such as confirmation, payments made by the customer before the confirmation date but received shortly after that date by the client, are not considered a misstatement.

When performing tests of controls,

- The auditor generally makes an assessment of the rate of error the auditor expects to find in the population to be tested.
- This assessment is based on the auditor's understanding of the design of the relevant controls and whether they have been implemented or the examination of a small number of items from the population.

- Similarly, for tests of details, the auditor generally makes an assessment of the expected amount of error in the population.
- These assessments are useful for *designing* an audit sample and in determining sample size.
- For example, if the expected rate of error is unacceptably high, tests of controls will normally not be performed.

- However, when performing tests of details, if the expected amount of error is high, 100% examination or the use of a large sample size may be appropriate.

Sample Size

- The auditor shall determine a sample size sufficient to *reduce* sampling *risk* to an *acceptably low level*.
- The level of sampling risk that the auditor is willing to accept affects the sample size required.
- The *lower* the *risk* the auditor is willing to accept, the *greater* the *sample size* will need to be
- The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgement. There are various factors typically on the determination of sample size. When circumstances are similar, the effect on sample size of factors will be similar regardless of whether a statistical or non- statistical approach is chosen.

Examples of Factors Influencing Sample Size for Tests of Controls - The following are factors that the auditor may consider when determining the sample size for *tests of controls.*

FACTOR	EFFECT ON SAMPLE SIZE
An *increase* in the extent to which the auditor's *risk assessment* takes into account relevant controls	*Increase*
An *increase* in the *tolerable* rate of deviation	*Decrease*
An *increase* in the *expected* rate of deviation of the population to be tested	*Increase*
An *increase* in the auditor's desired level of *assurance*	*Increase*

Examples of Factors Influencing Sample Size for Tests of Details

The following are factors that the auditor may consider when determining the sample size for *tests of details.*

FACTOR	EFFECT ON SAMPLE SIZE
An *increase* in the auditor's assessment of the *risk* of material misstatement	*Increase*
An *increase* in the use of *other* substantive *procedures* directed at the same assertion.	*Decrease*
An *increase* in the auditor's desired level of *assurance*.	*Increase*
An *increase* In *Tolerable* misstatement.	*Decrease*
An *increase* in the amount of misstatement the auditor *expects* to find in the population	*Increase*
Stratification of the population when appropriate	*Decrease*

Selection of Items for Testing (Selecting the sample)

- The auditor should select items for the sample with the *expectation* that all sampling units in the population have a *chance* of *selection*.
- Statistical sampling requires that sample items are selected at random so that each sampling unit has a known chance of being selected.
- The sampling units might be *physical* items (such as invoices) or *monetary* units.
- With non-statistical sampling, an auditor uses professional *judgement* to select the items for a sample.
- Because the purpose of sampling is to draw conclusions about the entire population, the auditor endeavours to select a representative sample by choosing sample items which have characteristics typical of the population, and the sample needs to be selected so that bias is avoided.

Whatever may be the *approach* of non-statistical or statistical sampling, the sample *must* be *representative*. This means that it must be closely *similar* to the whole population although *not necessarily* exactly the *same*. The sample must be large enough to provide statistically meaningful results

Sampling Risk

This arises from the possibility that the auditor's **conclusion**, **based** on a **sample**, may be **different** from the **conclusion reached if** the **entire population** was **subjected** to the **same** audit **procedure**.

Sampling Risk in Test of Details			
		The recorded value of population is	
		OK	Not OK
The sample indicates that the population is	OK	• Correct Decision	• Incorrect Decision • Risk of Incorrect Acceptance • Not effective
	Not OK	• Incorrect Decision • Risk of Incorrect Rejection • Not Efficient	• Correct Decision

Sampling Risk in Test of Control			
		The actual operation of control is	
		OK	Not OK
The sample indicates that the control in operation in	OK	• Correct Decision	• Incorrect Decision • Risk of Over reliance • Risk of assessing the CR too low • Not effective
	Not OK	• Incorrect Decision • Risk of under reliance • Risk of Assessing the CR too high • Not Efficient	• Correct Decision

Non-Sampling Risk

"Non-sampling risk" arises from factors that cause the auditor to reach an erroneous conclusion for any reason **not related** to the size of the **sample**.

For example,

- ordinarily the auditor finds it necessary to rely on audit evidence that is persuasive rather than conclusive,
- the auditor might use inappropriate audit procedures, or
- the auditor might misinterpret audit evidence and fail to recognize an error.
- Human Mistakes

Tolerable Misstatement and Deviation

Tolerable misstatement

A **monetary amount** set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is **not exceeded** by the **actual misstatement** in the population.

Tolerable rate of deviation

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

Performing Audit Procedures

- The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.
- If a selected item is not appropriate for the application of the audit procedure, the audit procedure is ordinarily performed on a replacement item.
    - For example, a cancelled cheque may be selected when testing for evidence of payment authorization. If the auditor is satisfied that the check had been properly cancelled such that it does not constitute an error, an appropriately chosen replacement is examined.
- If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a ***deviation*** from the prescribed control, in the case of tests of controls, or a ***misstatement***, in the case of tests of details.
- An example of a suitable alternative audit procedure might be the examination of subsequent receipts when no reply has been received in response to a positive confirmation request.

Nature And Cause Of Deviations And Misstatements

The auditor shall

- ***investigate*** the ***nature*** and ***cause*** of any ***deviations*** or misstatements identified, and
- ***evaluate*** their ***possible*** ***effect*** on the purpose of the audit procedure and on other areas of the audit.

In analysing the deviations and misstatements identified,

- the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time.

In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures to those items. In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud.

In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a ***high degree*** of ***certainty*** that such misstatement or ***deviation*** is ***not representative of the population***.

The auditor shall obtain a high degree of certainty by performing ***additional audit procedures*** to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

Anomaly may be defined as a misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population. (one-off event)

Projecting Misstatements

The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded.

When a misstatement has been established as an ***anomaly***, it may be ***excluded*** when ***projecting misstatements*** to the population.

However, the effect of any such misstatement, if ***uncorrected***, still needs to be considered in ***addition*** to the projection of the non-anomalous misstatements.

For ***tests of details***, the auditor shall ***project*** misstatements found in the sample to the population whereas for ***tests*** of ***controls***, ***no explicit projection*** of deviations is ***necessary*** since the sample deviation rate is also the projected deviation rate for the population as a whole. (if there are 8% deviation in the sample, this will also become the rate of deviation in the population)

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.

For tests of controls,
- an unexpectedly high sample deviation rate may lead
  - to an increase in the assessed risk of material misstatement, unless further audit evidence substantiating the initial assessment is obtained.

For tests of details, an unexpectedly high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no material misstatement exists

In the case of tests of details, the projected misstatement plus anomalous misstatement, if any, is the auditor's best estimate of misstatement in the population.

When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested.

The closer the projected misstatement plus anomalous misstatement is to tolerable misstatement, the more likely that actual misstatement in the population may exceed tolerable misstatement.

Also if the projected misstatement is greater than the auditor's expectations of misstatement used to determine the sample size, the auditor may conclude that there is an unacceptable sampling risk that the actual misstatement in the population exceeds the tolerable misstatement.

Considering the results of other audit procedures helps the auditor to assess the risk that actual misstatement in the population exceeds tolerable misstatement, and the risk may be reduced if additional audit evidence is obtained.

In case the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may request management.
- to investigate misstatements that have been identified and the potential for further misstatements and
- to make any necessary adjustments; or tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance.

For example, in the case of tests of controls, the auditor might
- extend the sample size,
- test an alternative control or
- modify related substantive procedures.

Sample Selection Methods

Some of the important methods of selecting the sample are discussed below -

Random Sampling

- Random selection ensures that all items in the population have a equal chance of selection.
- It may involve use of random number tables.
- Random sampling includes two very popular methods which are discussed below

Simple Random Sampling

- Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected.

- Samples are selected through a random number table.
- Random number tables are simple and easy to use and also provide assurance that the auditors' bias does not affect the selection.
- Each item in a population is selected by use of a random number table either with the help of a computer or picking up a number in a random way.

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. Example

The population can be considered homogeneous, if say, trade receivables balances fall within the range of ₹ 50,000 to ₹ 2,00,000 and not in the range between ₹500 to ₹ 11,50,000.

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
- 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 judgement.

Example

The population in the range between ₹500 to ₹ 11,50,000 say for trade receivables balances may be divided into groups as follows:-

1. balances in excess of ₹ 10,00,000;
2. balances in the range of ₹ 7,75,001 to ₹ 10,00,000;
3. balances in the range of ₹ 5,50,001 to ₹ 7,75,000
4. balances in the range of ₹ 2,25,001 to ₹ 5,50,000; and
5. balances ₹ 2,25,000 and below.

From these above groups the auditor may pick up different percentages of items from each of the group.

- From the top group i.e. balances in excess of ₹ 10,00,000, the auditor may examine all the items;
- from the second group 25 per cent of the items;
- from the third group 10 percent of the items; and
- from the lowest group 2 percent of the items may be selected.

Random sample is chosen from each stratum using random number tables.

The reasoning behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences.

It can be seen that the stratified sampling is simply an extension of simple random sampling.

Stratification means

- *dividing* a *heterogeneous* (Diversified) population
- into a *Homogeneous* (having similar characteristics) sub population,
- where samples are drawn from each subpopulation.

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.

- The starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerised random number generator or random number tables.
- When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.
- Example
  - If in a population of branch sales, particular branch sales occur only as every 50th item and the sampling interval selected is also 50. The result would be that either the auditor would have selected all or none of the sales of that particular branch.
- Therefore, systematic sampling when chosen as a method should be carefully applied to bring together every type of transaction within its purview. More than one starting point can be considered to minimise such risk.

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.

In this individual monetary units are identified as sampling units.

Value-Weighted Selection

- Values are given weight.
- This selection is done in such a way that high value items for example invoice have high chance of selection.
- Having selected specific monetary units from within the population, for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units.
- One benefit of this approach is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes.
- This approach may be used in conjunction with the systematic method of sample selection and is most efficient when selecting items using random selection.

Haphazard sampling

- Haphazard selection, in which the
  - auditor selects the sample
  - *without following a structured technique.*
- The auditor should try to 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.

Block Sampling

- This method involves
  - *selection* of a *block*(s) of
  - Contiguous (in sequence) items from within the population.

- Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population.
- Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw conclusion about the entire population based on the sample.
- If the client has the idea of the block selection pattern of the auditor, then material misstatements and deviations can be easily manipulated by management's practice of recording them.
- Exampl
    - Take the first 100 sales invoices from the sales day book in the month of September; alternatively take any four blocks of 25 sales invoices.
- Therefore, once the first item in the block is selected, the rest of the block follows items to the completion.
- There is a close similarity between this method and non-statistical sampling. Consequently it has similar characteristics, namely, simplicity and economy. On the other hand there is a risk of bias and of establishing a pattern of selection which may be noted by the auditees.

Approaches To Sampling

1. Non-statistical or
2. Statistical sampling approaches.

Statistical Sampling

Probability Theory

Statistical sampling is an approach to sampling that has the

- ***random selection*** of the sample units;
- and the use of ***probability theory***
    - in determining the appropriate sample ***size***
    - In ***Sample selection***
    - to ***evaluate*** sample ***results***,
    - including measurement of ***sampling risk*** characteristics.

Mathematical and statistical methods

Sample is chosen by applying certain ***mathematical*** and ***statistical*** methods.

More Scientific

Statistical Sampling- ***More Scientific***

Probability theory, a branch of mathematics concerned with the analysis of random phenomena. The outcome of a random event cannot be determined before it occurs, but it may be any one of several possible outcomes. The actual outcome is considered to be determined by chance. (https://www.britannica.com/science/probability-theory)

Large number of similar items

Widely used where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.

No personal bias

There is ***no personal bias*** of the auditor in the case of statistical sampling.

Projection more reliable

Since it is scientific, the results of the sample can be evaluated and projected on the whole population in a more ***reliable*** manner.

For Example: An auditor while verifying the Purchases during the year realised that the purchase transactions in that year are more than 95000 in number, then in such case, statistical sampling will be highly recommended in the audit program.

Advantages of Statistical Sampling

1. The amount of testing (sample size) does ***not increase*** in ***proportion*** to the ***increase*** in the ***size*** of the area (universe) tested. (Smaller sample size gives a better representation of the population, in judgemental or non statistical sampling sample size is large still it does not give a fair representation of the population)
2. The sample selection is ***more objective*** and thereby more ***defensible***.
3. The method provides a means of estimating the
   - ***minimum sample size associated*** with a ***specified risk***. (Basically helps in determining the sample size depending upon audit risk)
4. It provides a means for deriving a "***calculated risk***" (sampling error) i.e. the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.
5. It may provide a ***better description*** of a ***large*** mass of ***data*** when compared to a non-statistical approach of sampling.
6. Results of sampling can be evaluated and projected in a better way

Non-Statistical Sampling

The sample size and its composition are determined on the basis of the

- ***personal experience*** and
- ***knowledge*** of the auditor.

Does not have any of the characteristics of random selection and use of probability theory.

This approach is simple. The sample may not be a true representative of the total population because of personal bias and no scientific method of selection.

For example,

- April, August and March may be selected in year one and different months would be selected in the next year,
- On the basis of the value of items, The top 10 highest values. Etc.

- An attempt would be made to ***avoid establishing*** a ***pattern*** of selection year after year.
- An ***element*** of ***surprise*** is maintained.
- It is a common practice to check large numbers of items towards the close of the year so that the adequacy of cut-off procedures can also be determined.
- Also, because year end transactions are prone to high risk of misappropriation.

The non-statistical sampling is ***criticised*** on the grounds that it is ***neither objective nor scientific.***

- ***Expected degree*** of ***objectivity cannot*** be assured in nonstatistical sampling
- because the ***risk*** of personal ***bias*** in selection of sample items cannot be eliminated.

Projection may not be as accurate as it was in statistical sampling because the sample has not been selected in accordance with the mathematically based statistical techniques.

The auditor with his experience and knowledge of the client's business can evaluate the sample findings to make audit decisions without the mathematical proof of accuracy.

Misc Topic

Factors that should be considered for deciding upon the extent of checking on a sampling plan

The factors that should be considered for deciding upon the extent of checking on a sampling plan are following:

1. *Size* of the organisation under audit.
2. *State* of the internal *control*.
3. *Adequacy* and *reliability* of books and records.
4. *Tolerable error* range.
5. *Degree* of the desired *confidence*.

Audit Evidence-Specific Considerations For Selected Items (SA 501)

Objective

The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the:

a. *Existence* and *condition* of inventory;
b. *Completeness* of *litigation* and claims involving the entity; and
c. *Presentation* and *disclosure* of *segment information* in accordance with the applicable financial reporting framework.

Inventory

SAAE Regarding Existence and condition of inventory

When inventory is material to the FSs, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by

a. *Attendance* at *physical inventory counting*, *unless impracticable*, to:
    i. Evaluate *management's instructions and procedures* for recording and controlling the results of the entity's physical inventory counting;
    ii. *Observe* the performance of management's count procedures;
    iii. *Inspect* the inventory; and
    iv. Perform *test counts;* and
b. *Performing audit procedures* over the *entity's final inventory records* to determine whether they accurately reflect actual inventory count results.

Attendance at Physical Inventory Counting

Attendance at Physical Inventory Counting Involves:

a. *Inspecting* the inventory to ascertain its *existence* and evaluate its condition, and performing test counts;
b. *Observing* compliance with management's instructions and the performance of procedures for recording and controlling the results of the physical inventory count; and
c. *Obtaining audit evidence* as to the reliability of management's count procedures.

Matters Relevant in Planning Attendance at Physical Inventory Counting

Matters relevant in planning attendance at physical inventory counting include,

- *Nature* of inventory.
- *Stages* of completion of work in progress.
- The *risks* of material misstatement related to inventory.
- The nature of the *internal control* related to inventory.
- Whether *adequate procedures* are expected to be established and proper instructions issued for physical inventory counting.
- The *timing* of physical inventory counting.
- Whether the entity maintains a *perpetual inventory system*.
- 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
- Whether the *assistance* of an auditor's *expert* is needed.

Physical inventory counting is conducted at a date other than the date of the FSs

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

If the Auditor is unable to Attend Physical Inventory Counting due to Unforeseen Circumstances

If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an *alternative date*, and perform audit procedures on intervening transactions.

Attendance is impracticable

- If attendance at physical inventory counting is impracticable, the auditor shall perform *alternative audit procedures* to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is *not* possible to do so, the auditor shall *modify* the opinion in the auditor's report in accordance with SA 705.
- In some cases where attendance is impracticable, alternative audit procedures, for example inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.
- In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705 requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.

Inventory under the custody and control of a third party

When inventory under the custody and control of a third party is material to the FSs, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following

a. Request *confirmation* from the third party as to the *quantities* and *condition* of inventory held on behalf of the entity.
b. Perform *inspection* or other audit procedures appropriate in the circumstances.

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

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

Litigation and Claims

The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

a. *Inquiry* of management and, where applicable, others within the entity, including in-house legal counsel;
b. Reviewing *minutes* of meetings of TCWG and correspondence between the entity and its external legal counsel; and
c. Reviewing *legal expense accounts*.

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 *management* and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor. If law, regulation or the respective legal

professional body prohibits the entity's external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures

Letter of Specific Inquiry - Communication with the Entity's External Legal Counsel

- If it is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry, for example if the professional body to which the external legal counsel belongs prohibits response to such a letter, the auditor may seek direct communication through a letter of specific inquiry. For this purpose, a letter of specific inquiry includes:
  - A list of litigation and claims;
  - Where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
  - A request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.
- In certain circumstances, the auditor also may judge it **necessary** to *meet* with the entity's external legal counsel to discuss the likely outcome of the litigation or claims.
- This may be the case, for example, where:
  - The auditor determines that the matter is a *significant* risk.
  - The matter is *complex*.
  - There is *disagreement* between management and the entity's external legal counsel. Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

Modification in the opinion

If-

a. management **refuses** to give the auditor *permission* to *communicate* or *meet* with the entity's external legal **counsel**, or the entity's external legal counsel refuses to respond appropriately to the letter of inquiry, or is prohibited from responding; and
b. the auditor is **unable** to *obtain sufficient appropriate audit evidence* by performing alternative audit procedures,

the auditor shall **modify** the opinion in the auditor's report in accordance with SA 705.

Written Representations

The auditor shall request management and, where appropriate, TCWG to provide written representations that

- all known **actual** or **possible litigation** and claims
- whose **effects** should be considered when preparing the FSs
- have been
  - **disclosed** to the auditor and
  - appropriately **accounted** for and *disclosed* in accordance with the applicable financial reporting framework.

Segment Information

Segment Information refers to information about different types of products and services of an enterprise and its operations in different geographical areas

Obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information.

The auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by

- **Obtaining** an **understanding** of the *methods* used by management in determining segment information, and (Auditor un methods ki understanding obtain karega jinhe use karke management segment information determine karti hai)
  - Evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework

- Where appropriate, testing the application of such methods; and
- Performing analytical procedures or other audit procedures appropriate in the circumstances.

Understanding of the Methods Used by Management

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:

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

Auditor's responsibility regarding the presentation and disclosure of segment information

- The auditor's responsibility regarding the presentation and disclosure of segment information is in relation to the FSs taken as a whole.
- Accordingly, the auditor is not required to perform audit procedures that would be necessary to express an opinion on the segment information presented on a stand alone basis.

SA 505 - External Confirmations

Definition of 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.

Definitions of other terms

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.

External Confirmation Procedures adopted by the Auditor to Obtain Audit Evidence

When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

a. Determining the information to be confirmed or requested;
b. Selecting the appropriate confirming party;

c. *Designing* the confirmation *requests*, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and
d. *Sending* the requests, including *follow-up* requests when applicable, to the confirming party

Determining the information to be confirmed or requested;

- External confirmation procedures frequently are performed to confirm or request information regarding account balances and their elements.
- They may also be used to confirm terms of agreements, contracts, or transactions between an entity and other parties, or to confirm the absence of certain conditions, such as a "*side agreement*"

Selecting the appropriate confirming party;

- Responses to confirmation requests provide more relevant and reliable audit evidence when confirmation requests are sent to a confirming party the auditor believes is *knowledgeable* about the information to be confirmed.
- For example, a financial institution official who is knowledgeable about the transactions or arrangements for which confirmation is requested may be the most appropriate person at the financial institution from whom to request confirmation.

Designing Confirmation Requests

Design of a confirmation request

- The design of a confirmation request may directly affect the confirmation response rate, and
- the reliability and the nature of the audit evidence obtained from response

Factors to be considered by auditor when designing confirmation requests

Factors to consider 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 *authorisation* 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 authorisation.
vii) The *ability* of the *intended* confirming *party* to *confirm* or provide the requested information (for example, individual invoice amount versus total balance).

Positive confirmation request

- A positive external confirmation request asks the confirming party to reply to the auditor in *all* cases, either by indicating the confirming party's agreement with the given information, or by asking the confirming party to provide information.
- A response to a positive confirmation request ordinarily is expected to provide *reliable* audit evidence.
- There is a risk, however, that a confirming party may reply to the confirmation request without verifying that the information is correct.
- The auditor may reduce this risk by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, and ask the confirming party to fill in the amount or furnish other information. On the other hand, use of this type of "blank" confirmation request may result in lower response rates because additional effort is required of the confirming parties

Determination of properly addressed requests

Determining that requests are properly addressed includes testing the validity of some or all of the addresses on confirmation requests before they are sent out.

Follow-Up on Confirmation Requests

- The auditor may send an *additional* confirmation request when a reply to a previous request has not been received within a reasonable time.
- For example, the auditor may, having re-verified the accuracy of the original address, send an additional or follow-up request.

Management's Refusal to Allow the Auditor to Send a Confirmation Request

If management refuses to allow the auditor to send a confirmation request, the auditor shall

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

Reasonableness of Management's Refusal

- A common reason advanced is the existence of a legal *dispute* or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely confirmation request.
- The auditor is required to seek audit evidence as to the *validity* and *reasonableness* of the reasons because of the risk that management may be attempting to deny the auditor access to audit evidence that may reveal fraud or error.

Alternative Audit Procedures

Examples of alternative audit procedures the auditor may perform include:

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

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is *unreasonable*, or the auditor is *unable* to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall *communicate* with TCWG in accordance with *SA 260*. The auditor also shall determine the *implications* for the audit and the auditor's opinion in accordance with *SA 705*.

Types of Confirmation request

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

- A response to a positive confirmation request ordinarily is expected to provide reliable audit evidence.
- There is a risk, however, that a confirming party may reply to the confirmation request without verifying that the information is correct.
- The auditor may reduce this risk by using positive confirmation requests that do not state the amount (or other information) on the confirmation request and ask the confirming party to fill in the amount or furnish other information.

Negative Confirmations (When to use?)

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.

Negative Confirmations Other points

- The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request.
- Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request.
- Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favour, and less likely to respond otherwise.
- For example, Holders of bank deposit accounts may be more likely to respond if they believe that the balance in their account is understated in the confirmation request, but may be less likely to respond when they believe the balance is overstated. Therefore, sending negative confirmation requests to holders of bank deposit accounts may be a useful procedure in considering whether such balances may be understated, but is unlikely to be effective if the auditor is seeking evidence regarding overstatement.

Evaluating the Evidence Obtained

The auditor shall evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether performing further audit procedures is necessary. When evaluating the results of individual external confirmation requests, the auditor may categorise such results as follows:

- A response by the appropriate confirming party indicating agreement with the information provided in the confirmation request, or providing requested information without exception;
- A response deemed unreliable;
- A non-response; or
- A response indicating an exception.

The auditor's evaluation, when taken into account with other audit procedures the auditor may have performed, may assist the auditor in concluding whether sufficient appropriate audit evidence has been obtained or whether performing further audit procedures is necessary.

SA 510 Initial Audit Engagements - Opening Balances

Objective

In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether

a. Opening balances contain *misstatements* that *materially affect* the *current period's FSs*; and
b. *Appropriate accounting policies* reflected in the opening balances have been *consistently* applied in the current period's FSs, or *changes* thereto are properly *accounted* for and adequately *presented* and *disclosed* in accordance with the applicable financial reporting framework.

Definitions

Initial audit engagement

An engagement in which either:

- The FSs for the prior period were *not audited*; or
- The FSs for the prior period were *audited* by a *predecessor auditor*.

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

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

Objective of Auditor with respect to Opening Balances in conducting an Initial Audit Engagement.
In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

a. Opening balances contain *misstatements* that *materially affect* the *current period's FSs*; and
b. *Appropriate accounting policies* reflected in the opening balances have been *consistently* applied in the current period's FSs, or *changes* thereto are properly *accounted* for and adequately *presented* and *disclosed* in accordance with the applicable financial reporting framework.

Audit Procedures regarding Opening Balances

Read Recent FS and Audit Report
The auditor shall *read* the most recent FSs, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.

Obtain SAAE Whether OB Contains MS Having Material Affect on FS
The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's FSs by

a. **Correct Brought Forward and Disclosure of adjustment**
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. **Appropriate Accounting Policies**
Determining whether the *opening balance*s reflect the *application* of *appropriate accounting policies*; and

c. **Performing one or more of the following**
   i. **Careful reading of Audited FS and other Docs**
   Where the prior year FSs were audited, *perusing* the copies of the audited FSs including the other relevant documents relating to the prior period FSs;
   ii. **Evaluate Audit Procedures**
   Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
   iii. **Specific Audit Procedures**
   Performing specific audit procedures to obtain evidence regarding the opening balances.

Misstatement in Opening Balance
If the auditor obtains audit evidence that the opening balances contain misstatements that could *materially affect* the *current period's FSs*, the auditor shall *perform such additional audit procedures* as are appropriate in the circumstances to determine the effect on the current period's FSs.

Misstatement in Current period's FS

If the auditor *concludes* that such *misstatements exist* in the current period's FSs, the auditor shall communicate the misstatements with the appropriate level of management and TCWG in accordance with SA 450.

Procedures adopted by the Auditor to Obtain Audit Evidence regarding opening balances

Nature and extent of Audit Procedures

The nature and extent of audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances depend on such matters as:

- The *accounting policies* followed by the entity.
- The *nature* of the account balances, classes of transactions and disclosures and the risks of material misstatement in the current period's FSs.
- The *significance* of the opening balances relative to the current period's FSs.
- Whether the prior period's FSs were audited and, if so, whether the predecessor auditor's opinion was *modified*.

If the prior period's FSs were audited by a predecessor auditor

- Auditor can get evidence on opening balances from predecessor's audited financials and supporting schedules.
- *Ordinarily*, the current auditor can place *reliance* on the closing balances contained in the FSs 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.

For current assets and liabilities

- Audit evidence for opening balances of current assets and liabilities may come from current audit procedures.
- Collecting (paying) opening receivables (payables) in current period gives evidence of their initial existence, rights, obligations, and value.
- For inventories, current audit on closing balance offers limited evidence on opening inventory, necessitating additional procedures.:
    - Observing a current physical inventory count and reconciling it to the opening inventory quantities.
    - Performing audit procedures on the valuation of the opening inventory items.
    - Performing audit procedures on gross profit and cut-off.

For non- current assets and liabilities

For non-current assets like property and long-term liabilities, evidence comes from accounting records and, sometimes, third-party confirmations. In other cases, the auditor may need to carry out additional audit procedures.

Audit Conclusions and Reporting

Opening balances

If the auditor is *unable* to obtain *s*ufficient *a*ppropriate *a*udit *e*vidence regarding the opening balances, the auditor shall *express* a *qualified* opinion or a *disclaimer* of opinion, as appropriate, in accordance with SA 705.

If the auditor *concludes* that the opening balances contain a *misstatement* that materially affects the current period's FSs, and the effect of the misstatement is not properly accounted for or *not* adequately presented or disclosed, the auditor shall *express* a *qualified* opinion or an *adverse* opinion, as appropriate, in accordance with SA 705.

Consistency of Accounting Policies

If the auditor concludes that

a. the current period's accounting policies are *not consistently* applied in relation to opening balances in accordance with the applicable financial reporting framework; or

b. a *change* in accounting policies is *not properly accounted* for or not adequately *presented* or *disclosed* in accordance with the applicable financial reporting framework, the auditor shall *express* a *qualified* opinion or an *adverse* opinion as appropriate in accordance with SA 705.

SA 550 Related Parties

Scope

This Standard on Auditing (SA) deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of FSs. Specifically, it expands on how SA 315, SA 330 and SA 240 are to be applied in relation to risks of material misstatement associated with related party relationships and transactions.

Definition of 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

Meaning of control and significant influence in reference to related party

- Many financial reporting frameworks discuss the concepts of control and significant influence. They generally explain that:
  i. Control is the *power* to *govern* the financial and operating policies of an entity so as to obtain benefits from its activities; and
  ii. 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.
- The existence of the following relationships may indicate the presence of control or significant influence:
  i. Direct or indirect equity holdings or other financial interests in the entity.
  ii. The entity's holdings of direct or indirect equity or other financial interests in other entities.
  iii. Being part of TCWG or key management (i.e., those members of management who have the authority and responsibility for planning, directing and controlling the activities of the entity).
  iv. Being a close family member of any person referred to in subparagraph (iii).
  v. Having a significant business relationship with any person referred to in subparagraph (iii).

Meaning of Related Parties with Dominant Influence

Related parties, by virtue of their ability to exert control or significant influence, may be in a position to exert *dominant influence* over the entity or its management. Consideration of such behaviour is relevant when identifying and assessing the risks of material misstatement due to fraud.

Meaning of Special-Purpose Entities as Related Parties

In some circumstances, a special-purpose entity may be a related party of the entity because the entity may in substance control it, even if the entity owns little or none of the special- purpose entity's equity.

Nature of Related Party Relationships and Transactions

- Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the FSs than similar transactions with unrelated parties.
- However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the FSs than transactions with unrelated parties
- For example,
    - Related parties may operate through an *extensive* and *complex range* of relationships and structures, with a corresponding increase in the complexity of related party transactions.
    - *Information systems* may be *ineffective* at identifying or summarising transactions and outstanding balances between an entity and its related parties.
    - Related party transactions may *not* be *conducted* under *normal market terms* and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

Understanding the Entity's RPRT

The auditor shall inquire of management regarding:

- The *identity* of the entity's related parties, including *changes* from the prior period;
- The *nature* of the relationships between the entity and these related parties; and
- Whether the entity entered into any *transactions* with these related parties during the period and, if so, the *type* and *purpose* of the transactions.
- The auditor shall *inquire* of management and others within the entity, and perform *other risk assessment procedures* considered appropriate, to obtain an *understanding* of the *controls* if any in that management has established to
    - *Identify*, *account* for, and *disclose* related party relationships and transactions in accordance with the applicable financial reporting framework.
    - *Authorise* and *approve* significant transactions and arrangements with related parties; and
    - *Authorise* and *approve* significant transactions and arrangements outside the normal course of business.

Considerations specific to smaller entities by the auditor

- Control environment in smaller entities is likely to be different from larger entities. In particular TCWG may not include an outside member, and the role of governance may be undertaken directly by the owner-manager where no other owner exists.
- Control activities in smaller entities are likely to be less formal and smaller entities may have no documented processes for dealing with related party relationships and transactions.
- An owner-manager may mitigate some of the risks arising from related party transactions, or potentially increase those risks, through active involvement in all the main aspects of the transactions.
- For such entities, Auditor gains understanding of related party transactions and controls through management inquiry, observation of oversight, and document inspection.

Records or documents that may provide information about related party relationships and transactions

During the audit, the auditor should maintain alertness for related party information while reviewing records and documents. He may inspect the following records or documents that may provide information about related party relationships and transactions, for example:

1. Entity *income tax returns*.
2. *Information* supplied by the entity to regulatory authorities.
3. *Documents* associated with the entity's filings with a securities regulator e.g, prospectuses)
4. *Statements* of conflicts of interest from management and TCWG.
5. *Contracts* and *agreements* with key management or TCWG.
6. Significant *contracts* and *agreements* not in the entity's ordinary course of business.
7. Significant *contracts re-negotiated* by the entity during the period.
8. Specific *invoices* and correspondence from the entity's professional advisors.
9. *Internal auditors' reports.*
10. *Shareholder registers* to identify the entity's principal shareholders.

11. Life insurance policies acquired by the entity.
12. Records of the entity's investments and those of its pension plans.

Analytical Procedures (SA 520)

Need of Analytical procedures

Routine checks alone are insufficient to reveal all errors or fraud in accounts; trend analysis, ratio analysis, and reasonable tests, collectively termed overall tests, are also necessary.

What is the meaning of Analytical Procedures?

As per the Standard on Auditing (SA) 520 "Analytical Procedures", the term "analytical procedures" means

- evaluations of financial information
- through analysis of plausible relationships
- among both financial and non-financial data.

It also encompasses such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Nature of analytical procedures.

Analytical procedures include

- 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,
      - such as gross margin percentages.
  - Between financial information and relevant non-financial information,
    - such as payroll costs to number of employees.

Purpose and timing of Analytical Procedures

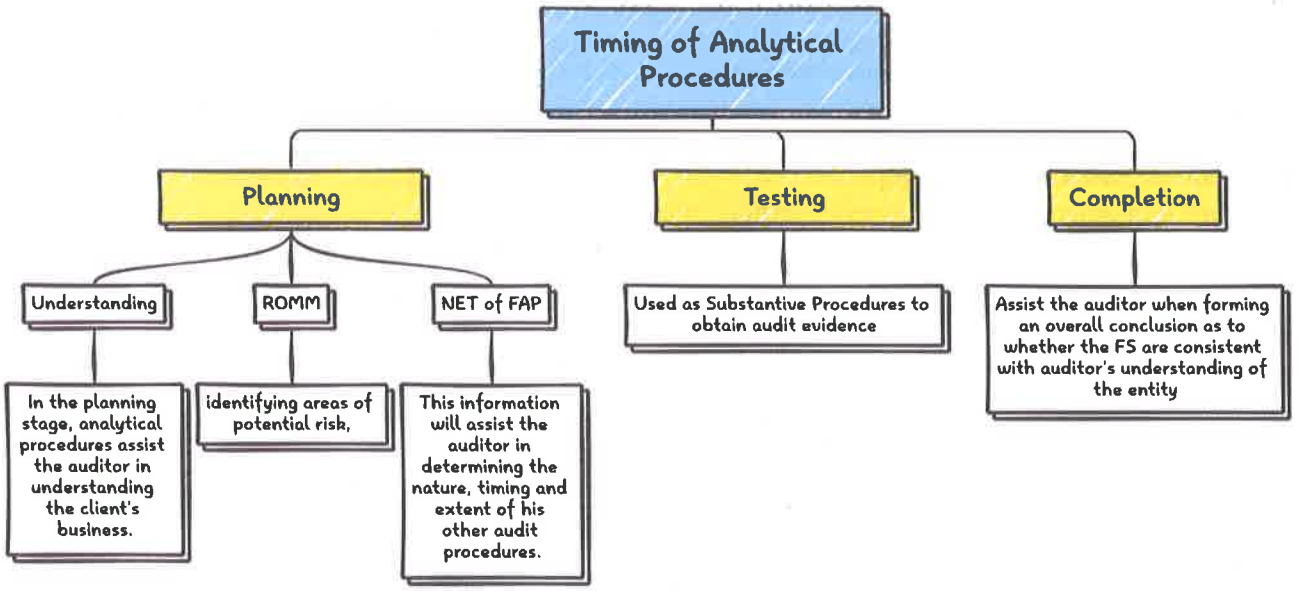
- Analytical procedures involve comparing and relating data to determine if data in the FSs seems reasonable.
- These are helpful in the detection of unusual state of affairs and mistakes in accounts
- It will assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.
- Few Examples
  - Comparing Profit and Loss Statement balances of an entity with another similar entity in the same trade can reveal reasons for variations in profitability rates.
  - Comparing current Profit and Loss Statement balances with the previous period can identify reasons for profit increases or decreases over the years.
  - Establishing expense ratios from the Profit and Loss Statement and comparing them with previous years helps ascertain the extent of changes in expenditure relative to sales and trading profit's relation to sales.
  - The cost of importing goods subject to a uniform ad-valorem duty can be verified through the amount of duty paid.
  - The quantity of sugar sold by a mill can be independently verified through the amount of GST paid.

- Income or expenses directly tied to profits or sales can be independently verified, like commission on net profits or sales percentage.

The process of calculating ratios, trends, and comparisons is alsoknown as analytical review.

Timing of Analytical Procedures

- Experienced auditors use analytical procedures in *all* stages of the audit.
- Analytical Procedures are required in the
  - *planning* phase and
  - it is often done during the *testing* phase.
  - In addition, these are also required during the **completion** phase



Factors to be considered for using Analytical Procedures as Substantive Audit Procedures

The auditor should consider the following factors for Substantive Audit Procedures:

Availability of Data

The availability of reliable and relevant data will facilitate effective analytical procedures.

Disaggregation

The degree of disaggregation in available data can directly affect the degree of its usefulness in detecting misstatements.

Account Type

Substantive analytical procedures are more useful for certain types of accounts than for others.

- *Income* statement accounts tend to be *more predictable* because they reflect *accumulated* transactions over a period,
- whereas *balance sheet* accounts represent the *net effect* of transactions at a point in time or are subject to greater management *judgement*.

Source - Type of class of transactions

Some classes of transactions tend to be more predictable because they consist of numerous, similar transactions.

Whereas the transactions recorded by

- *non-routine* and
- estimation SCOTs (Significant Classes of Transactions) are often subject to management judgement and therefore *more difficult* to *predict*.

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).

A predictable relationship is one that may *reasonably* be *expected* to *exist* and *continue* over time.

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.

Completeness - Through analytical procedures we can get an idea of whether all sales are recorded or not.
Valuation - analytical procedures will also give an idea about unusual fluctuations in valuations of assets and liabilities having an effect on other items.

Inherent Risk or "What Can Go Wrong"

When we are designing audit procedures to address an inherent risk or "what can go wrong", we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence. 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*.

Techniques Available as Substantive Analytical Procedures

Substantive analytical procedures generally take one of the following forms

Trend analysis

- commonly used technique.
- The auditor evaluates
  - whether the *current balance* of an account moves in *line* with the *trend established with previous balances* for that account, after adjusting for relevant factors responsible for changes
- *comparison* of
  - *current data with* the *prior period* balance or
  - with a *trend in two or more prior period balances.*

In other words, trend analysis implies

- analysing account fluctuations
- by comparing current year to prior year information and,
- also, to information derived over several years.

Ratio analysis

- Ratio analysis is useful for analysing
  - asset and liability *accounts* as well as revenue and expense accounts.
- An *individual balance sheet account is difficult to predict* on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales).
- Ratios can also be compared
  - *over time* or
  - to the ratios of separate entities *within the group*, or
  - with the ratios of *other companies in the same industry*.

Reasonableness tests

Does not Rely on

Does *not* rely on data and events of prior periods.

Uses non-financial data of current period

- *Uses non-financial data* for the audit period under consideration
  - Example
    - *occupancy rates* to estimate rental income or
    - *interest rates* to estimate interest income or expense

More applicable to income statement, accrual and prepayment accounts

- These tests are generally *more applicable* to *income statement* accounts and certain accrual or *prepayment* accounts.

Review Relationship for Reasonableness

- In other words these tests are made by
  - reviewing the relationship of certain account balances (FDs) to other balances (Interest)
  - for *reasonableness of amounts.*

Structural modelling

A modelling tool *constructs a statistical model*

- from *financial* and/or *non-financial data* of prior accounting periods
- to *predict current* account balances

(Simple words - We use a statistical model to predict current account balance on the basis of prior accounting periods.)

The most commonly used procedure is regression analysis, which is used for income statements using monthly data for the past three years.

The 36 or 48 monthly observations are used to establish a relationship that is used to predict current period balances.

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

1. Determine *Suitability for Assertion*
   - Determine the suitability of particular substantive analytical procedures for given assertions, Taking account of the
     - assessed risks of material misstatement and
     - Tests of details, if any, for these assertions;
     - Predictability of the amount
2. Evaluate *Reliability* of Data
   - Evaluate the reliability of data
     - from which the auditor's expectation of recorded amounts or ratios is developed,
     - taking account of
       - *Source* of Information
       - *Comparability* of the information
       - *Nature* & *Relevance* of Information
       - *Controls* over the preparation of the information
3. *Develop* an *expectation*
   - Develop an expectation of recorded amounts or ratios and
   - evaluate whether the expectation is sufficiently precise to *identify* a *misstatement* that, individually or when aggregated with other misstatements, may *cause* the *financial statements* to be *materially misstated*; and
4. Determine *Acceptable Difference*

- Determine the **amount** of any difference of recorded amounts from expected values that is acceptable without further investigation.

Suitability of Particular Analytical Procedures for given assertions

- Substantive analytical procedures are generally **more applicable to large volumes of transactions** that tend to be **predictable** over time.
- Suitability of a particular analytical procedure will depend upon the **auditor's assessment** of how **effective** it will be in **detecting** a **misstatement** that may cause the financial statements to be materially misstated, whether individually or in aggregate.
- The determination of the suitability of particular substantive analytical procedure is influenced by the **nature** of the **assertion** and the auditor's assessment of the **risk** of **material misstatement**. If risk is high due to lack of controls we will use more tests of details and less (or even no) substantive analytical procedure.
- Substantive analytical procedure may also be considered **suitable** to **support** the **test** of **details**.

The Reliability of Data

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

1. **Source** of the information available. For example, information may be more reliable when it is obtained from **independent** sources outside the entity;
2. **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
3. **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;
4. **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.

Evaluation of whether the Expectation is sufficiently precise

Matters relevant to the auditor's evaluation of **whether the expectation can be developed sufficiently precisely to identify a misstatement** that may cause the financial statements to be materially misstated, include:

1. The **accuracy** with which the **expected results** of substantive analytical procedures can be **predicted**. Higher the accuracy, the more precise the expectations can be.For example, the auditor may expect greater consistency in comparing salaries and wages from one period to another than in comparing discretionary expenses, such as research etc.

2. The **degree** to which **information** can be **disaggregated**. For example, substantive analytical procedures may be more effective when applied to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.

3. The **availability** of the **information**, **both** financial and non-financial. For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of employees (current, who left, new joinees) etc, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information

Amount of difference of Recorded amounts from expected values that is acceptable

The auditor's determination of the amount of difference from the expectation that can be accepted without further investigation is influenced by

- **materiality** and
- the **consistency** with the desired level of assurance,
- taking account of the **possibility** that a **misstatement** may **cause** the **FSs** to be **materially misstated**. As the assessed risk increases, the amount of difference considered acceptable without investigation decreases in order to achieve the desired level of persuasive evidence.

Investigating Results of Analytical Procedures

If analytical procedures performed in accordance with SA 520 identified

- *fluctuations* or *relationships* that are *inconsistent* with other relevant information or
- that *differ* from *expected values* by a *significant* amount, the auditor shall *investigate* such *differences* by:

Inquiring of management and obtaining appropriate audit evidence relevant to management's responses:

Audit evidence relevant to *management's responses* may be obtained by evaluating those responses taking into account

- the auditor's *understanding* of the entity and its environment, and
- with *other audit evidence* obtained during the course of the audit.

Performing other audit procedures as necessary in the circumstances

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*.

Analytical procedures that assist when forming an overall conclusion

- Conclusions from analytical procedures, when designed and performed properly, support findings from auditing individual FS components.. This assists the auditor to draw reasonable conclusions on which to base the auditor's opinion.
- Analytical procedures might uncover a new risk of material misstatement, requiring auditors to revise their risk assessment and modify subsequent audit procedures as per SA 315 and SA 330.

Chapter 5 - Audit of Items of Financial Statements

Assertions

- Assertions refers to the ***representations*** by ***management***, ***explicit*** or ***otherwise***, that are ***embodied*** in the FS, as ***used*** by the ***auditor*** to consider the different types of potential ***misstatements*** that may occur.
- In preparing FSs, Company's management makes implicit or explicit claims (i.e. assertions).
- These assertions are categorised for Account balance, Transaction and related disclosures
- The auditor then needs to draw an audit programme to verify the assertions made by the management by obtaining sufficient and appropriate audit evidence for each of the claims made on Account Balances, Class of Transactions and Related Disclosures.

Assertions about classes of transactions and events for the period under audit

1. **Occurrence** – transactions and events that have been recorded have ***occurred*** and ***pertain*** to the entity.
2. **Completeness** – ***all*** transactions and events that should have been ***recorded*** have been recorded.
3. **Accuracy** – amounts and other data relating to recorded transactions and events have been ***recorded appropriately***.
4. **Cut-off**– transactions and events have been recorded in the ***correct accounting period***.
5. **Classification** – transactions and events have been recorded in the ***proper accounts***.

Assertions about account balances at the period end

1. **Existence** – assets, liabilities, and equity interests ***exist***.
2. **Rights and obligations** – the entity ***holds*** or ***controls*** the rights to assets, and liabilities are the obligations of the entity.
3. **Completeness** – ***all*** assets, liabilities and equity interests that should have been ***recorded*** have been recorded.
4. **Valuation and allocation** – assets, liabilities, and equity interests are included in the financial statements at ***appropriate amounts*** and any resulting valuation or allocation ***adjustments*** are appropriately ***recorded***.

For example
If Company PK Girpade PVT LTD. balance sheet shows Building with carrying amount of ₹ 150 lakh, the auditor shall assume that the management has claimed/ asserted that:

- The building recognized in the balance sheet exists as at the period- end **(existence assertion);**
- Company PK Girpade PVT LTD. owns and controls such building **(Rights and obligations assertion);**
- The building has been valued accurately in accordance with the measurement principles **(Valuation assertion);**
- All buildings owned and controlled by Company X are included within the carrying amount of ₹ 150 lakh **(Completeness assertion)**.

For example

- **Existence:** Inventory recognized in the balance sheet actually existed as at the period end.
- **Rights and obligations:** The entity owns or controls the inventory recorded in the FS i.e. the purchase invoices have been made in the name of client. Any inventory held by the entity on behalf of another entity has not been recognized as part of inventory of the entity.
- **Completeness:** All inventory units held by the entity that should have been recorded, have been recognized appropriately in the FS. Any inventory held by a third party on behalf of the entity has been included as part of the inventory balance. Inventory held by the entity as a Consignee shall be excluded.
- **Valuation:** Inventory has been recognized at the lower of
  - cost and
  - NRV in accordance with AS 2 - Inventories.
  - Any costs that could not be reasonably allocated to the cost of production (e.g. general and administrative costs) and any abnormal wastage have been excluded from the cost of inventory. An acceptable valuation basis (eg.FIFO, Weighted average etc.) has been used to value inventory as at the period-end.

Assertions about presentation and disclosure

1. **Occurrence and rights and obligations** – disclosed events, transactions, and other matters have *occurred* and *pertain* to the entity.
2. **Completeness** – *all* disclosures that should have been included in the financial statements have been *included*.
3. **Classification and understandability** – financial information is appropriately *presented* and *described*, and disclosures are clearly expressed.
4. **Accuracy and valuation** – financial and other information are disclosed *fairly* and at *appropriate amounts*.

Audit of Share Capital

General Audit procedures

1. *Tally* the period-end share capital balance authorised, issued and paid up to the previous year audited FS
2. If there is *no change* during the year, obtain a *written confirmation/representation* from the Company Secretary that there were no changes to the entity's capital structure during the year.
3. If there is any *change*, verify whether the paid up capital as at the period-end is within the *limits* of authorised capital. Authorised capital should be verified by examining *MOA*.
4. Obtain the certified copies of relevant *resolutions* passed at the meetings of BODs, shareholders authorising the *increase/ decrease* in *authorised* share capital, if required, or *paid up share* capital.
5. If *Fresh issue* made in the current year, check with compliance of Companies Act 2013 with regard to
    - Return of *Allotment*,
    - *Minimum Subscription*,
    - *Minimum application money* to be collected,
    - Maintenance of *separate Bank account*,
    - Payment of *underwriting commission* as per Sec 40 etc.
6. No shares have been issued at *Discount* (Sec. 53 of Companies Act)
7. Check if Shares are issued for *cash or* for *Consideration other than cash*.
8. Compliance with *SEBI regulations* and *Guidelines*.
9. Obtain and verify copies of *forms filed* with Ministry of Corporate Affairs (MCA)
    - Form SH 7 for increase in authorised share capital,
    - Form PAS 3 for increase in paid up capital and
    - Form FC-GPR with RBI in case of Foreign Direct Investment (FDI) by a Non-resident shareholder and verify the number of securities issued along with the issue price.
10. In case there was an increase in share capital, verify whether the Company has accurately calculated the required fee and stamp duty payable to MCA.

Issue of Shares at Premium

- *Section 52* of the Companies Act, 2013 provides that a Company shall transfer the amount received as premium to *securities premium account* and state the *purpose* for which the amount in the account can be applied.
- There is no restriction or conditions prescribed in the Act for issue of shares at premium.

Application of securities premium account

The securities premium account may be applied by the company for the following purposes:

a. towards the issue of unissued shares of the company to the members of the company as fully paid *bonus shares*;
b. in writing off the *preliminary expenses* of the Company;
c. in writing off the *expenses* of, or the *commission* paid or *discount* allowed on, any issue of shares or debentures of the company;
d. in providing for the *premium payable* on the *redemption* of any redeemable *preference shares* or of any *debentures* of the company; or
e. for the *purchase* of its *own shares* or other securities under Section 68. (Buyback)

The auditor needs to verify

- whether the premium received on shares, if any, has been transferred to a "securities premium account" and
- whether the application of any amount out of the said "securities premium account" is only for the purposes mentioned above.

Issue of Shares at Discount

According to Section 53 of the Companies Act, 2013,

- A company shall not issue shares at a discount, except in the case of an issue of sweat equity shares given u/s 54 of the Companies Act, 2013.
- Any shares issued by a company at a discounted price shall be void.
- Notwithstanding anything mentioned in above two points, a company may issue shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations specified by RBI under RBI Act, 1934 or the Banking (Regulation) Act, 1949.
- Where any company fails to comply with the provisions of this section, such company and every officer who is in default shall be liable to a penalty which may extend to an amount equal to the amount raised through the issue of shares at a discount or ₹ 5 lakh, whichever is less, and the company shall also be liable to refund all monies received with interest at the rate of 12% p.a. from the date of issue of such shares to the persons to whom such shares have been issued.

Verification aspects

The auditor needs to check the following:

1. movement in share capital during the year
2. Verify that Company has not issued any of its shares at a discount by reading the minutes of meeting of its directors and shareholders
3. verify that whether the company has issued shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations specified by RBI under RBI Act, 1934 or the Banking (Regulation) Act, 1949.

Issue of Sweat Equity Shares

Meaning

According to Section 54 of the Companies Act, 2013, the employees may be compensated in the form of 'Sweat Equity Shares". "Sweat Equity Shares" mean equity shares issued by

- the company to employees or directors at a
  - discount or
  - for consideration other than cash
- for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

Verification aspects

The auditor needs to verify that the Sweat Equity Shares issued by the company are of a class of shares already issued and following conditions have been complied with (as per Section 54):

a. The issue is authorised by a special resolution passed by the company;
b. the resolution specifies the number of shares, the current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;
c. where the equity shares of the company are listed on a recognised stock exchange, the sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board and if they are not so listed, the sweat equity shares are issued in accordance with such rules as may be prescribed.

The rights, limitations, restrictions and provisions as applicable to equity shares shall be applicable to the sweat equity shares issued under this section and the holders of such shares shall rank pari passu with other equity shareholders.

Reduction of Capital (Section 66)

The auditor will carry out the following audit procedures:

1. Confirm that the shareholders' meeting, which was held to pass the special resolution, was duly convened and that the proposal was circularised in advance to all the shareholders;
2. Check that the Articles of Association authorises reduction of capital;
3. Evaluate that there has been no default w.r.t repayment of deposits accepted by company or payment of interest on such deposits. Reduction of capital shall not be affected if such default exists.
4. Examine the order of the Tribunal confirming the reduction and ensure that a copy of the order and the minutes have been registered and filed with the ROC.
5. Check the Registrar's Certificate as regards to reduction of capital;
6. Vouch the accounting entries recorded to reduce the capital and to write down the assets by reference to the resolution of shareholders and other documentary evidence;
7. Check whether the requirements of Schedule III wrt reduced capital have been complied with.
8. Confirm whether the revaluation of assets has been properly disclosed in the Balance Sheet;
9. Verify the adjustment made in the members' accounts in the Register of Members and confirm that either the paid-up amount shown on the old share certificates has been altered or new certificates have been issued in lieu of the old, and the old ones have been cancelled;
10. Confirm that the words "and reduced", if required by the order of the Tribunal, have been added to the name of the company in the Balance Sheet.
11. Check if the company has complied with all the terms and conditions imposed by the tribunal while confirming reduction of share capital.
12. Verify that the Memorandum of Association of the company has been suitably amended.

If the Company has made any buyback of securities, ensure compliance of specific requirements as given under sec 68 of Companies Act 2013.

Disclosure requirements of Schedule III

For each class of share capital (different classes of preference shares to be treated separately):

a. the number and amount of shares authorised;
b. the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;
c. par value per share;
d. a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;
e. the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;
f. shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by or by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;
g. shares in the company held by each shareholder holding more than 5% shares specifying the number of shares held;
h. shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts;
i. for the period of 5 years immediately preceding the date as at which the Balance Sheet is prepared:
    i. Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) without payment being received in cash.
    ii. Aggregate number and class of shares allotted as fully paid up by way of bonus shares.
    iii. Aggregate number and class of shares bought back.
j. terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date.
k. calls unpaid (showing aggregate value of calls unpaid by directors and officers)
l. forfeited shares (amount originally paid up)
m. A company shall disclose Shareholding of Promoters as below

Shares held by promoters at the end of the year				% Change during the year***
S. No.	Promoter Name	No. of shares	% of total shares**	
Total				

** Details shall be given separately for each class of shares
*** % change shall be computed with respect to the number at the beginning of the year or if issued during the year for the first time then with respect to the date of issue.

Where in respect of an issue of securities made for a specific purpose, the whole or part of the amount has not been used for the specific purpose at the balance sheet date, there shall be indicated by way of note how such unutilised amounts have been used or invested.

Disclosures regarding Funds advanced or loaned or invested with other persons

- Where company has
  - advanced or loaned or invested funds (either borrowed funds or share premium or any other sources or kind of funds)
  - to any other person(s) or entity(ies), including foreign entities (Intermediaries)
  - with the understanding (whether recorded in writing or otherwise)
  - that the ***Intermediary*** shall
    - ***directly*** or ***indirectly*** ***lend*** or ***invest*** in other persons or entities identified in any manner whatsoever by or on behalf of the company (Ultimate Beneficiaries) or
    - provide any ***guarantee***, ***security*** or the like to or on behalf of the Ultimate Beneficiaries;
- The company shall disclose the following:-
  a. ***date*** and ***amount*** of ***fund advanced*** or ***loaned*** or ***invested*** in Intermediaries with complete details of each Intermediary.
  b. ***date*** and ***amount*** of ***fund further advanced*** or ***loaned*** or ***invested*** by such Intermediaries to other intermediaries or Ultimate Beneficiaries along with complete details of the ultimate beneficiaries.
  c. ***date*** and ***amount*** of ***guarantee***, ***security*** or the like provided to or on behalf of the Ultimate Beneficiaries
  d. ***declaration*** that relevant provisions of the Foreign Exchange Management Act, 1999 and Companies Act has been complied with for such transactions and the transactions are not violative of the Prevention of Money-Laundering act, 2002

Disclosures regarding Funds received from other persons

- Where a company has
  - received any fund
  - from any person(s) or entity(ies), including foreign entities (Funding Party)
  - with the understanding (whether recorded in writing or otherwise)
  - that the ***company*** shall
    - ***directly*** or ***indirectly*** ***lend*** or ***invest*** in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party (Ultimate Beneficiaries) or
    - provide any ***guarantee***, ***security*** or the like on behalf of the Ultimate Beneficiaries,
- The company shall disclose the following
  a. ***date*** and ***amount*** of ***fund received*** from Funding parties with complete details of each Funding party.
  b. ***date*** and ***amount*** of ***fund further advanced*** or ***loaned*** or ***invested*** by other intermediaries or Ultimate Beneficiaries along with complete details of the other intermediaries or ultimate beneficiaries.
  c. ***date*** and ***amount*** of ***guarantee***, ***security*** or the like provided to or on behalf of the Ultimate Beneficiaries
  d. ***declaration*** that relevant provisions of the Foreign Exchange Management Act, 1999 and Companies Act has been complied with for such transactions and the transactions are not violative of the Prevention of Money-Laundering act, 2002

Audit of Reserves and Surplus

Meaning

Reserves are the amounts appropriated out of profits that are not intended to meet any liability, contingency, commitment or diminution in the value of assets known to exist as at the date of the Balance Sheet

Types of Reserves

The reserves can be segregated as revenue or capital reserves.

Revenue reserves

Revenue reserves represent profits that are available for distribution to shareholders or below purposes such as:

- To *supplement* divisible profits in lean years,
- to *finance* an extension of business,
- to *augment* the working capital of the business or
- to generally *strengthen* the company's financial position.

Capital Reserve

- Capital Reserve represents a reserve which does *not* include any amount regarded as *free for distribution*. They can be utilised only for certain limited purposes. Example, Securities premium, CRR
- Capital Reserve is created from *capital profits* earned through sale of capital assets such as sale of fixed assets, profit on sale of shares.
- A capital reserve, generally, can be utilised for *writing down fictitious assets* or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realised.
- But the amount of *securities premium* or *capital redemption reserve* account can be utilised only for the purposes specified in Sections 52 and 55 of the Companies Act, 2013, respectively.

Assertions to be Examined

1. **Existence** - To establish the existence of reserves and surplus as at the year end.
2. **Completeness** - Reserves and Surplus balances that were supposed to be recorded have been recognized in the FS
3. **Valuation** - Reserves and Surplus balances have been valued appropriately as per relevant law and regulation and applicable FRF
4. **Presentation and disclosure** - Required disclosures for reserves and surplus have been appropriately made.

Audit Procedures

1. Compare *opening balance* of reserves and surplus to the previous year audited FS
2. For *addition/utilisation* in current year, in case of:
    a. Profit and Loss balance –
        - Trace the movement to surplus/ deficit as per the *Statement* of *profit* and *loss* for the year under audit.
        - The movement should be traced in the *Statement* of *Changes* in *Equity*.
        - Check the *resolution* passed by the *board* of *directors* regarding the recommendation of dividend and *resolution passed* by *shareholders* regarding declaration of dividend.
    b. Securities Premium - Confirm whether the company has issued any shares in excess of the nominal value of the shares. Ensure that application of securities premium amount is as per Section 52.

Disclosure requirements of Schedule III

Ensure whether the following disclosure requirements of Schedule III (Part 1) to Companies Act, 2013 have been complied with:

1. Reserves and Surplus shall be classified as:
    a. Capital Reserves;
    b. Capital Redemption Reserve;
    c. Securities Premium.;
    d. Debenture Redemption Reserve;

e. Revaluation Reserve;
f. Share Options Outstanding Account;
g. Other Reserves– (specify the nature and purpose of each reserve and the amount in respect thereof);
h. Surplus i.e., balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/ from reserves, etc.;
(Additions and deductions since last balance sheet to be shown under each of the specified heads);

2. A reserve specifically represented by earmarked investments shall be termed as a "fund".
3. Debit balance of statement of profit and loss shall be shown as a negative figure under the head "Surplus". Similarly, the balance of "Reserves and Surplus", after adjusting the negative balance of surplus, if any, shall be shown under the head "Reserves and Surplus" even if the resulting figure is in the negative.

Audit of Borrowings

Borrowings are the amount borrowed using external sources like bank loans, debentures, public fixed deposits etc.

Audit procedures for "Existence"

(Ensure that all borrowings on the balance sheet represent valid claims by banks or other third parties)

- *Review board minutes* for approval of new lending agreements. During review, make sure that any new loan agreements or bond issuances are *authorized*.
- *Ensure* that significant debt commitments should be *approved* by the board of directors
- *Agree* details of loans recorded such as interest rate, nature and repayment terms to the *loan agreement*.
- *Verify* that the loans obtained are within the *borrowing limits* of the entity.
- *Roll out* and obtain independent *balance confirmations* (SA 505) in respect of all the borrowings from the lender (banks/ financial institutions etc.).
- *Agree* details of leases and hire purchase creditors recorded to *underlying contracts/agreements*.
- In case of *Debentures*, *examine trust deeds* for terms and dates of redemption borrowing restrictions and compliance with covenants.
- When debt is retired, *ensure* that a discharge is received on assets securing the debt.
- Obtain *Written Representation* that all the liabilities which have been recorded represent a valid claim by the lenders.

Direct confirmation procedures

Roll out and *obtain independent* balance *confirmations* in respect of all the borrowings from the lender (banks/ financial institutions etc.) and perform the following:

a. Ascertain that the confirmation asks for *all* information likely to be relevant to the tests of debt and related interest balances (e.g., applicable interest rates, due dates, collateral and security interests).
b. Send reminders for non-replies.
c. *Compare* the balances are per the confirmations obtained to the books of the accounts. Ask for *reconciliations*, if there are any *differences* and test the *supporting* documents for the reconciling items on a test check basis.

Audit procedures for "Completeness"

(Check that all borrowings have been accounted for in the books of the company on a timely basis)

- Obtain a *schedule* of short term and long term borrowings (including debts outstanding at the end of the previous year, as well as any new debt or renewal of debt) showing beginning and ending balances and borrowings taken and repaid during the year, and perform the following:
  - Consider any *evidence* of *additional debt* obtained through *examination* of minutes of the board of directors, significant contracts, confirmations from banks/ lenders, support for subsequent cash disbursements (when testing payables) etc.
  - Trace the closing balances as per the schedules to the general ledger.
- *Review subsequent transactions* after the end of the reporting period to determine if there are unrecorded liabilities at year end and the transactions are recorded in the correct period. (Eg: Fresh loan taken near the balance sheet date)

Audit procedures for "Valuation"

(Ensure that liability is recorded at the correct amount)

- *Determine* that the *accounting policies* and *methods* of recording debt are appropriate and applied consistently.
- *Agree* loan balance and loan payables to the *loan agreement*.
- *Recompute* the interest and *discount* or *premium* on *redemption*, if any.
- *Check* computation of the *amortisation* of *premium* or *discount*, if any.
- For foreign currency loans, check the *closing exchange rate*(s) used and *verify* the *computations* of the restatements of foreign currency balances outstanding at year end. (As per AS 11)
- Read the *provisions* in loan and debt *agreements* and perform the following:
    - Test that the entity is in *compliance* with *loan covenants* and other significant provisions of the agreements.
    - If there are any provisions with which the entity is *not in compliance*, *determine* whether the *debt* should be *classified* as *current*. If *enforcement* of the provisions has been *waived* by the lender in case of breach of any covenant by the entity, *obtain confirmation* of the waiver from the lender.
- Examine the *due dates* on loans for proper *classification* between long-term and short-term.
- Where instalments of long-term loans falling due within the next twelve months have been disclosed in the financial statements (e.g. in parentheses or by way of a footnote), verify the *correctness* of the *amount* of such *instalments*.
- Examine the *debt agreements* for any restrictive covenants. Review restrictive covenant and provisions relating to default and ensure disclosure thereof in the financial statements.
- Examine the important *terms* in the loan agreements and the documents, if any, evidencing charge in respect of such loans and advances. Examine whether the *requirements* of the applicable *statute* regarding creation and registration of charges have been *complied* with including disclosure of the same to the extent mandated by statute and considered necessary for proper understanding of the user of financial statements.
- In case the *value* of the *security falls* below the amount of the loan outstanding, *examine* whether the loan is classified as secured only to the extent of the market value of the security.
- Examine the *hire purchase agreements* for the purchase of assets by the entity and ensure the correctness of the amounts shown as outstanding in the accounts, and also examine the security aspect.
- He should carefully review the borrowings from *related parties* and ensure *compliance* with *AS 18 or IND AS 24*. Verify whether liabilities towards bank in respect of bills discounted, bills negotiated, cheques discounted, etc. are correctly reflected and disclosed in the financial statements.
- The auditor should also verify that the *amount borrowed* is *within* the *borrowing powers* of the company as laid down by the *Articles* of Association and *Memorandum* of Association.
- *Verify* that the *company* has *not contravened* the restrictions laid down by *Section 180* of the Companies Act, in respect of the borrowings of the company. Also, check compliance of *Sections 185* and *186* of the Companies Act, 2013. Examine the *purpose* for which the amount is borrowed and ensure that the amount is *not used against* the *interest* of the company.
- Where the entity has *accepted deposits*, examine whether the *directives* issued by the Reserve Bank of India or other appropriate authority have been *complied* with.

Disclosure as per Schedule III

(Ensure that borrowings have been presented, classified and disclosed in the FS in accordance with the requirements of applicable FRF)

Long-term borrowing

i. Long-term borrowings shall be classified as:
    a. Bonds/debentures;
    b. Term loans:
        A. from banks.
        B. from other parties.
    c. Deferred payment liabilities;

d. Deposits;
e. Loans and advances from related parties;
f. Long term maturities of finance lease obligations;
g. Other loans and advances (specify nature).

ii. Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.
iii. Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.
iv. Bonds/debentures (along with the rate of interest and particulars of redemption or conversion) shall be stated in ***descending order of maturity or conversion***, starting from farthest redemption or conversion date.
v. Particulars of any redeemed bonds/debentures which the company has power to reissue shall be disclosed.
vi. Terms of repayment of term loans and other loans shall be stated.
vii. Period and amount of continuing default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case.
viii. Other Long term Liabilities shall be classified as:
- Trade Payables
- Others

Short Term Borrowings

i. Short-term borrowings shall be classified as:
a. Loans repayable on demand;
A. from banks.
B. from other parties.
b. Loans and advances from related parties;
c. Deposits;
d. Other loans and advances (specify nature).

ii. Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.
iii. Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.
iv. Period and amount of default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case.
v. Current maturities of Long term borrowings shall be disclosed separately.

Where the company has not used the borrowings from banks and financial institutions for the specific purpose for which it was taken at the balance sheet date, the company shall disclose the details of where they have been used.

Disclosures related to borrowings in special cases

Borrowings on the basis of security

Where the Company has borrowings from banks or financial institutions on the basis of security of current assets, it shall disclose the following:-

- whether ***quarterly returns or statements*** of current assets filed by the Company with banks or financial institutions are in ***agreement with the books of accounts***.
- if not, ***summary of reconciliation and reasons of material discrepancies***, if any to be adequately disclosed.

Wilful Defaulter

Where a company is a declared wilful defaulter by any bank or financial institution or other lender, following details shall be given:

- ***Date*** of declaration as wilful defaulter,
- ***Details of defaults*** (amount and nature of defaults),

A person or a company is termed as a "wilful defaulter" When the borrower (individual or company) defaults on their payment obligation, even when it has the capacity to honour the said obligations. There is a deliberate intention of not repaying the loan. (other reasons are also there, but we will stick to this only for our limited understanding).
Wilful defaulter" here means a person or an issuer who or which is categorized wilful defaulter by any bank or financial institution or consortium thereof, in accordance with the guidelines on wilful defaulters issued by the Reserve Bank of India.

Registration of charges or satisfaction with Registrar of Companies

Where any charges or satisfaction yet to be registered with Registrar of Companies beyond the statutory period, details and reasons thereof shall be disclosed.

Funds advanced or loaned or invested with other persons

- Where company has
  - advanced or loaned or invested funds (either borrowed funds or share premium or any other sources or kind of funds)
  - to any other person(s) or entity(ies), including foreign entities (Intermediaries)
  - with the understanding (whether recorded in writing or otherwise)
  - that the *Intermediary* shall
    - *directly* or *indirectly* *lend* or *invest* in other persons or entities identified in any manner whatsoever by or on behalf of the company (Ultimate Beneficiaries) or
    - provide any *guarantee*, *security* or the like to or on behalf of the Ultimate Beneficiaries;
- The company shall disclose the following:-
  a. *date* and *amount* of *fund* *advanced* or *loaned* or *invested* in Intermediaries with complete details of each Intermediary.
  b. *date* and *amount* of *fund further advanced* or *loaned* or *invested* by such Intermediaries to other intermediaries or Ultimate Beneficiaries along with complete details of the ultimate beneficiaries.
  c. *date* and *amount* of *guarantee*, *security* or the like provided to or on behalf of the Ultimate Beneficiaries
  d. *declaration* that relevant provisions of the FEMA, 1999 and Companies Act has been complied with for such transactions and the transactions are not violative of the PMLA, 2002

Funds received from other persons

- Where a company has
  - received any fund
  - from any person(s) or entity(ies), including foreign entities (Funding Party)
  - with the understanding (whether recorded in writing or otherwise)
  - that the *company* shall
    - *directly* or *indirectly* *lend* or *invest* in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party (Ultimate Beneficiaries) or
    - provide any *guarantee*, *security* or the like on behalf of the Ultimate Beneficiaries,
- The company shall disclose the following
  a. *date* and *amount* of *fund* *received* from Funding parties with complete details of each Funding party.
  b. *date* and *amount* of *fund* *further* *advanced* or *loaned* or *invested* by other intermediaries or Ultimate Beneficiaries along with complete details of the other intermediaries or ultimate beneficiaries.
  c. *date* and *amount* of *guarantee*, *security* or the like provided to or on behalf of the Ultimate Beneficiaries
  d. *declaration* that relevant provisions of the FEMA, 1999 and Companies Act has been complied with for such transactions and the transactions are not violative of the PMLA, 2002

Audit of Trade Receivables

Points to be considered in respect of trade receivables

It is important to carry out compliance procedures in the sales audit as part of the debtors' audit procedure. Check to ensure that the system for receivables has the following features:

- Only *bona fide* sales lead to receivables
- Sales are made to *approved customers.*
- All such sales are *duly recorded* in the books
- Once recorded, the debts can only be *eliminated* by receipt of cash or on the authority of a responsible official
- Debts are *collected promptly*
- Balances are regularly *reviewed* and *aged*, a proper system of *follow up* exists and if necessary *adequate provision* for bad debt exists
- Clear *segregation of duties* relating to identification of debt, receipt of income, reconciliations and write off of debts

To establish the EXISTENCE of trade receivables as at the period- end

i. Check whether there are *controls* in place to ensure that
   - invoices cannot be recorded more than once and
   - receivable balances are automatically recorded in the general ledger from the original invoice.

ii. Ask for a period-end accounts receivable ageing report and trace the balance as per the report to the general ledger.

iii. Check whether *realization* is recorded invoice-wise or not.
   - If not, check that money received from debtors is adjusted chronologically invoice-wise and on FIFO basis i.e. previous bill is adjusted first.

iv. If any *large balance* is due for a long time, auditor should ask for reasons and justification for the same.

Direct confirmation procedures

i. A list of trade receivables selected for *confirmation* should be given to the entity for preparing request letters for confirmation which should be properly addressed.

ii. The auditor should maintain strict control to ensure the correctness and proper *dispatch* of request letters. It should be ensured that *confirmations* as well as any *undelivered letters* are returned to the auditor and not to the client.

iii. Any *discrepancies revealed* by the confirmations received or by the additional tests carried out by the auditor may have a *bearing* on *other accounts not* included in the *original sample*.

iv. Where *no reply is received,* the auditor should perform alternative procedures regarding the balances. This could include:
   - Agreeing the *balance to cash received* subsequently;
   - Preparing a detailed analysis of the balance, ensuring it consists of identifiable transaction and confirming that these revenue transactions actually occurred. (*examination in depth* for those balances)

v. If there are any *related party receivables*, review them for *collectability* as well as whether they were *properly authorized* and the value of such transactions were reasonable and at arm's length.

vi. Check that receivables for *other than sales or services* are not included in the list.

vii. Review a *trend line of sales* and *accounts receivable*, or a *comparison* of the two over time, to check if there are any unusual trends i.e. perform Analytical procedures. Make inquiries about reasons for changes in trends with the management and document the same in audit work papers.

All Trade receivable balances that were supposed to be recorded have been recognized in the financial statements. (COMPLETENESS)

1. The auditor needs to satisfy himself of the *cut-offs.* Without a cut-off, sales could be *understated* or *overstated*, hence there is a need to perform the following cut off procedure:
   a. Ensure that all goods invoiced prior to the cut off have been invoiced and included in debtors on a test check basis;
   b. Ensure that no goods invoiced after the year- end have been included in debtors for the period under Audit.

2. *Test invoices listed* in the *receivable report*. Select a few invoices from the accounts receivable ageing report and compare them to supporting documentation to see if they were billed with the *correct amounts*, to the *correct customers*, and on the *correct dates*.
3. *Match invoices to shipping/ dispatch log*. Match invoice dates to the shipment dates for those items in the shipping/ dispatch log, to see if sales are being recorded in the *correct accounting period*. This can include an examination of invoices issued subsequent to the period being audited, to see if they should have been included in the period under audit.
4. *Assess bills and hold sales*. If there is a situation where the Company is billing customers for sales despite still retaining the goods on-site (known as "bill and hold"), examine *supporting documentation* to determine whether a *sale has actually taken place or not.*
5. Check if the Company has recorded an inordinately *large amount* of *customer returns* after the audit period, which would suggest that the Company may have shipped more goods near the end of the audit period than what the customers had authorized to inflate the profits of the company;
6. Review the *process* of giving *discounts/ incentives* and check whether the same were given as per the Company's policy/ general industry trends.
7. Review *credit memos*, on a sample basis, issued during the audit period to see if they were properly *authorized*.

Trade receivable balances have been VALUED appropriately

1. Review the *process* followed by the Company to derive an *allowance* for doubtful accounts.
2. Check if provisions are made at *appropriate rates* considering the recoverability of amounts due.
3. Obtain the *ageing report* of accounts receivable , split between not currently due, 30 days old, 30-60 days old, 60- 180 days old, 180- 365 days old and more than 365 days old.
4. Obtain the list of *debtors* under *litigation* and compare with previous year.
5. Identify those debtors which appear doubtful;
    - discuss with management about reasons as to why these debtors are not included in the provision for bad debts.
    - Perform further testing where any disputes exist.
6. Check that *write-offs* of the receivable balances have been *approved* by an appropriate authority i.e. the Board of Directors in case of a company.

Required DISCLOSURE for trade receivables have been appropriately made

1. Check that the restatement of foreign currency trade receivables has been done properly in accordance with AS 11.
2. Proper disclosure of Related Party Transactions regarding receivables have been made as per AS 18 or IND AS 24.
3. Ensure that the transactions with parties covered under Section 189 of the Companies Act, 2013 are reported properly in CARO,2020.
4. Ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 are made for each amount disclosed under the heading "Trade Receivables"
    i. Trade Receivables ageing schedule.
    ii. Trade receivables shall be sub-classified as:
        a. Secured, considered good
        b. Unsecured, considered good;
        c. Doubtful.
    iii. Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.
    iv. Debts due by
        a. directors or other officers of the company or any of them either severally or jointly with any other person or
        b. firms or private companies respectively in which any director is a partner or a director or member should be separately stated.

Trade Receivables ageing schedule

Particulars	Amount (in ₹)				
	Outstanding for following periods from due date of payment#				
	Less than 6 Months	6 Months to 1 year	1-2 years	More than 3 years	Total
Undisputed Trade receivables considered good					
Undisputed Trade Receivables considered doubtful					
Disputed Trade Receivables considered good					
Disputed Trade Receivables considered doubtful					

#Where no due date of payment is specified, in that case disclosure shall be from the date of the transaction. Unbilled dues shall be disclosed separately.

Audit of Cash and cash equivalents

To establish the Existence of cash and cash equivalent balances as at the period- end.

1. Check by Surprise
   - Special care is necessary in regard to verification of cash balances.
   - The cash should be checked not only on the last day of the year, but also checked again sometime after the close of the year without giving notice of the auditor's visit either to the entity or to his staff. (Surprise check)
2. More than one cash balance
   - If there are more than one cash balances, e.g., when there is a cashier, a petty cashier, a branch cashier and, in addition, there are imprest balances with employees, all of them should be checked simultaneously.
3. Presence of cashier and sign
   - It is desirable for the cashier to be present while cash is being counted and he should be made to sign the statement prepared containing details of the cash balance counted along with denomination of Cash.

Cash and cash equivalent balances that were supposed to be recorded have been recorded in the financial statements. (COMPLETENESS)

1. If there is any rough Cash Book or details of daily balance are separately kept, the auditor should *test entries from the rough Cash Book* with those in the Cash Book to prove that entries in the Cash Book are correct.
2. If the auditor finds any slip, chit or I.O.U.s in respect of *temporary advances paid to the employees* included as part of the cash balance, he should check whether those are *approved by an authorized official* and *recorded in the appropriate accounts*.
3. The auditor should also perform a cash sensitivity analysis
   - by compiling a summary of total cash receipts and payments each month and
   - analyzing the trends to see if there have been variations in any specific month and
   - request brief descriptions from the management.

Verification of BRS

1. The auditor needs to ***obtain*** bank reconciliation statements (BRS) for all bank accounts maintained by the entity as at the reporting period and additionally need to understand the client's process and periodicity of making the BRS.
2. The auditor should ensure that BRS is signed by the ***authorized personnel*** so that he is able to assign responsibility in case of any errors.
3. Verification of BRS shall entail the following:
    a. ***Tallying*** the balance as per bank book to the bank confirmation/ statement.
    b. Checking of all material reconciling items included under ***cheques issued but presented for payment*** to the underlying bank book forming part of books of account. For all cases where cheques have become stale i.e. 3 months or more have lapsed since the issue date, the same should not appear in the BRS and should instead be taken back to liabilities
    c. Checking of all material reconciling items included under ***cheques deposited but not credited by bank*** by requesting for bank deposit slips, duly acknowledged by bank and verifying if the balances were credited by bank subsequently by tallying to the bank statement of subsequent period.
    d. Checking of ***all material reconciling items*** included under amounts or charges debited/ credited by bank but not accounted for by requesting for bank statements for the period under audit and tallying the same. If the amounts are found to be ***material***, the auditor should ensure that the management ***records*** the ***adjustments*** for the same in its books of account. If management ***does not adjust,*** the auditor shall consider to ***qualify*** his report.

Direct confirmation procedure

1. A significant and important audit activity is to ***contact banks***/ financial institutions directly and ask them to ***confirm*** the amounts held in current accounts, deposit accounts, etc as of the end of the reporting period under audit.
2. The Company should be asked to ***investigate*** and ***reconcile*** the ***discrepancies***, if any, including seeking written explanations/ clarifications from the banks/ financial institutions on any unresolved queries.
3. The auditor should emphasize for confirmation of 100% of bank account balances. In remote situations, where ***no reply*** is received, the auditor should perform ***additional testing*** regarding the balances. This testing could include
    a. ***Agreeing*** the ***balance*** to bank ***statement*** received by the Company or internet/ online login to account in auditor's personal presence;
    b. ***Sending*** the audit ***team*** member to the bank branch along with the entity's personal to obtain balance confirmation from the bank directly.

Cash and cash equivalent balances have been VALUED appropriately

In addition to the procedures performed above, the auditor should ensure that all bank accounts holding ***foreign currency*** have been ***restated*** at the closing exchange rates as per applicable FRF

Required DISCLOSURES for cash and cash equivalents have been appropriately made.

1. Cash and cash equivalents shall be classified as:
    a. Balances with banks;
    b. Cheques, drafts on hand;
    c. Cash on hand;
    d. Others (specify nature)
2. Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.
3. Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.
4. Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.
5. Bank deposits with more than 12 months' maturity shall be disclosed separately.

Audit of Inventories

To establish the EXISTENCE of Inventories as at the period- end.

- Review *entity's plan* for performing inventory count.
- Ensure that *consigned goods* have been *segregated*.
- Auditor should participate in the inventory count with the management.
- *Test counts* of inventory by auditor should include:
  - *observing employees* are adhering to the agreed plan.
  - assuring that *all items* are properly *tagged*.
  - Assuring that there is *appropriate supervision* on the count procedure.
  - Observing that *proper amounts* are shown on tags.
  - Staying *alert* at all times and specifically being cautious about empty boxes, etc. and obsolete items.
  - Performing *cut-off testing* by documenting the last 5-10 receiving reports and shipping documents as of the period end.
  - Ensuring *exclusion* of *third party stock* and damaged or obsolete stock.
  - *Investigating* any *significant differences* between the physical stock take and the stock records as per Books. The auditor should ask the entity's personnel to sign all stock count sheets and also agree the variances observed, if any, to avoid any conflicts.
- When the entity uses a periodic system for inventory count, it should be undertaken at the end of the period. If the entity uses a perpetual system with proper and adequate records, inventory may be counted at interim dates.
- *Confirm* or investigate any *inventory* of the entity *lying with* a *third party* (specifically relevant for cases where the entity gets job work done in its process of production).

Only the inventories held by the entity have been recorded in the financial statements and do not include any inventories that belong to third parties but does include inventories owned by the entity and lying with a third party (COMPLETENESS)

- Perform *analytical procedures* (comparison tests with industry averages, budgets, prior years, trend analysis, etc.).
- Perform purchase and sales *cutoff tests*.*Trace shipping documents* (bills of lading and receiving reports, warehouse records, and inventory records) to accounting records immediately before and after year-end.
- With respect to tagged inventory, perform *tests* for *omitted* transactions and tests for *invalid* transactions.
- Verify the clerical and *arithmetical accuracy* of inventory listings.
- Reconcile physical *inventory amounts with perpetual records.*
- Reconcile physical *counts* with general ledger control totals.
- Reconcile inventories which belong to client but are held with *third parties* like transporters, warehouses, port authorities etc.
- Goods received on *consignment basis* have been properly *segregated* from other items of inventory.

Valid legal ownership rights (RIGHTS AND OBLIGATIONS)

The entity has valid legal ownership rights over the inventories claimed to be held by the entity and recorded in the FS.

- Vouch recorded purchases to underlying *documentation* (purchase requisition, purchase order, receiving report, vendor invoice and cancelled cheque or payment file).
- Evaluate the *consigned* goods.
- Examine client *correspondence*, sales and receivables records, purchase documents.
- Review material purchase commitment *agreements*.
- Examine *invoices* for evidence of ownership i.e. the invoices shall be in the name of the client.
- Auditors shall obtain *confirmation* for significant items of inventory as per *SA 501*.
- For instances of inventory held by third party, the auditor should insist on obtaining declaration from the third party on its business letterhead and signed by an authorized personnel of that third party confirming that the items of inventory belong to the entity and are being held by such third party on behalf of and for the benefit of the entity under audit.

Inventories have been VALUED appropriately and as per generally accepted accounting policies and practices (VALUATION)

General Points

- Depending on how the business *operates*, the management may value inventory using *First-in-first-out (FIFO) or weighted average basis.*
- Consider the *reasonableness* of the *method* adopted.

For Raw materials and consumables

- Ascertain what *elements of cost* are included e.g. carriage inward, non-refundable duties etc.
- If standard costs are used, enquire into the *basis of standards*; how these are compared with actual costs and how variances are analyzed and accounted for/ treated in accounting records.
- *Test check cost prices* used with purchase invoices received in the month(s) prior to counting.
- *Follow up* valuation of all damaged or obsolete inventories with a view to establishing a realistic net realizable value.

For Work in progress

- Ascertain how the various *stages* of production/ value additions are measured and in case estimates are made, understand the basis for such estimates.
- Ascertain what *elements of cost* are included. If *overheads* are included, ascertain the basis on which they are included and compare such basis with the available costing and financial data/ information maintained by the entity.
- Ensure that material costs *exclude* any *abnormal* wastage factors.

For Finished goods and goods for resale

- Enquire as to what costs are included, how these have been established and ensure that the *overheads* included have been determined based on *normal costs* and appear reasonable in relation to the information disclosed in the financial statements.
- Ensure that inventories are valued at *net realizable value* if they are likely to fetch a value *lower* than their *cost*.
- *Follow up* for items that are *obsolete*, *damaged*, slow moving and ascertain the possible realizable value of such items. For the purpose, request the client to provide inventory ageing split between less than 30 days, 30-60 days old, 60- 90 days old, 90- 180 days old, 180- 365 days old and more than 365 days old.
- *Follow up* any inventories which at time of observance of physical counting were noted as being *damaged* or obsolete.
- Examine *vendor price lists* to determine if recorded cost is less than current prices.
- Calculate inventory turnover *ratio*. Obsolete inventory may be revealed if ratio is significantly lower.
- In manufacturing environments, test overhead allocation rates and ensure that *only direct labour, direct material and overhead* have been *included.*

Goods Lying with Third Party

The auditor should check that the materiality of the item under this caption is included in inventories.

i. He should obtain *confirmation* of the amount of goods lying with them.
ii. He should inquire into the *necessity* of sub contractor retaining the inventory.
iii. The *goods lying* with them for a *very long period* would merit auditors' special attention for making provision.
iv. The *records, voucher/slips* for the *regulating* the *movement* of *inventory* into and out of entity for sub-contracting work be reviewed by vouching for few transactions for ensuring existence and working of internal control system for them.
v. The *valuation* of inventories should be *correctly made* for including material cost on appropriate inventory valuation formulae and also for inclusion of proportionate processing charges for the work in process with the contractors.
vi. Evaluate the *condition* of *goods* and see whether adequate provision has been made.

vii. Check whether ***subsequently*** the goods lying with third party were sold or received back after the expiry of the stipulated time period.

viii. Ensure that the ***goods*** have been ***included*** in the ***closing inventory*** though lying with a third party.

Examples of costs to be excluded in determining cost of Inventory

In determining the cost of inventories, it is appropriate to ***exclude*** certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

i. ***abnormal*** amounts of ***wasted*** materials, labour, or other production costs;

ii. ***storage costs***, ***unless*** those costs are ***necessary*** in the ***production*** process prior to a further production stage;

iii. ***administrative overheads*** that do ***not contribute*** to ***bringing*** the inventories to their ***present location*** and condition; and

iv. ***selling*** and ***distribution*** costs.

Required DISCLOSURES for inventories have been appropriately made

Ensure whether the following disclosures as required under Schedule III (Part 1) to the Companies Act, 2013 have been made:

- Whether inventory has been classified as:
  - Raw materials
  - Work-in-progress
  - Finished goods
  - Stock-in-trade (goods acquired for trading)
  - Stores and spares
  - Loose tools
  - Others (specify nature).
- Whether goods-in-transit have been disclosed separately under each sub-head of inventories.
- Mode of valuation shall be stated.

Audit of Tangible Fixed Assets

Recognition Criteria for PPE

- The cost of an item of PPE should be recognised as an asset if
  a. It is probable that ***future economic benefits*** associated with the item will ***flow*** to the enterprise, and
  b. The ***cost*** of the item can be measured ***reliably***.
- An item that qualifies for recognition as an asset should be measured at its cost

Elements of Cost

The cost of an item of PPE comprises:

a. its ***purchase price,*** including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

b. any ***costs*** directly ***attributable*** to ***bringing*** the asset to the ***location*** and condition.

c. the initial estimate of the costs of dismantling, removing the item and restoring the site on which it is located, referred to as decommissioning, restoration and similar liabilities.

Examples of directly attributable costs

a. costs of employee benefits arising directly from the construction or acquisition of the item of PPE

b. costs of site preparation;

c. initial delivery and handling costs;

d. installation and assembly costs;

e. costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition

f. professional fees.

Examples of costs that are not costs of an item of PPE

a. costs of opening a new facility or business, such as, inauguration costs;
b. costs of introducing a new product or service (advertising and promotional activities);
c. costs of conducting business in a new location or with a new class of customer and
d. administration and other general overhead costs.

To establish the EXISTENCE of PPE as at the period-end

1. Review *entity's plan* for performing *physical verification* of PPE
    - By whom
    - Period
2. *Evidence* of appropriate *supervision* of those performing physical verification of PPE should be examined.
3. Obtain PPE physical verification *report* backed by the *working* sheets from the entity and perform the following procedures:
    - Assess if *all* items of PPE are properly *tagged* and carry *identification marks*/ numbers.
    - *Reconciliation* of items of PPE as physically verified with the fixed asset register.
    - Verify the *discrepancies* noted, based on physical verification undertaken and the manner in which such discrepancies have been *dealt* with in the entity's books and financial statements.

Additions to PPE during the period under audit have been recorded in the financial statements (COMPLETENESS)

- Verify the *movement* in the PPE schedule compiled by the management i.e. Opening balances + Additions during the period – Deletions during the period = Closing balances. Tally the closing balance to the entity's books of account.
- Check the *arithmetical accuracy* of the movement in PPE schedule.
- *Tally* the opening balances to the previous year audited financial statements.
- For additions during the period under audit, obtain a *listing* of *all additions* from the management and perform the following procedures:
    - For all material additions, verify if such expenditure meets the *criteria* of PPE as per *AS 10* Revised.
    - Ensure that the entity is not recognizing costs of the day-to-day servicing in the carrying amount of an item of property, plant and equipment.
    - *Test* the *purchase invoice,* installation certificate or report or other similar documentation maintained by the entity to verify the date of addition, for all additions samples of PPE during the period under audit.
    - Verify whether the PPE additions have been *approved* by authorized personnel.
    - Verify whether proper *internal processes* and *procedures* like inviting competitive quotations/ floating tenders etc. were followed prior to finalising the vendor for procuring items of PPE/ awarding of work contract for capital projects by checking the supporting documents of the samples selected.
- In relation to *deletions* to PPE, understand from the management the reason and rationale for deletion and the manner of disposal.
    - Obtain the management *approval* and discard note authoring disposal of the asset
    - Verify the *process* followed for sale of discarded PPE.
    - Verify that the management has accurately *recorded* the deletion, profit or loss on disposal of PPE

PPE have been VALUED appropriately and as per generally accepted accounting policies and practices

- Verify that the entity has *charged depreciation on all items* of PPE *unless* any item of PPE is *non-depreciable* like freehold land;
- Assess that the *depreciation method* used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity.
- The auditor should also verify whether the management has done an *impairment assessment* to determine whether an item of PPE is impaired as per the requirements of AS 28.

The entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements (RIGHTS AND OBLIGATION)

- Verify that *purchase invoices* are in the name of the entity that entitles legal title of ownership to the respective entity.
- For all additions to *land* and *building* in particular, the auditor should check the *conveyance deed/ sale deed* to verify whether the entity is the legal and valid owner or not.
- Verify the *original title deeds* for all *immovable properties* held as at the balance sheet date.
- If immovable property is given as *security* for any borrowings and the original title deeds are not available with the entity, the auditor should request the entity's management for obtaining a *confirmation* from the respective lenders that they are holding the original title deeds of immovable property as security.
- Verify the *register of charges* to assess that any charge has been created against the PPE.

Required DISCLOSURES for PPE have been appropriately made

i. Classification shall be given as:
   a. Land;
   b. Buildings;
   c. Plant and Equipment;
   d. Furniture and Fixtures;
   e. Vehicles;
   f. Office equipment;
   g. Others (specify nature).

ii. Assets under lease shall be separately specified under each class of asset.

iii. A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment) and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

iv. Where sums have been written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

Additional Disclosures

Title deeds of Immovable Property not held in name of the Company

The company shall provide the details of all the immovable property (other than properties where the Company is the lessee and the lease agreements are duly executed in favour of the lessee) whose title deeds are not held in the name of the company in format given below and where such immovable property is jointly held with others, details are required to be given to the extent of the company's share.

Relevant line item in the Balance sheet	Description of item of property	Gross carrying value	Title deeds held in the name of	Whether title deed holder is a promoter, director or relative# of promoter*/director or employee of promoter/direct or	Property held since which date	Reason for not being held in the name of the company (Also indicate the dispute if any)
PPE	Land & Building	-	-	-	-	
Investment property	Land & Building					
PPE retired from active use and	Land & Building					

held for disposal						
Others						

#Relative here means relative as defined in the Companies Act, 2013.
*Promoter here means promoter as defined in the Companies Act, 2013.

Where the Company has revalued its Property, Plant and Equipment,
Company shall disclose as to whether the revaluation is based on the valuation by a registered valuer as defined under rule 2 of the Companies (Registered Valuers and Valuation) Rules, 2017.

Capital-Work-in Progress (CWIP)

a. For Capital-work-in progress, following ageing schedule shall be given:

					(Amount in ₹)
	Amount in CWIP for a period of				Total*
CWIP	Less than 1 year	1-2 years	2-3 years	More than 3 years	
Projects in Progress					
Projects temporarily suspended					

Total shall tally with CWIP amount in the balance sheet

b. For capital-work-in progress, whose completion is overdue or has exceeded its cost compared to its original plan, following CWIP completion schedule shall be given**.

				(Amount in ₹)
	To be completed in			
CWIP	Less than 1 year	1-2 years	2-3 years	More than 3 years
Project 1				
Project 2				

**Details of projects where activity has been suspended shall be given separately

Audit of Intangible Assets

Meaning

- An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes
- As per AS 26 Intangible Assets, internally generated goodwill should not be recognized as an asset.

To establish the EXISTENCE of intangible fixed assets as at the period- end.

- Auditor should ensure that an intangible asset shall be recognised only if
  - it is probable that ***future economic benefits*** associated with the asset will ***flow*** to the entity;
  - ***cost*** of the item can be measured ***reliably***
- For verifying the existence of software, the auditor should verify whether such software is in active use by the entity and for the purpose, the auditor should verify the sale of related services/ goods during the period under audit, in which such software has been used.
- For verifying the existence of design/ drawings, the auditor should verify the production data to establish if such products for which the design/ drawings were purchased, are being produced and sold by the entity.
- In case any intangible asset is ***not in active use,*** deletion should have been recorded in the books of account ***post approvals*** by the entity's management and amortization charge should have ceased beyond the date of deletion.

Additions to Intangible assets during the period under audit have been recorded appropriately in the financial statements (COMPLETENESS)

- Verify the *movement* in the *intangible assets schedule* compiled by the management i.e. Opening balances + Additions - Deletions = Closing balances.
- Tally the closing balances to the entity's books of account.
- Check the *arithmetical accuracy* of the movement in intangible assets schedule.
- For additions during the period under audit, obtain a *listing* of *all additions from* the *management* and undertake the following procedures:
    - For all material additions, verify whether such *expenditure meets* the *criterion for recognition* of an intangible asset as per AS 26.
    - Ensure that no *cost related to research* gets recognized as an intangible asset.
    - Check the *certificate* or *report* or other similar *documentation* maintained by the entity to *verify* the *date* of *use* of the intangible which could be linked to date of commencement of commercial production/ economic use to the entity, for all additions to intangible assets during the period.
    - Verify whether the *additions* (acquisitions) have been *approved* by appropriate personnel.
    - Verify whether *proper internal processes* and procedures like inviting competitive quotations/ proper tenders etc. were followed prior to finalizing the vendor for procuring item of intangible assets by testing those documents on a sample basis.
- In relation to *deletions* of intangible assets,
    - understand from the management the *reason* and rationale for deletion and the manner of disposal.
    - Obtain the management *approval* and disposal note authoring disposal of the asset from its active use.
    - Verify the *process* followed for sale of discarded asset,
        - example inviting competitive quotes, tenders and the basis of calculation of sales proceeds.
    - Verify that the management has *accurately recorded* the deletion of intangible asset (original cost and accumulated amortization up to the date of disposal) and the resultant gain/ loss on disposal in the entity's books of account.

Intangible assets have been VALUED appropriately and as per generally accepted accounting policies and practices

- Verify that the entity has charged *amortization* on *all* intangible assets;
- Verify that the amortization *method* used reflects the pattern in which the asset's *future economic benefits* are *expected* to be consumed by the entity.
- The auditor should also verify whether the management has done an *impairment assessment* to determine whether an intangible asset is impaired. For this purpose, the auditor needs to verify whether the entity has applied *AS 28* - Impairment of Assets.

The entity has valid legal ownership rights over the Intangible Assets claimed to be held by the entity and recorded in the financial statements (RIGHTS AND OBLIGATION)

The auditor while performing testing of additions should also verify that all expense invoices/ purchase contracts are in the *name* of the *entity* that entitles legal title of ownership to the entity.

Required DISCLOSURES for Intangible Assets have been appropriately made

i. Classification shall be given as:
    a. Goodwill
    b. Brands /trademarks;
    c. Computer software;
    d. Mastheads and publishing titles;
    e. Mining rights;
    f. Copyrights, and patents and other intellectual property rights, services and operating rights;
    g. Recipes, formulae, models, designs and prototypes;
    h. Licences and franchise;
    i. Others (specify nature).

ii. A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of intangible assets) and other adjustments and the related depreciation and impairment losses or reversals shall be disclosed separately.

iii. Where sums have been written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

Additional Disclosures

Intangible assets under development:

- Intangible assets under development ageing schedule shall be given
- For Intangible assets under development, whose completion is overdue or has exceeded its cost compared to its original plan, a different Intangible assets under development completion schedule shall be given.

Audit of Trade Payables and Other Current Liabilities

Classification of Liabilities

A liability shall be classified as current when it satisfies any of the following criteria:

a) it is expected to be settled in the company's *normal operating cycle;*
b) it is held primarily for the purpose of being *traded*;
c) it is due to be settled within *twelve months* after the reporting date; or
d) the company does *not* have an *unconditional right* to *defer settlement* of the liability for *at least twelve months after the reporting date*. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current.

To establish the EXISTENCE of trade payables and other current liabilities as at the period-end

- Check whether there are *controls* in place to ensure that any purchase/ expense invoice does not get recorded more than once and payable balances are automatically recorded in the general ledger at the time of recording of expense.
- Obtain the *accounts payable ageing report* and trace its balances to the *general ledger*.
  - If there are any differences, investigate reconciling items.
  - Journal entries specially for large amounts should be carefully examined.

Direct confirmation procedure

- An *important audit activity* is to contact vendors directly/independently and ask them to confirm the amounts of accounts payable. This should necessarily be done *for all significant account payable balances* as at the period-end and for parties from whom material purchases have been made during the period under audit *even if period-end balance of such parties is not significant*.
- The auditor employs direct confirmation procedure with the *consent* of the entity under audit.
- There may be situations where the *management of the entity requests the auditor not to seek confirmation* from certain trade payables. In such cases, the auditor should consider whether there are valid grounds for such a request.
- The trade creditors may be requested to confirm the balances either
  - as at the date of the balance sheet, or
  - as at any other selected date which is reasonably close to the date of the balance sheet.

  The date should be decided by the auditor in consultation with the Company.
- The form of requesting confirmation from the trade creditor may be either
  - the form with balance as at year end wherein the trade creditor is requested to respond whether or not he is in agreement with the balance shown, or

- the form with no balance wherein the trade creditor is requested to respond to the balance as per his records. The use of the form with no balance is preferable.

- The method of selection of the trade creditors should not be revealed to the Company.
- A list of trade creditors selected for confirmation should be given to the entity for preparing request letters for confirmation which should be properly addressed.
- In the alternative, the auditor may request the client to furnish duly ***authorised confirmation letters*** and the auditor may fill in the names, addresses and the amounts relating to trade creditors selected by him and mail the letters directly.
- The auditor should maintain strict ***control*** to ensure the correctness and proper dispatch of request letters. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client. Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor, may have a bearing on other accounts not included in the original sample.
- Where ***no reply*** is received, the auditor should perform ***additional testing*** regarding the balances. This testing could include:
  - Testing of ***subsequent payments*** in respect of the trade payables to whom confirmations were rolled out but no replies received.
  - Agreeing the details of the respective balance to the underlying ***vendor invoices***;
  - Preparing a ***detailed analysis*** of the balance, ensuring it consists of identifiable transactions and confirming that these purchases/ expense transactions actually occurred. (examination in depth).
- If there are any ***related party payables***, review whether they were ***properly authorized*** and the ***value*** of such transactions were ***reasonable*** and at ***arm's length***. Review a ***trend line*** of ***purchases/ expenses*** and ***accounts payable***, or a comparison of the two over time, to see if there are any unusual trends. Make inquiries about reasons for changes in trends from the management.

Trade payables and liability balances that were supposed to be recorded have been recognized in the financial statements. (COMPLETENESS)

- The auditor needs to perform the following ***cut off procedures***:
  - For the last 5 invoices received/ recorded at the end of the reporting date (cut off date) and which have been included in the trade payables; the risk and rewards of ownership in goods should have been transferred in favour of the entity;
- Test purchases/ expenses on a sample basis selecting the same from the accounts payable ledgers and checking their ***supporting documents*** to ensure that the purchases were recorded at the ***correct amounts*** and correct ***dates***.
- ***Match purchase invoice dates to the gate entry*** (inward) dates to check whether the purchases are being recorded in the correct accounting period. This can include an examination of purchase/ expense invoices received subsequent to the period being audited, to see if they should have been included in the period under audit.
- Review ***subsequent expense vouchers***. Review all material expense vouchers recorded post the balance sheet date to see if they relate to transactions from within the audit period.

Statutory dues liability

- In relation to ***statutory dues liability*** like withholding tax (TDS) payable, GST payable, luxury tax payable, professional tax payable, PF and ESI payable etc., prepare a ***reasonability statement*** with respect to sales/ purchases/ employee benefit expenses. Example- GST liability for last month may be calculated by applying the applicable rate to the sales made and in case of any variance with the GST liability recorded by the entity, reasons for variance should be requested from client and in case found satisfactory, the same should be maintained as part of audit documentation.
- Similarly, Provident Fund liability for last month may be calculated by applying the applicable rate to the employee benefit expense and in case of any variance with the liability recorded by the entity, reasons for variance should be requested from client and in case found satisfactory, the same should be maintained as part of audit documentation.
- Further, the auditor should obtain and verify the

- challans for deposits made subsequent to the period-end for all statutory liabilities as at the balance sheet date and
- also analyse the reasons, if any, in consultation with the management for any variance between the amounts deposited subsequently vis-à-vis the liability recorded in books of account.

- He shall prepare a complete list of all statutory dues and consider his reporting requirements under CARO, 2020.

Trade payables and other liability balances have been VALUED appropriately.

1. Review the ***process followed by the Company to identify if any old creditor balance/ liability needs to be written back***. This will include a consistency comparison with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment.
2. Obtain the ***ageing of payable balances***, split between current, less than 30 days old, 30-60 days old, 60-180 days old, 180- 365 days old and more than 365 days old .
3. Also, obtain the ***list of vendors with whom*** the ***Company*** has ***disputes*** and any claims from customers, under litigation and compare with previous year.
4. Check that ***write backs*** in the liability balances assessed as no longer payable have been ***approved*** by an appropriate and authorised member of senior management, for example – CEO/MD.
5. Check that the ***restatement*** of ***foreign currency trade payables*** has been done properly In accordance with AS.
6. Understand ***management's process*** to ***identify*** the ***principal amount*** and the ***interest due*** thereon (if any) remaining ***unpaid*** to any ***M***icro, ***S***mall and ***M***edium Sized ***E***nterprises suppliers at the end of accounting year. Test check the management process to assess if the auditor could rely on the management process.

Required DISCLOSURES for trade payables and other liabilities have been appropriately made

Ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made:

Disclosures relating to Micro and Small enterprises

- Principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year.
- Amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year.
- Amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under MSME Development Act, 2006.
- Amount of interest accrued and remaining unpaid at the end of each accounting year.
- Amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under section 23 of the MSME Development Act, 2006

Trade payables due for payment

The ageing schedule shall be given for Trade payables due for payment.

					(Amount in ₹)
Particulars	**Outstanding for following periods from due date of payment#**				
CWIP	**Less than 1 year**	**1-2 years**	**2-3 years**	**More than 3 years**	**Total**
(i) MSME					
(ii) Others					
(iii) Disputed Dues- MSME					
(iv) Disputed Dues - Others					

- # similar information shall be given where no due date of payment is specified in that case disclosure shall be from the date of the transaction.
- Unbilled dues shall be disclosed separately.

Other Current Liabilities

The amount shall be classified as:

- Current maturities of finance lease obligations
- Interest accrued but not due on borrowings
- Interest accrued and due on borrowings
- Income received in advance
- Unpaid Dividends
- Application money received for allotment of securities and due for refund and interest accrued thereon. Share application money includes advances towards allotment of share capital. The terms and conditions including the number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted shall be disclosed. It shall also be disclosed whether the company has sufficient authorised capital to cover the share capital amount resulting from allotment of shares out of such share application money. Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the document inviting application for shares along with the reason for such share application money being pending shall be disclosed. Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable, i.e., the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under "Other current liabilities";
- Unpaid matured deposits/debentures and interest accrued thereon
- Unpaid matured debentures and interest accrued thereon
- Others (specify nature).

Audit of Loans and Advances and Other Current Assets

To establish the EXISTENCE of loans and advances and other current assets as at the period-end.

For establishing existence of loans and advances ***direct confirmation procedures*** should be performed, the principal amount, interest receivable, if any, as per the agreed terms between the parties, may also be included as part of the balance to be confirmed.

Loans and advances and other current asset balances that were supposed to be recorded have been recognized in the financial statements. (COMPLETENESS)

1. Obtain a ***list*** of all advances and other current assets and ***compare*** them ***with balances*** in the ***ledger***.
2. Verify loan ***agreements*** and ***acknowledgements*** of parties in respect of outstanding loans.
3. Examine, in case of material loan or advances, ***authorisation*** by the Memorandum and Articles of Association in the case of Company.
4. The auditor should confirm that the loans advanced were within the ***competence*** of persons who had advanced the same, directors in the case of a Company, partners in the case of a firm and trustees in the case of a trust.
5. Inspect the ***minutes*** of meeting of board of directors to confirm if all material loans and advances were approved by the board of directors.
6. Inspect if any ***security*** has been deposited against due repayment of the loan.
7. Ascertain if loans are being ***recovered regularly*** as per ***agreed instalments***.
8. If there are any ***related party*** loans and advances, review whether they were properly ***authorized*** and the value of such transactions were reasonable and at ***arm's length.***
9. In relation to balances with statutory authorities like GST input credit, prepare a ***reasonability*** with respect to purchases/ expenses by applying the applicable rate to the purchases/ expenses and in case of any variance with the asset recorded by the entity, reasons for variance should be requested from the entity.

10. Obtain *statutory returns filed* with the authorities like GST returns and verify whether the amount recorded as per books of account tallies with the claim made with the authorities.

Loans and advances and other current asset balances have been VALUED appropriately.

1. Assess the allowance for doubtful accounts.
    a. Review the *process* followed by the Company to derive an allowance for doubtful accounts.
    b. *Compare* the process used in the *last year* and determine the appropriateness of the method used.
2. Obtain the *ageing report* of loans and advances, split between not currently due, 30 days old, 3060 days old, 60- 180 days old, 180- 365 days old and more than 365 days old.
3. Obtain the *list* of loans and advances under *litigation* and *compare* with previous year.
4. Identify those loans and advances that appear *doubtful*; discuss with management about the *reasons* as to why these loans/ advances are not included in the provision for doubtful balances.
5. Examine *bad loans*/ advances write-offs. Prepare schedule of movements on Bad loans/ advances – Provision Accounts and loans/ advances written off
6. Examine that *write-offs* or other reductions in the recoverable balances have been approved by the appropriate authority.
7. Check that the *restatement* of foreign currency loans and advances/ other current assets has been done properly in accordance with *AS 11*.

Required DISCLOSURE for loans and advances and other current assets have been appropriately made

Ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made:

Long Term loans & Advances

i. Long-term loans and advances shall be classified as:
    a. Capital Advances;
    b. Loans and advances to related parties (giving details thereof);
    c. Other loans and advances (specify nature).
ii. The above shall also be separately subclassified as:
    a. Secured, considered good;
    b. Unsecured, considered good;
    c. Doubtful.
iii. Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.
iv. Loans and advances due by
    a. Directors or other officers of the company or any of them either severally or jointly with any other persons or
    b. amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Short-term loans and advances

i. Short-term loans and advances shall be classified as:
    a. Loans and advances to related parties (giving details thereof);
    b. Others (specify nature).
ii. The above shall also be sub-classified as:
    a. Secured, considered good;
    b. Unsecured, considered good;
    c. Doubtful.
iii. Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.
iv. Loans and advances due by
    a. directors or other officers of the company or any of them either severally or jointly with any other person or
    b. amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

Additional Disclosures

Following disclosures shall be made where Loans or Advances in the nature of loans are granted to promoters, Directors, KMPs and the related parties (as defined under Companies Act, 2013,) either severally or jointly with any other person, that are:

a. repayable on demand or
b. without specifying any terms or period of repayment

Type of Borrower	Amount of loan or advance in the nature of loan outstanding	Percentage to the total Loans and Advances in the nature of loans
Promoters		
Directors		
KMPs		
Related Parties		

Audit of Provisions and Contingent Liabilities

Meaning of Provision

- A provision is a liability which can be measured only by using a ***substantial degree of estimation***.
- A provision is recognised when:
  - an entity has a ***present obligation*** (legal or constructive) as a result of a past event;
  - it is probable that an ***outflow*** of resources embodying economic benefits will be required to settle the obligation; and
  - a ***reliable estimate*** can be made of the amount of the obligation.

  If these conditions are not met, no provision should be recognized.

Meaning of Contingent Liabilities

A contingent liability is:

- a ***possible obligation*** that arises from ***past events*** and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- a ***present obligation*** that arises from past events but is not recognized because:
  - it is ***not probable*** that an ***outflow*** of resources embodying economic benefits will be required to settle the obligation; or
  - the ***amount*** of the obligation ***cannot*** be ***measured*** with ***sufficient reliability***.

Audit Procedure for verification

1. Obtain a ***list*** of ***all provisions*** and compare them with balances in the ledger.
2. Inspect the ***underlying agreements*** like agreement with customers to assess warranty commitments, any legal and other claims on the entity i.e. litigations.
3. Obtain the ***underlying working*** and the ***basis*** for each of the provisions made, from the management and verify whether the same is complete and accurate.

Audit Procedures in case of use of Management Expert

- Wherever required, obtain ***expert's report***, ***calculation*** and underlying ***working*** for the provision amount,
  - example for warranty involving complex calculations, some entities get that valued through an actuary.In such a case, the auditor may request the management to ***share*** the ***actuarial valuation report***.
  - The auditor should then verify the underlying assumptions used by the expert with the data shared by the management.
- As per SA 500 – "Audit Evidence", issued by ICAI, when using the work of a management's expert, audit evidence that the auditor should obtain include:
  - Evaluate the ***competence***, ***capabilities*** and ***objectivity*** of that expert:
    - Whether the expert is employed by the entity or is an outside party.
    - Whether the expert is independent in respect of the entity.

- Auditor's previous experience of the work of the expert.
- Knowledge of the expert, his qualification, membership of a professional body or industry association, etc.

- Obtain an ***understanding*** of the work of that expert:
  - Whether the auditor has expertise to evaluate the work of the expert.
  - Evaluating the assumptions and methods used by the management.
  - Evaluating the nature of internal or external data used by the expert.
- Evaluate the ***appropriateness*** of his work as audit evidence for the relevant assertion:
  - Relevance and reasonableness of the expert's findings or conclusions
  - Evaluating the relevance, completeness and accuracy of the source data used by the expert.
- The auditor shall obtain ***written representation*** from the management that it has made all the provisions which were required to be made as per the recognized accounting principles.

Required DISCLOSURE for provisions have been appropriately made

Ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made:

Provisions

Long-term provisions

The amounts shall be classified as:

a. Provision for employee benefits;
b. Others (specify nature).

Short-term provisions

The amounts shall be classified as:

a. Provision for employee benefits.
b. Others (specify nature).

Contingent liabilities and commitments (to the extent not provided for)

i. Contingent liabilities shall be classified as:
   - Claims against the company not acknowledged as debt;
   - Guarantees;
   - Other money for which the company is contingently liable.

ii. Commitments shall be classified as:
   a. Estimated amount of contracts remaining to be executed on capital account and not provided for;
   b. Uncalled liability on shares and
   c. other investments partly paid;

Disclosure requirements of AS 29

Provisions

- For each class of provision, an enterprise shall disclose:
  - the carrying amount at the beginning and end of the period;
  - additional provisions made in the period, including increases to existing provisions;
  - amounts used (i.e. incurred and charged against the provision) during the period;
  - unused amounts reversed during the period.
- An enterprise shall disclose the following for each class of provision:
  - a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
  - an indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning future events; and
  - the amount of any expected reimbursement, stating the amount of any asset that has been recognized for that expected reimbursement.

Contingent Liability

Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:

- an estimate of its financial effect
- an indication of the uncertainties relating to any outflow; and
- the possibility of any reimbursement.

Audit of Sale of Products and Services

Sales and collections cycle

- The sales and collections cycle in a business refers to the set of processes that begin when a customer purchases goods or services and ends when the entity receives complete payment against the sales.

Important items / High ROMM

- Sales is one of the most important items in the FS which will have a considerable effect on the profit generated, closing stock etc. As per SA 315, the risk of material misstatement in case of revenue items is generally high.

Test Sale Transaction and Controls

- As part of the year-end audit of an entity's FS, auditors test sales transactions and the internal controls over those transactions to ensure that the entity is not materially misstating its revenues or accounts receivable.

Clear understanding about organisation and revenue centres.

- Auditor needs to obtain a clear understanding about the organisation and its revenue centres.
- Example, Type of services or products the entity provides, demand for the services or products, major selling product/service, introduction of new products/service line, discontinuance of products/services, major customers, sales term (Credit or cash sales).

Understanding of Controls

- An auditor needs to obtain an understanding of the management control (internal control) in respect of sales process.
- Example
  - Whether segregation of duties exist,
  - who checks the credit limit (if applicable),
  - who authorizes sales orders, who raises sales invoice,
  - when and how the goods are delivered/despatched or services are provided,
  - who collects and records the amounts received from debtors,
  - who ensures that the risks and rewards are transferred to the customer, how the sales have been recognised in the system.

Test of controls/ Strength and Reliability

- An auditor tests the controls the entity has set up for the sales cycle to determine how strong and reliable they are. If they are strong and operating effectively, the auditor can reduce the extent of substantive testing.
- Any deficiencies in the internal control shall be communicated as per SA 265.

Substantive audit procedures

- Performing substantive audit procedures is a must.
- Substantive analytical procedures will consist of sales trend analysis, comparison with previous accounting period, category-wise sales analysis, any analysis the auditor may find relevant and most important of all, building a sales expectation and comparing that with the client's sales records.
- Example
  - For a manufacturing company, if the average sales price of product X is ₹ 10 and 1,500 units were sold in that month, the auditors expected sales will be ₹ 15,000. The auditor should compare this

figure with the client's data and see what they have recorded against Product X. The auditor should consider discussing any variances (see if there were discounts or sales were wrongly booked in the system) between his expectations and client's records. The auditor will have to also identify and understand how the entity accounts for their sales discounts and sales return in the system and how those affect the gross sales.

Audit Procedures - Recorded sales represent goods shipped/ services performed during the period (OCCURRENCE)

1. Ensure revenue is not overstated by performing following audit procedures
    a. Check whether a *single sales invoice* is recorded twice or a *cancelled sales invoice* could also be recorded.
    b. Test check a few *invoices* with their relevant *entries in sales journal*.
    c. Obtain *confirmation* from few customers to ensure *genuineness* of sales transaction Whether any fictitious customers and sales have been recorded.
    d. Whether any *shipments* were done *without* the *consent* and agreement of the customer, *especially* at the *year end* to inflate the sales figure
    e. Whether unearned revenue recorded as earned.
    f. Whether any substantial uncertainty exists about collectability.
    g. Whether customer obligations are contingent on other actions (financing, resale, etc.).
2. Review *sequence* of sales invoices
3. Review *journal entries* for *unusual transactions*
4. Calculate the *ratio* of *sales return* to *sales* and *compare* it with previous year and enquire for the reasons for increase/ decrease
5. Check the *sales return with a sales* invoice, challan, credit note, stock register, etc.

All sales made during the period were recorded and there is no understatement or overstatement. - (COMPLETENESS)

1. Perform *cut-off procedures* to ensure that revenues are recognised in the current accounting **period**.
    - Cut-off errors will usually arise when companies recognise revenue based on the date on which the sales invoices are generated rather than the date on which the risks and rewards are transferred to the buyer.
2. Auditors should verify the *credit notes* issued after the accounting period.
    - Sometimes sales team or sales personnel can make fictitious sales before the year-end to meet performance target and cancel out those sales with a post year end credit note.
3. *Trace* from the *shipping documents* to the sales journal.
4. Check whether *quantity* is appearing in sales *register* or not.
5. Check *reconciliation* of total sales/goods dispatched as per stock records and financial records and statutory records like GST.
6. Review *GST tax and GST returns* and ensure that the same are reconciled with revenue reported in the profit and loss account.
7. Verify the *reasonableness* of *GST* by applying the applicable rate to the gross sales value and compare the amount of GST as per statutory returns and analyze the reasons for variance, if any.

All sales are accurately measured as per applicable accounting standards and correctly journalized, summarized, and posted (MEASUREMENT)

1. Trace a *few transactions* from *inception* to *completion*. (Examination in depth)
    - E.g: Take few sales transaction, and check from the receipt of sales order to the payment of receivable balance, every underlying document to ensure if it is properly recorded at every stage and measured accurately taking into consideration all the incentives, discounts, if any. The recognition shall be according to the revenue recognition policy of the entity.
2. If the client is engaged in *export* sales, then *compliance* with *AS 11* shall be ensured.

3. Auditors must *understand* the client's *operations* and related *GAAP* issues e.g. point of sale revenue recognition vs. percentage of completion, wherever applicable.
4. *Compare* the *rate* of sales affected with *related parties* and review them for collectability, as well as whether they were properly *authorized* and the value of such transactions were reasonable and at *arm's length*.

Required DISCLOSURE for sales have been appropriately made

Ensure whether the following disclosures as required under Schedule III (Part II) to Companies Act, 2013 have been made:

A) **In respect of a company other than a finance company**, revenue from operations shall disclose separately in the notes revenue from—
   (a) Sale of products;
   (b) Sale of services;
   (ba) Grants or donations received (relevant in case of section 8 companies only)]
   (c) Other operating revenues;
   Less: Excise duty.

B) **In respect of a finance company**, revenue from operations shall include revenue from—
   (a) Interest; and
   (b) Other financial services.

C) Brokerage and discount on sales other than usual trade discount to be disclosed separately

D) Transactions with related parties to be disclosed appropriately in notes to accounts.

Audit of Other Income comprising interest income, dividend income, Gain/ Loss on sale of investments etc.

Recognition of Income

Interest income

Interest income on fixed deposits is recognized on a *time proportion basis* taking into account the amount outstanding and the applicable interest rate.

Dividend

Dividends are recognised in the statement of profit and loss *only* when:

i. the entity's *right* to *receive* payment of the dividend is *established*;
ii. it is probable that the economic *benefits* associated with the dividend will *flow* to the entity; and
iii. the *amount* of the dividend can be measured *reliably*.

Gain/(loss) on sale of investment

Gain/(loss) on sale of investment in mutual funds is recorded as other income on *transfer* of title from the entity and is determined as the *difference* between the *redemption* price and *carrying* value of the investments.

Assertions to be examined

- **Occurrence**- Recorded other income was earned during the Period
- **Completeness** - Other income earned during the period was appropriately recorded and there is no understatement or overstatement.
- **Measurement**- Other income has been measured appropriately as per the applicable accounting standards
- **Presentation and Disclosure** - Required disclosure for other income have been appropriately made

Audit procedures for verifying interest income on FD

- Obtain a *listing* of *fixed deposits* opened during the period under audit along with the applicable interest rate and the number of days for which the deposit was outstanding during the period.
- Verify the *arithmetical accuracy* of the interest calculation made by the entity by recomputing i.e. multiplying the deposit amount with the applicable rate and number of days during the period under audit.
- For *deposits* still *outstanding* as at the period- end, trace the same to the *direct confirmations* obtained from the respective bank/ financial institution.

- Obtain a *confirmation* of *interest* income from the *bank* and verify that the *interest* income *as* per *bank reconciles* to the *calculation* shared *by* the *entity*.
- Obtain a copy of *Form 26AS* (TDS withholding by the bank/ financial institution) and *reconcile* the *interest* reflected therein to the *calculation* shared *by client*.

Audit procedures for verifying Dividend Income

- Verify that the dividends are *recognised* in the statement of profit and loss *only when* the entity's *right* to *receive* payment of the dividend is *established*, provided it is probable that the economic *benefits* associated with the dividend will *flow* to the entity; and the *amount* of the dividend can be measured *reliably*.

Audit procedures for verifying Gain/(loss) on sale of investment in mutual funds

- Verify that *Gain/(loss)* on sale of *investment* in *mutual funds* is *recorded* as other income *only* on
  - *transfer* of title from the entity AND
  - is *determined* as the *difference* between the *redemption* price and *carrying* value of the Investments.
- For the purpose, *obtain* the *mutual fund statement* and trace the gain / loss as recorded in the *books* of account to the gain/ loss as reflected in the *statement*

Disclosure requirements of Schedule III

Classification of Other Income

'Other income' has been classified as:

a) Interest Income (in case of a company other than a finance company);
b) Dividend Income;
c) Net gain/loss on sale of investments;
d) Other non-operating income (net of expenses directly attributable to such income)

Undisclosed income

The Company shall give details of any transaction not recorded in the books of accounts that has been surrendered or disclosed as income during the year in the tax assessments under the Income Tax Act, 1961 (such as, search or survey or any other relevant provisions of the Income Tax Act, 1961), unless there is immunity for disclosure under any scheme and also shall state whether the previously unrecorded income and related assets have been properly recorded in the books of account during the year.

Audit of Purchases

Purchases and disbursement cycle

- Purchases and disbursement cycle in a business refers to the set of processes that begin when an order for buying goods or services is placed based on requirements of the production/ user department and ends when the entity receives the product and makes complete payment to the vendor.

Test Purchases and Controls

- As part of the year-end audit of an entity's FS, auditors test purchase transactions and the internal controls over those transactions to ensure that the entity is not materially misstating its purchases or accounts payables.

Clear understanding about organisation and production centres.

- Auditor needs to obtain a clear understanding about the organisation and its production centres
- Example, Type of services or products they procure that are used in the production/ rendering of services, sources of procurement whether domestic or overseas, general availability and terms and conditions of purchase of the service or products, major vendors, credit period, quality checks, purchase terms (Credit or cash purchase) etc.

Understanding of Controls

- An auditor needs to identify the control points over purchases.

- Example
  - whether segregation of duties exist, whether competitive quotes are invited,
  - whether a purchase committee exists who authorises purchase price, issues and authorizes purchase orders,
  - when and how the goods are received and acknowledged,
  - who checks the quality, quantity and specifications of the goods received and prepares Goods Receipt Note (GRN),
  - who approves the vendor invoice,
  - whether a 2 way/ 3 way match process exists (i.e. tally between purchase order, GRN and vendor invoice),
  - how the purchases have been recognised in the system.

Test of controls/ Strength and Reliability

- An auditor tests the controls the entity has set up for the purchase cycle to determine whether they are effective or not. If the controls are effective, the auditor can reduce the extent of substantive testing.
- The auditor selects a random sample of transactions and examines the related purchase orders, GRN, purchase invoices, inward gate entry register and vendor reconciliation/ statements.

Performing substantive audit procedures

- Performing substantive audit procedures is a must.
- Substantive analytical procedure will consist of purchase trend analysis, comparison with previous accounting period, category wise purchases, any analysis auditor may find relevant and most important of all setting a purchase expectation in relation to the sales made during the period under audit and compare that with the client's purchase records.
- Example
  - The auditor would need to know the purchase prices of the products or services over the year, monthly average purchase price per product or service etc. E.g: If the purchase price is 100 and if 15000 units were received under multiple orders during the year, the auditor expects the purchases to be 15,00,000. If there is a variance in the amount recorded in the books, he shall check for additional details like discounts received, change of purchase price for few orders due to excess demand etc.

Audit Procedures for Recorded purchases represent goods actually received/ services availed during the period (OCCURRENCE)

Ensure purchases are not understated/ overstated by performing following audit procedures:

1. Whether any ***fictitious vendors*** have been booked or purchases have been recorded by ***reviewing*** the ***vendor selection process*** followed by the entity and also performing procedures to ***ensure existence*** of the vendors.
2. Whether the goods were ***received*** at the ***factory gate*** and whether there ***exists*** an ***entry*** in the ***security gate*** inward register
3. Whether ***quality inspection*** of goods was done.
4. Whether a ***goods receipt note*** was ***prepared*** and ***signed*** by an appropriate client personnel.
5. Whether the purchase ***invoice*** was ***approved*** as per delegation of authority and whether a 3 or 2-way match was done.
6. Whether the stock ***record*** has been ***updated*** by the ***authorised personnel***.

Special considerations during audit of purchases

1. The purchase invoice received should be the ***"Original" copy*** (and not photocopy/ carbon copy) against which the entity has recorded the purchase in its books of account.
2. Purchase invoice should have been ***booked*** only once ***risk*** and ***reward*** incidental to ownership has been transferred to the entity.
3. Purchase ***invoice*** should be in the ***name*** of ***entity***. However, in case of different ***branches***, it should be ***addressed*** to the ***appropriate branch***.

4. *Input tax* component should have been booked in the input tax ledger. The auditor should obtain tax returns filed with the authorities and *tally* the *input tax* as reflected in the *books* to the amount *disclosed* in the *returns*.
5. In case of purchases made from *related parties* or allied and associated concerns, the auditor needs to verify if requisite *approval* from Board of Directors (appropriate authority) has been obtained and should verify the selected samples and perform analytical procedures in relation to *price* of goods to confirm that the price charged is at arm's length.
6. The auditor should *review whether purchases should be capitalized* or *expensed off* in Statement of Profit and loss according to his professional judgement.
7. Review *journal entries* for unusual transactions.

Audit Procedures For

- All purchases made during the period were recorded and there in no understatement or overstatement. **(COMPLETENESS)**
- All purchases have been measured appropriately **(MEASUREMENT)**

In addition to the procedures for establishing occurrence of purchases as discussed above, the auditor should:

1. Perform *cut-off test* to ensure that purchases are recognised in the correct accounting period. For the purpose, the auditor should examine material inward records, say, last 5 transactions at the period end to check that all corresponding invoices have been duly entered in the Purchases book and none have been omitted.
2. Ensure correct accounting treatment of *goods – in – transit* as per the agreed terms with the vendor regarding transfer of risk and reward of ownership in goods.
3. Obtain *written representation* from the management that *all* the *purchases* that took place during the year have been *properly recorded* in the books.
4. Perform *analytical procedures* to obtain audit evidence as to overall reasonableness of *purchase quantity* and price which may include:
    - *Consumption Analysis*: Auditor should *scrutinize raw material consumed* as per manufacturing account and *compare* the same with *previous years* with closing stock and ask for the *reasons* from the management, if any significant *variations* are found.
    - *Stock Composition Analysis:* Auditor to collect the reports from management for composition of stock i.e. *raw materials* as a *percentage* of *total stock* and *compare* the same with *previous year* and ask for *reasons* from management in case of significant *variations*.
    - Ratios: Auditor should compare the *creditors turnover ratios* and *stock turnover ratios* of the *current year* with *previous years*.
    - Auditor should review quantitative reconciliation of closing stocks with opening stock, purchases and consumption.

Required DISCLOSURES for purchases have been appropriately made

Ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made:

- Whether purchases of stock-in-trade have been specifically disclosed.
- Whether changes in inventories of finished goods, stock–in-trade and work- in-progress have been specifically disclosed.
- Whether the transactions with related parties are appropriately disclosed in notes to accounts.

Audit of Employee Benefits Expenses

Obtaining an understanding as to hiring, appraisal and retirement process

- *Tests* the *controls* the entity has set around the employee benefit payment process to determine how effective they are. If they are *effective*, the auditor can *reduce* the *substantive testing*. Common internal controls over the employee benefit payment cycle includes
    - maintaining of attendance records,

- employee master,
- authorisation and approval of monthly payroll processing and disbursement,
- computation of employee deductions like payroll taxes,
- accrual of other benefits like gratuity,
- leave encashment, bonus etc.

- The auditor ***selects*** a ***random sample*** of transactions and examines the related appointment letters, appraisal letters, attendance records, HR policies, employee master etc.
- Performing substantive audit procedures is a must. Substantive ***analytical procedure*** will consist of
  - monthly expense ***reasonability***,
  - ***comparison*** with previous accounting period,
  - setting an ***expectation*** in relation to the expense incurred during the period under audit and comparing that with the client's business operations and overall trend in the industry.

Assertions to be Examined

- **Occurrence**- Recorded employee benefit expenses were actually incurred during the period
- **Completeness** - Employee benefit expenses pertaining to the period have been recorded appropriately
- **Measurement** - Employee benefit expenses have been measured appropriately. There is no understatement or overstatement.
- **Presentation and Disclosure** - Required disclosures for employee benefit expenses have been appropriately made

Audit Procedures

- Obtain an ***understanding*** of the entity's ***process*** of capturing employee attendance.
  - There is always a risk that an entity could record expense for fictitious employees. To address this risk, the auditor may choose to meet the employees in person, on a sample basis. Further, the auditor may choose to select a sample of employees and ask the payroll department to share their bank details/ identity proofs of the employees.
- Obtain a ***list*** of ***employees*** as at the period- end along with a monthly movement ***split*** between ***new*** hires, ***leavers*** and ***continuing*** employees.
- Select sample on random basis of ***new hires***, obtain the ***appointment letter*** and verify whether the ***salary*** for first month and subsequent months was ***processed*** as per the agreed terms.
- Select sample on random basis of ***resigned employees***, obtain their ***full*** and ***final computation*** and verify whether ***all*** their ***dues*** including post-retirement benefits like gratuity, leave encashment have been ***paid*** and whether the respective employee's ***acknowledgement*** on final computation has been ***obtained***.
- Obtain the ***monthly salary registers*** for ***all 12 months***.
  - Calculate the average salary per employee per month and compare with the PY and preceding month and analyse the reasons for variance which could be attributable to annual increments, an employee at senior level joining/ leaving the entity, bonus pay-out etc.
- Verify if accrual/ ***provision*** has been made for all employee benefits and obligations like bonus, gratuity, leave encashment, etc.
- In ***case provident fund*** (PF), employee state insurance (ESI) are ***applicable*** to the entity, compile a ***reasonability*** by applying the rate to the basic wages and comparing to the amount recorded in books and analyse reasons for variance, if any. Also, obtain monthly deposit challans to verify if the month on month liability was subsequently deposited with the authorities and within the specified timelines.
- Perform ***analytical procedures*** to obtain audit evidence as to overall ***reasonableness*** of employee benefit expenses.
  - Auditor should analyse units produced per employee and compare the same with previous years and present industry trends and ask for the reasons from the management, if any significant variations are found.

Required DISCLOSURES for employee benefit expenses have been appropriately made

Ensure whether employee benefit expenses has been classified as:

a) salaries and wages,
b) contribution to provident and other funds,
c) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP),
d) staff welfare expenses

Audit of Depreciation and Amortisation

Meaning

- An asset's cost should proportionally be expensed based on the period over which the asset is expected to be used. It is done through depreciation and amortization.
- Depreciation represents systematic allocation of the depreciable value of an item of *PPE* over its useful life while.
- Amortisation represents systematic allocation of the depreciable amount of an *intangible asset* over its useful life.

Attributes auditor needs to consider while verifying Depreciation and amortisation expense.

Auditor needs to consider the following attributes while verifying for depreciation and amortisation expenses:

- Obtain the *understanding* of entity's *accounting policy* related to depreciation and amortisation.
- Ensure the Company *policy* for *charging depreciation* and *amortisation* is as per the relevant provisions of *Companies Act/ applicable accounting standards.*
- The accounting policy has been *applied consistently* year on year.
- Any *change* in the accounting policy has been *adequately disclosed*.
- Whether the *depreciation* has been *calculated* after making adjustment of *residual value* from the cost of the assets.
- Whether depreciation and amortisation charges are *valid*.
- Whether depreciation and amortisation charges are *accurately calculated* and *recorded*.
- Whether all depreciation and amortisation charges are recorded in the *appropriate period*.
- Ensure the *parts* (components) of each item of property, plant and equipment that are to be *depreciated* separately have been *properly identified*.
- Whether the *most appropriate depreciation method* for each separately depreciable component has been used.

Assertions to be examined

- **Occurrence**- Recorded depreciation and amortisation expenses were actually incurred during the period
- **Completeness** - Depreciation and amortization expenses pertaining to the period have been recorded appropriately and there is no understatement/overstatement
- **Measurement** -Depreciation and amortisation expenses have been measured appropriately.
- **Presentation and Disclosure -** Required disclosures for depreciation and amortisation have been appropriately made

Audit Procedures

1. Obtain an *understanding* of entity's *process* of charging depreciation and amortization.
2. Obtain the *fixed asset register* maintained by the entity.
    - There is always a risk that an entity could capitalize expense of revenue nature to increase its profit or charge capital expenditure directly in income and expense statement to reduce its profit. To address this risk, the auditor may choose to check the nature of asset from fixed asset register.
    - There is always a risk that a fake asset has been capitalized in the books and to mitigate this risk, auditors should physically verify the fixed assets, at least the ones that are material in value. Obtain a list of all additions/ deletions along with their proper approval from the authorised person for the same.
3. *Select* the *sample* of assets from the Fixed Assets Register, on *materiality* considerations and verify the *rates* of depreciation and depreciation *calculations*.

4. Ensure Intangible assets like patents, goodwill, copy rights have been *properly amortized* over the period.
5. Ensure depreciation is charged on the assets from the date when it is *ready to use* and not from the date of actual usage
6. Ensure depreciation on *revalued* amount has been *properly accounted* for from revaluation reserve.
7. Depreciation computation as per *Income tax Act*, 1961- Ensure that additions are *tallying* with the *additions* as per *Companies Act* and the opening WDV to the Tax audit schedule for the assessment year preceding the previous year under audit.
8. Perform *analytical procedures* to obtain audit evidence as to *overall reasonableness* of *depreciation* and *amortisation* expense - check the arithmetical accuracy of records and perform independent calculations.
9. Ensure that the depreciation and amortization has been *charged* as per the *useful lives* of PPE and intangible assets.
10. Ensure that *residual values* have been properly verified as that impacts the computation of depreciation.
11. Ensure that the depreciation and amortization has been computed *prospectively whenever there is any change in useful lives of PPE and intangible assets*.

Required disclosures for depreciation and amortisation have been appropriately made

Ensure whether the following disclosures as required have been made:

- Accounting policy for depreciation and amortization.
- Useful lives of assets as per Schedule II to the Companies Act, 2013.
- Residual value of assets.
- Depreciation method.

Audit of Other Expenses like Power and Fuel, Rent, Repair to Building, Plant and Machinery, Insurance, Travelling, Legal and Professional, Miscellaneous Expenses

Attributes to be examined while vouching expenses

- Whether the expenditure was in relation to the entity's business and *not a personal expenditure*. (Occurrence)
- Whether the expenditure had a *valid supporting documents* like travel tickets, insurance policy, third party invoice etc.; - (Accuracy & Completeness)
- Whether the expenditure pertained to current *period under audit*; (Cut-off)
- Whether the expenditure qualified as a *revenue* and *not capital* expenditure; - (Classification)
- Whether the expenditure has been *classified* under the *correct expense head*;
- Whether the expenditure was authorised as per the delegation of authority matrix; (Internal Control)

Audit procedures for Rent expense

- Obtain a *month wise expense schedule* along with the *rent agreements*.
- Examine whether expense has been *recorded* for all 12 months and whether the rent paid is as per the underlying agreement.
- Examine whether the agreement contains any *escalation clause* and if yes, verify whether the rent has been *increased* or adjusted during the period only as per escalation clause.
- Verify whether the *agreement* is in the *name* of the *entity*
- Verify whether the *expense* pertains to *premises* used for running *business* operations of the entity.

Audit procedures for Power and fuel expense

- Obtain a *month wise expense schedule* along with the power bills.
- Verify whether the expenses have been *recorded* for *all 12 months*.
- Compile a *month wise summary* of *power units consumed* and the applicable rate and *check* the *arithmetical accuracy* of the bill raised on a monthly basis.
- Analyse the *monthly power units* consumed by linking it to units of *finished goods produced* and *investigate* reasons for variance in monthly trends.

Audit procedures for Insurance expense

- Obtain a summary of insurance policies taken along with their *validity* period.
- Verify whether the expense has been *correctly classified* between *prepaid* and *expense* for the *period* based on the number of days.

Audit procedures for Legal and professional expenses

- Obtain a *month-wise* and *consultant*-wise *summary*.
- In case of *monthly retainership* agreements, verify whether the expenditure for *all 12 months* has been recorded correctly.
- For *non- recurring* expenses, select a sample and *vouch* for the *attributes* discussed above.
- The auditor should be *cautious* while vouching for legal expenses as the same may highlight a *dispute* for which the entity may *not* have *made* any *provision* and the *matter* may also *not* have been *discussed/ highlighted* to the auditor for his *specific consideration*.

Audit procedures for Travel, repair and maintenance, printing and stationery, miscellaneous expenses

- The auditor should select a *sample* and *vouch* for the *attributes* discussed above.
- Wherever possible, the auditor should try to prepare a *summary* of expenditure on a *monthly* basis and then *analytically compare* the *trends*.
- Perform analytical procedures to obtain audit evidence as to overall *reasonableness* of other expense which may include *expenditure per unit* of *production* analysis.
- Auditor should analyse expenses per unit produced and *compare* the same with *previous years* and *present industry trends* and ask for the *reasons* from the management, if any *significant variations* are noticed.

Required DISCLOSURE for other expenses have been appropriately made

Ensure other expense have been classified under:

- Rent.
- Insurance.
- Power and fuel.
- Repairs and maintenance- Building, Plant and machinery, others.
- Legal and professional.
- Printing and stationary.
- Travel expenses.
- Miscellaneous expenses.

Other Points

Details of Benami Property held

Where any proceedings have been initiated or pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and the rules made thereunder, the company shall disclose the following:-

a. *Details* of such property, including year of acquisition,
b. *Amount* thereof,
c. Details of *Beneficiaries*,
d. If property is in the books, then *reference* to the item in the Balance Sheet,
e. If property is *not* in the books, then the *fact* shall be *stated* with reasons,
f. Where there are *proceedings* against the company under this law as an abetter of the transaction or as the transferor then the *details* shall be provided,
g. *Nature* of proceedings, *status* of same and company's view on same.

Details of Crypto Currency or Virtual Currency

Where the Company has traded or invested in Crypto currency or Virtual Currency during the financial year, the following shall be disclosed:-

a. *profit* or *loss* on transactions involving Crypto currency or Virtual Currency

b. ***amount*** of ***currency*** held as at the reporting date,
c. ***deposits*** or ***advances*** from any person for the purpose of ***trading*** or ***investing*** in Crypto Currency/ virtual currency.

Following Ratios to be disclosed

a. Current Ratio,	b. Debt-Equity Ratio	c. Debt Service Coverage Ratio,
d. Return on Equity Ratio,	e. Inventory turnover ratio,	f. Trade Receivables turnover ratio,
g. Trade payables turnover ratio,	h. Net capital turnover ratio,	i. Net profit ratio,
j. Return on Capital employed,	k. Return on investment.	

The company shall explain the items included in numerator and denominator for computing the above ratios. Further explanation shall be provided for any change in the ratio by more than 25% as compared to the preceding year.

Corporate Social Responsibility (CSR)

Where the company covered under section 135 of the companies act, the following shall be disclosed with regard to CSR activities:-

a. ***amount required*** to be spent by the company during the year,
b. ***amount*** of expenditure ***incurred***,
c. ***shortfall*** at the end of the year,
d. ***total*** of ***previous years shortfall***,
e. ***reason*** for shortfall,
f. ***nature*** of CSR activities,
g. details of ***related party transactions***, e.g., contribution to a trust controlled by the company in relation to CSR expenditure as per relevant Accounting Standard,
h. where a ***provision*** is made with respect to a liability incurred by entering into a contractual obligation, the movements in the provision during the year should be shown separately.

Relationship with Struck off Companies

Where the company has any transactions with companies struck off under section 248 of the Companies Act, 2013 or section 560 of Companies Act, 1956, the Company shall disclose the following details:-

Name of struck off Company	Nature of transactions with struck off Company	Balance outstanding	Relationship with the Struck off company, if any, to be disclosed
	Investments in securities		
	Receivables		
	Payables		
	Shares held by stuck off company		
	Other outstanding balances (to be specified)		

Chapter 6 - Audit Documentation

SA 230 - Audit Documentation

Definition of Audit Documentation:

- Audit Documentation refers to the record of
  - audit procedures ***performed***
  - relevant audit evidence ***obtained***, and
  - conclusions the auditor ***reached***.
- Terms such as "working papers" or "work papers" are also sometimes used.

Objective of the Auditor

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

a) A ***sufficient*** and ***appropriate*** record of the basis for the auditor's report; and
b) ***Evidence*** that the ***audit*** was ***planned*** and ***performed*** in accordance with ***SAs*** and applicable legal and regulatory requirements

Nature of Audit Documentation

Audit documentation provides

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

Purpose of Audit Documentation

The following are the purpose of Audit documentation:

1. Assisting the engagement team to ***plan*** and ***perform*** the audit.
2. Assisting members of the engagement team to ***direct*** and ***supervise*** the audit work, and to discharge their ***review*** responsibilities.
3. Enabling the engagement team to be ***accountable*** for its work.
4. Retaining a record of matters of continuing ***significance*** to ***future audits***.
5. Enabling the conduct of ***quality control reviews*** and inspections in accordance with ***SQC 1***.
6. Enabling the conduct of ***external inspections*** in accordance with applicable legal, regulatory or other requirements.

Form, Content and Extent of Audit Documentation

The auditor shall prepare audit documentation that is sufficient to enable an ***experienced auditor*** to understand.

a) The ***n***ature, ***t***iming and ***e***xtent of the audit procedures:
b) The ***results*** of the ***a***udit ***p***rocedures performed, and the ***a***udit ***e***vidence obtained; and
c) ***Significant matters*** arising during the audit and the ***conclusions*** reached thereon,significant professional ***judgements*** made in reaching those conclusions

Invoice no., date, amt were recorded

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

- The ***identifying characteristics*** of the specific items or matters tested. (Assertions tested)
- ***Who performed*** the audit work and the ***date*** such work was completed; and
- ***Who reviewed*** the audit work performed and the ***date*** and ***extent*** of such review.

Audit team member A performed this work → it was completed on 15th Oct.
Senior auditor B reviewed & completed on 20th Oct., review focused on specific points.

The auditor shall document ***discussions*** of ***significant matters*** with management, those charged with governance, and others, including the ***nature*** of the significant matters discussed and ***when*** and with ***whom*** the discussions took place.

If the auditor identified *information* that is *inconsistent* with the auditor's *final conclusion* regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency

Experience Auditor

- An *individual* (whether *internal* or *external* to the firm) who has *practical audit experience* and a reasonable understanding of:
  - *Audit processes*;
  - *SAs* and applicable legal and regulatory requirements;
  - The *business environment* in which the entity operates; and
  - *Auditing* and *financial reporting* issues relevant to the entity's industry.

Factors affecting form, contents and extent of audit documentation

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

1. The *size* and *complexity* of the entity. → MNC or local company
2. The *nature* of the *audit procedures* to be performed. → AEIOU, Reperform, External confirmation
3. The identified *risks* of material misstatement. → higher RoMM, more Documentation
4. The significance of the *audit evidence* obtained. → More imp. the AE, more detailed AD
5. The nature and extent of *exceptions* identified. → Mistatement or Deviation Material or not?
6. 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. → some Judgements are complex, such as accounting estimates or valuation Judgements. In these cases, the auditor needs to explain how and why they chose a particular conclusion.
7. The audit *methodology* and *tools* used. → Use of technology influences the form, extent of AD

Examples of Audit Documentation

- Audit Documentation include:
  - Audit programmes.
  - Analyses.
  - Issues memoranda.
  - Summaries of significant matters.
  - Letters of confirmation and representation.
  - Checklists.
  - Correspondence (including e-mail) concerning significant matters.
- Audit documentation is *not* a *substitute* for the entity's *accounting records*.
- The auditor *may* include *copies* of the *entity's records* (for example, significant and specific contracts and agreements) as part of audit documentation.
- The auditor need *not* include in audit documentation
  - *superseded drafts* of working papers and financial statements,
  - notes that reflect *incomplete* or *preliminary thinking*,
  - previous copies of documents corrected for *typographical* or other errors, and *duplicates* of documents.

Timely Preparation of Audit Documentation

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

Audit File

Audit file may be defined as

- *one* or *more folders* or other storage media,
- in *physical* or *electronic* form, containing the records that comprise

- the audit *documentation* for a specific engagement.

Assembly of the Final Audit File

- The auditor's shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a *timely basis* after the date of the auditor's report.
- SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", An appropriate time limit within which to complete the assembly of the final audit file is ordinarily *not more than 60 days after the date of the auditor's report*.
- The completion of the assembly of the final audit file after the date of the auditor's report is an *administrative process* that *does not involve the performance of new audit procedures* or the drawing of new conclusions.
- *Changes* may , however be made to the audit documentation during the final assembly process if they are *administrative* in nature. Examples of such changes include.
    - Deleting or discarding *superseded* documentation.
    - *Sorting, collating* and cross referencing working papers.
    - *Signing off* on completion checklists relating to the file assembly process.
    - *Documenting audit evidence* that the auditor has *obtained, discussed* and *agreed* with the relevant members of the engagement team before the date of the auditor's report.
- After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.

Retention

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

Documentation of Significant Matters and Related Significant Professional Judgements

Judging the significance of a matter requires an *objective analysis of the facts* and circumstances.

An important factor in determining the *form*, *content* and *extent of audit documentation of significant matters* is the extent of *professional judgement* exercised in performing the work and evaluating the results. Higher the professional judgement , High the extent of documentation involved.

Documentation of the professional judgements

- helps in explaining the auditor's conclusions and
- Helps to reinforce the quality of the judgement.
    - Reviewing audit documentation.
    - Carrying out subsequent audits.

Example of Significant matters → Significant matters are those that comes to light during an audit and which can influence the auditor's opinion or report

1. Results of audit procedures indicating financial statements could be materially misstated
2. Results of audit procedures indicating a need to revise the assessment of risk of material misstatement and the responses to the same.
3. Situation causing significant difficulty in applying audit procedures.
4. Evidence that could result in modification in the auditor' opinion
5. Evidence that could lead to inclusion of Emphasis of matter paragraph in auditor's report.

Some examples of circumstances in which it is appropriate to prepare audit documentation relating to the use of professional judgment where the matters and judgments are significant.

- The basis for the auditor's conclusion on the reasonableness of a specific areas which is subject to *judgement* (for example, the reasonableness of significant accounting estimates).

- The basis for the auditor's conclusions about the **authenticity** of a document when further investigation is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

Completion Memorandum or Audit Documentation Summary

The auditor may consider it helpful to prepare and retain as part of the audit documentation a **summary** (sometimes known as a completion memorandum) that describes-

- the **significant matters** identified during the audit and
- how they were **addressed**.
- Such a summary may **facilitate** effective and efficient **review** and **inspection** of the audit documentation, particularly for **large** and **complex audits.**
- It may also help the auditor to consider whether he is able to achieve the objectives of the **relevant individual SAs** and the **overall objective** of the audit

Ownership of Audit Documentation

Standard on Quality Control (SQC) 1 provides that,

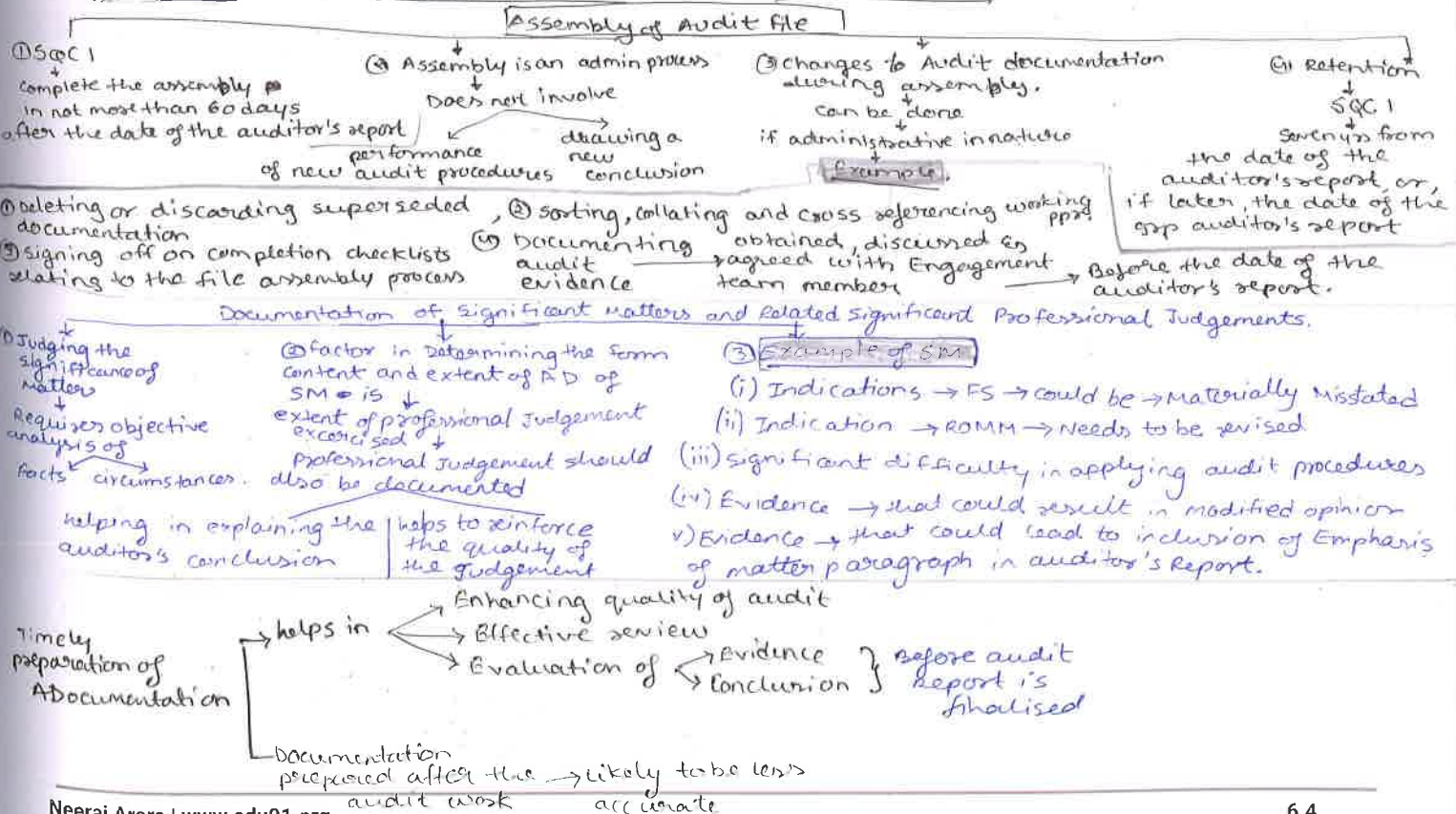
- unless otherwise specified by law or regulation,
- Audit documentation is the **property** of the **auditor**.

The auditor should adopt reasonable procedures for custody and confidentiality of his working papers.

He may at his **discretion**,

- make portions of, or extracts from, audit documentation available to **clients**,
- provided such disclosure does not **undermine** the **validity** of the work performed, or,
- in the case of assurance engagements, the **independence** of the auditor or of his personnel.

In the case of a company, the main auditor has to consider the report of the branch auditor and has a right to seek clarification and to visit the branch but cannot ask for the copy of working paper and therefore, the branch auditor is under no compulsion to give photocopies of his working paper to the principal auditor.



Chapter 7 - Completion And Review

SA 560 Subsequent Events

Basic

- SA 560, "Subsequent Events" deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements.
- SA 700 explains that the date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor becomes aware and that occurred up to that date.

Meaning of Subsequent Event

Subsequent Events

- Events occurring ***between*** the date of the ***f***inancial ***s***tatements ***and*** the date of the ***auditor's report***, and
- facts that become ***known*** to the auditor ***after*** the ***date*** of the ***auditor's report***
    - had they been known to the auditor at that date,
    - may have caused the auditor to amend the auditor's report.

Types of Subsequent Events

Type 1

Those events that provide additional evidence with respect to conditions that existed on the date of balance sheet and effect the estimation made in the preparation of the financial statements. The statement should be adjusted for any change in estimates resulting from the use of evidence of subsequent events.

For example

- Debtors as on balance sheet date are declared insolvent after the balance sheet date but before auditor's report
- Settlement of legal disputes before audit report date, which arose before balance sheet date.

Type 2

Those events which provide evidence with respect to conditions that did not exist on the date of the balance sheet being reported on but arose subsequent to the date. These events should not result in adjustments of the financial statements. Some of these events however may be of such a nature that disclosure of them is required to keep the financial statements from not being misleading.

For example

Purchase of business, Sale of shares and debentures, Loss of plant or inventory as a result of fire.

Objective of Auditor

- Obtain ***S***ufficient and ***A***ppropriate ***E***vidence about whether
    - events
        - occurring ***between*** the date of the ***f***inancial ***s***tatements ***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; and
- ***Respond appropriately***
    - to 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.

Audit Procedure Regarding Events Occurring between the Date of the Financial Statements and the Date of the Auditor's Report

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* and are *appropriately reflected* in those financial statements.

Risk assessment w.r.t Subsequent Event Shall Include

The auditor shall take into account the auditor's risk assessment which shall include the following:

- Obtaining an *understanding* of any procedures management has established to ensure that subsequent events are identified.
- *Inquiring* of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.
- Read the *minutes* of meeting of board of directors, executive committee, meeting of shareholders held after balance sheet date
- Read *latest interim financial statements*

Written Representations

The auditor shall request management and, where appropriate, those charged with governance, to provide a written representation 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

Meaning of "Date the financial statements are issued"

- It reflects the date that the auditor's report and audited financial statements are made *available to third parties*. The date the financial statements are issued generally depends on the regulatory environment of the entity.
- In some circumstances, the date the financial statements are issued may be the date that they are filed with a regulatory authority.
- Since audited financial statements cannot be issued without an auditor's report, the date that the audited financial statements are issued *must not only be at or later than the date of the auditor's report*, but must also be at or later than the date the auditor's report is provided to the entity

Facts Which Become Known To The Auditor After The Date Of The Auditor's Report But Before The Date The Financial Statements Are Issued

The auditor has *no obligation* 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
    - *Discuss* the matter with *management* and, where appropriate, those charged with governance.
    - *Determine* whether the financial statements need *amendment* and, if so,
    - *Inquire* how management intends to *address* the matter in the financial statements.

Management Amends

If 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 to the date of the *new auditor's report*
c. *Provide* a *new* auditor's *report* on the amended financial statements.

The new auditor's report shall not be dated earlier than the date of approval of the amended financial statements.

No Amendment By Management

When management *does not amend* the financial statements in circumstances where the auditor believes they need to be amended

- If the auditor's report has not yet been provided to the entity, the auditor shall *modify* the opinion as required by SA 705 and then *provide* the auditor's report or
- If the auditor's report has *already* been *provided* to the entity,
  - the auditor shall *notify* management and those charged with governance,
    - *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.

Facts Which Become Known to the Auditor After the Financial Statements have been Issued.

After the financial statements have been issued, the auditor has *no obligation* to perform any audit procedures regarding such financial statements.

- However, when, after the financial statements have been 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
    - *Discuss* the matter with management and, where appropriate, those charged with governance.
    - *Determine* whether the financial statements *need amendment* and, if so,
    - *Inquire* how management intends to *address* the matter in the financial statements.

Management Amends

If the management amends the financial statements, the auditor shall

a. *Carry* out the *audit procedures* necessary in the circumstances on the *amendment*.
b. Review the *steps* taken by *management* to *ensure* that *anyone* in *receipt* of the previously issued financial statements together with the auditor's report thereon is *informed* of the *situation*.
c. *Extend* the *audit procedures* to the date of the new auditor's report, and
d. Provide a *new auditor's report* on the amended financial statements.

Emphasis of Matter paragraph or Other Matter Paragraph

The auditor shall include in the new or amended 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.

No Steps by Management and No Amendments

If management

- does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation and
- does not amend the financial statements in circumstances where the auditor believes they need to be amended,

the auditor shall

- *notify* management and those charged with governance,
- that the auditor will *seek* to *prevent* future reliance on the auditor's report.
- If, despite such notification, management or those charged with governance do not take these necessary steps,

- the auditor shall take appropriate action to seek to prevent reliance on the auditor's report.

If laws and FRF permits management to restrict to the amendment of the financial statements to the effects of the subsequent events only, auditors focus only on specific statement amendments; otherwise, a broader approach is required.

Auditors may restrict audit procedures on subsequent event if laws and FRF allow specific financial statement amendments. In such a case

- Auditors should amend reports with an additional date, indicating that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements described in the relevant note to the financial statements or
- Auditors need to issue new or updated reports with Emphasis of matter paragraph stating that auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.

The broader approach -Auditors must update procedures until the new report's date, issue it post-approval of amended statements, and reflect changes therein.

SA 570 - Going Concern

Responsibility for assessment of the entity's ability to continue as a going concern

Management is required 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 future outcomes of events or conditions. Factors relevant for judgment about future outcomes of events or conditions are:

- The degree of uncertainty associated with the outcome of an event or condition.
- The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors.
- Information available at the time at which the judgment is made.

Responsibilities of the auditor

The auditor's responsibility is to

- obtain sufficient appropriate audit evidence
- about the appropriateness of management's use of the going concern assumption.

He shall consider

- whether there is a material uncertainty related to events and conditions
- that may cast significant doubt
- about the entity's ability to continue as a going concern.

Report in accordance with this SA

As per SA 200 The absence of any reference to going concern uncertainty in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

Risk assessment procedures and related activities

Consider events and conditions

The auditor shall remain alert as to whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.
In doing so, the auditor shall determine

- whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern.

- If done - Discuss with management.
- If not - Discuss with management the basis of use of going concern assumption.

Evaluating Management's Assessment

The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern and consider whether *all* relevant *information*, as known to auditor, is *included* in the assessment.

If management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the date of the financial statements, the auditor shall request management to extend its assessment period to at least twelve months from that date.

Period beyond Management's Assessment (Enquire Knowledge of Events or Condition)

The auditor shall inquire of management as to its knowledge of events or conditions beyond the period of management's assessment 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

When 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 perform procedures as follows:

- 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*.
- Evaluating *management's plans* for *future actions* in relation to its going concern assessment
- When the entity has prepared a *cash flow forecast*, then consider its reliability and also the underlying assumptions.
- Considering whether *any additional facts* or *information* have become available since the date on which management made its assessment.
- Requesting *written representations* from management or those charged with governance, regarding their plans for future action and the feasibility of these plans.

Examples of audit procedures when events or conditions have been identified that may cast significant doubt on the entity's ability to continue as going concern

- 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, those charged with governance and relevant committees for reference to financing difficulties
- *Inquiring* of the entity's *legal counsel* regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications
- *Confirming* the *existence*, *legality* and *enforceability* of *arrangements* to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds
- Evaluating the entity's *plans* to deal with *unfilled customer orders*
- *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*
- Obtaining and reviewing *reports* of *regulatory actions*
- Determining the adequacy of support for any *planned disposals of assets*

Examples of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern

Financial events or conditions

- Net liability or net current liability position

- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets
- Indications of withdrawal of financial support by creditors
- Negative operating cash flows indicated by historical or prospective financial statements
- Adverse key financial ratios
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows
- Arrears or discontinuance of dividends
- Inability to pay creditors on due dates
- Inability to comply with the terms of loan agreements
- Change from credit to cash-on-delivery transactions with suppliers
- Inability to obtain financing for essential new product development or other essential investments

Operating events or conditions

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

Other events or conditions

- Non-compliance with capital or other statutory or regulatory requirements, such as solvency or liquidity requirements for financial institutions
- 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
- Changes in law or regulation or government policy expected to adversely affect the entity
- Uninsured or underinsured catastrophes when they occur

Auditor Conclusions

Appropriateness of management's use of the going concern

The auditor shall evaluate whether sufficient appropriate audit evidence has been obtained regarding, and shall conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements.

Existence of Material Uncertainty

Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor's judgment, a material uncertainty exists related to events or conditions that, individually or collectively, may ***cast*** ***significant*** ***doubt*** on the ***entity's*** ***ability*** to ***continue*** as a ***going concern***.

Material Uncertainty

A material uncertainty exists when the

- ***magnitude*** of its potential impact and
- ***likelihood*** of occurrence
- is such that,
- in the auditor's ***judgment***,
- ***appropriate*** ***disclosure*** of the ***nature*** and ***implications*** of the uncertainty is ***necessary*** as per the AFRF.

Implications for the Auditor's Report

Use of Going Concern Basis of Accounting Is NOT Appropriate

If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is ***inappropriate***, the auditor shall express an ***adverse*** opinion.

Use of Going Concern Basis of Accounting Is Appropriate but a Material Uncertainty Exists

Adequacy of disclosures when events or conditions have been identified and a material uncertainty exists

If the auditor concludes that management's use of the going concern basis of accounting is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements: -

a) Adequately *disclose* the principal *events or conditions* 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 events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it *may* be *unable* to *realize* its *assets* and *discharge* its *liabilities* in the *normal course* of business.

Adequate Disclosure of a Material Uncertainty Is Made in the Financial Statements

If adequate disclosure about the *material uncertainty* 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 that discloses the matters.
    - *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 the auditor's *opinion* is *not modified* in respect of the matter.

Adequate Disclosure of a Material Uncertainty Is Not Made in the Financial Statements

If adequate disclosure about the *material uncertainty* is *not made* in the financial statements,

- the auditor shall Express a *qualified* opinion or *adverse* opinion, as appropriate, in accordance with SA 705
- In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that
- a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and
- that the financial statements *do not adequately disclose this matter*.

Adequacy of Disclosures When Events or Conditions Have Been Identified but No Material Uncertainty Exists

The auditor shall *evaluate whether,* in view of the requirements of the applicable financial reporting framework, the financial statements *provide adequate disclosures* about these events or conditions.

Management Unwilling to Make or Extend Its Assessment

If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor shall consider the *implications* for the auditor's *report*.

Significant Delay in the Approval of Financial Statements

If there is significant delay in the approval of the financial statements by management or those charged with governance after the date of the financial statements,

- the auditor shall *inquire* as to the *reasons* for the delay.
- If the auditor believes that the delay could be related to
    - events or conditions relating to the going concern assessment,
        - The auditor shall *perform* those *additional audit procedures* (as discussed under the heading - Additional audit procedures when events or conditions are identified) necessary,
        - as well as *consider* the *effect* on the auditor's *conclusion* regarding the existence of a material uncertainty.

SA 450 - Evaluation of misstatements identified during the audit

Objective

The *objective* of the auditor is to evaluate:

- The *effect* of *identified misstatements* on the audit; and

- The *effect* of *uncorrected misstatements*, if any, on the financial statements.

Definitions

Misstatement

A *difference* between the amounts, classification, presentation, or disclosure of a *reported* financial statement item and the amount, classification, presentation, or disclosure that is *required* for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from *error* or *fraud*.

Misstatements may result from:

- An inaccuracy in gathering or processing data from which the financial statements are prepared;
- An omission of an amount or disclosure;
- An incorrect accounting estimate arising from overlooking, or clear misinterpretation of, facts; and
- Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

To assist the auditor in evaluating the effect of misstatements accumulated during the audit and in communicating misstatements to management and those charged with governance, it may be useful to distinguish between factual misstatements, judgmental misstatements and projected misstatements.

- Factual misstatements are misstatements about which there is no doubt.
- Judgmental misstatements are differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate.
- Projected misstatements are the auditor's *best estimate* of *misstatements* in *populations*, involving the *projection* of *misstatements* identified in audit samples to the *entire populations* from which the samples were drawn. Guidance on the determination of projected misstatements and evaluation of the results is set out in SA 530.

Uncorrected misstatements

Misstatements that the auditor has *accumulated* during the audit and that have *not been corrected*.

Requirements

Accumulation of Identified Misstatements

The auditor shall *accumulate misstatements* identified during the audit, other than those that are clearly trivial.

Consideration of Identified Misstatements as the Audit Progresses

The auditor shall determine whether the overall audit *strategy* and audit *plan* need to be *revised* if:

- The *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.

Communication and Correction of Misstatements

- The auditor shall *communicate* on a *timely* basis all misstatements accumulated during the audit with the appropriate level of *management*, unless prohibited by law or regulation.
- The auditor shall *request* management to *correct* those misstatements.
- 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*.
- 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.

Evaluating the Effect of Uncorrected Misstatements

- Prior to evaluating the effect of uncorrected misstatements, the auditor shall *reassess materiality* determined in accordance with SA 320 to confirm *whether* it remains *appropriate* in the context of the entity's actual financial results.
- The auditor shall determine whether *uncorrected misstatements* are *material*, individually or in aggregate. In making this determination, the auditor shall consider
    - 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
    - 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.

Communication with Those Charged with Governance

- The auditor shall *communicate* with those charged with governance uncorrected misstatements and the *effect* that they, *individually* or in *aggregate*, may have on the *opinion* in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall *identify* material uncorrected misstatements *individually*. The auditor shall *request* that *uncorrected misstatements* be *corrected*.
- The auditor shall *also communicate* with those charged with governance 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.

Written Representation

The auditor shall request a written representation from *management* and, where *appropriate*, those charged with governance whether they *believe* the *effects* of *uncorrected misstatements* are *immaterial*, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation.

Documentation

The audit documentation shall include

- The amount below which misstatements would be regarded as *clearly trivial*;
- All *misstatements accumulated* during the audit and *whether* they have been *corrected*; and
- The *auditor's conclusion* as to whether *uncorrected misstatements* are *material*, individually or in aggregate, and the basis for that conclusion.

SA 580 Written Representation

Meaning

- A written representation is a
    - *written statement* by management provided to the auditor
    - to *confirm* certain matters or to *support* other audit evidence.
- Written representations in this context *do not include financial statements*, the *assertions* therein, or *supporting books and records*.

Written representations as audit evidence

- Similar to responses to inquiries, written representations are *audit evidence.*
- Although written representations provide necessary audit evidence they *do not provide sufficient appropriate audit evidence* on their own.
- The fact that management has provided reliable written representations does *not affect* the *nature* or *extent* of other audit *evidence* that the auditor obtains.

Objective of Auditor

The objectives of the auditor are:

a. To ***obtain***
   - written representations from management and, where appropriate, those charged with governance
   - 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;

b. To ***support***
   - ***other audit evidence*** relevant to the financial statements or specific assertions in the financial statements by means of written representations, and

c. To ***respond*** appropriately
   - to written representations provided or
   - Written representations requested by the auditor.

From Whom

- Auditors shall request written representations from ***management with appropriate responsibilities*** for the ***financial statements*** and ***knowledge*** of the ***matters*** concerned.
- People from whom written representation is to be requested may vary depending on the ***governance structure*** of the entity, and relevant ***law*** or ***regulations***; however, management (rather than TCWG) is often the responsible party.
- Written representations may therefore be requested from the entity's CEO and CFO, or other equivalent persons in entities that do not use such titles. In some circumstances , however, other parties, such as TCWG, are also responsible for the preparation and presentation of the financial statements.

Form of Written Representations

- The written representations shall be in the form of a ***representation letter addressed*** to the ***auditor***.
- If law or regulation requires management to make written public statements about its responsibilities, and the auditor determines that such statements provide representations as required by this SA regarding

Written representations about management's responsibilities

Written representation about management's responsibilities involves confirmation of fulfilment of management's responsibilities in following areas: -

Preparation of the financial statements

- Auditors must seek WR from management on their duty in ***responsibility*** for the ***preparation*** of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation.
- In some cases, management may include in the written representations qualifying language to the effect that representations are made to the ***best*** of ***its knowledge*** and belief.
  - It is reasonable for the auditor to accept such wording if the auditor is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.
- Auditors can ask management to confirm in written representations that appropriate inquiries were made for ***informed decision-making.***

Information provided and completeness of transactions

The auditor shall request management to provide a written representation that: -

a) It has ***provided*** the ***auditor*** with all relevant ***information*** and ***access*** as agreed in the terms of the audit engagement and

b) ***All transactions*** have been ***recorded*** and are ***reflected*** in the financial statements.

Why Written representations about management responsibilities necessary?

- Obtaining audit evidence on management's role in financial statement preparation and transaction completeness requires management's confirmation of fulfilling these responsibilities.
- The reason is that Auditors can't rely only on other audit evidence to judge if management prepared financial statements and provided the information as per their agreed and acknowledged responsibilities.
- For example, the auditor could not conclude that management has provided the auditor with all relevant information agreed in the terms of the audit engagement without asking it whether, and receiving confirmation that, such information has been provided.
- The auditor may also ask management to reconfirm its *acknowledgement* and *understanding* of those responsibilities in written representations.

This is particularly appropriate when: -

- Those *who signed* the *terms* of the audit engagement on behalf of the entity *no longer* have the *relevant responsibilities*;
- The *terms* of the audit engagement were prepared in a *previous year*;
- There is any *indication* that *management misunderstands* those *responsibilities*; or
- *Changes* in *circumstances* make it appropriate to do so.

Management's responsibilities shall be described in the "Written representations required about management responsibilities" in the manner in which these responsibilities are described in the terms of the audit engagement

Additional WR for deficiencies in Internal Control

In addition to WR provided to auditor regarding management responsibility, auditor may consider it necessary to request management to provide a WR that it has communicated to the auditor *all deficiencies* in internal *control* of which management is aware.

Written representations about specific assertions

In addition, the auditor may consider it necessary to request management to provide written representations about specific assertions in the financial statements to *support* an *understanding* that the auditor has obtained from other audit evidence of management's judgment or intent in relation to a specific assertion.

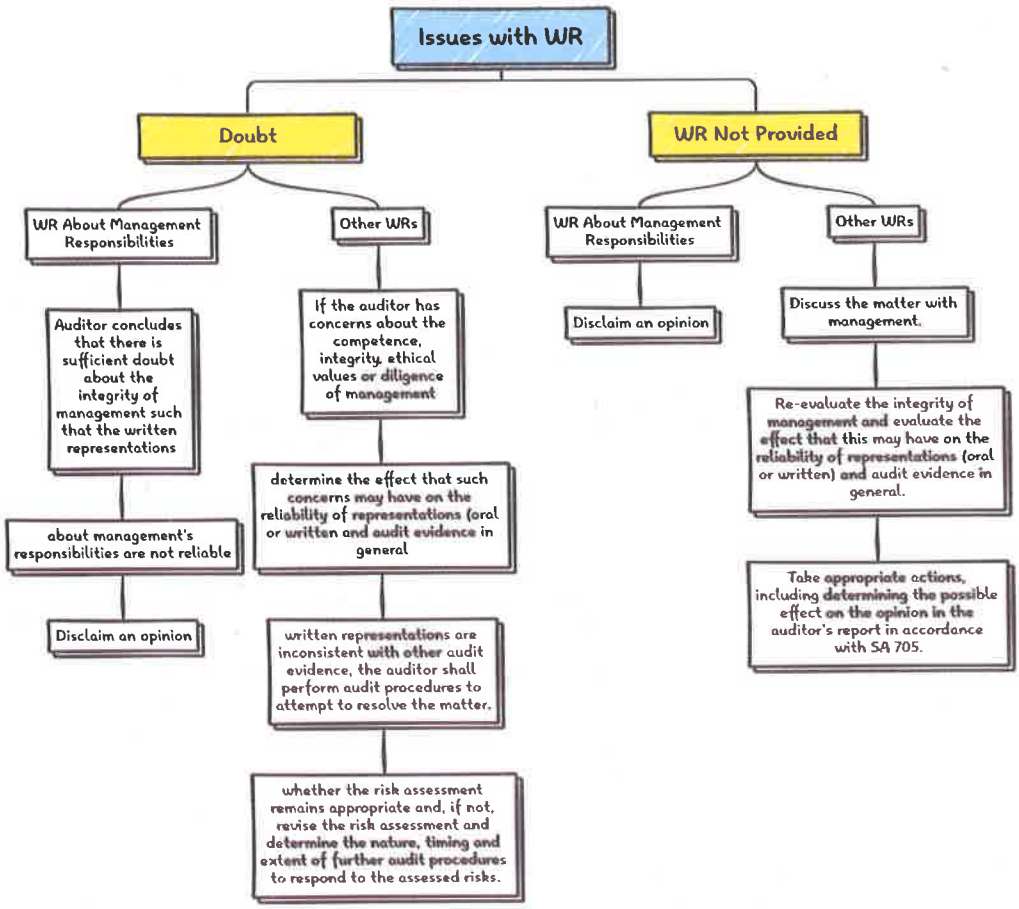
For example, Let us say The auditor needs to understand management's intentions to accurately value investments. When it comes to investments, their value can be significantly affected by the intentions of management regarding the holding period of the investment, plans to sell it, or to use it for some business operations. If an auditor cannot independently verify the intent of management through other means, they may require management to provide a written statement of their intentions regarding the investments. This representation serves as audit evidence and is part of the auditor's documentation.

Considerations while obtaining evidence about, or evaluating, judgments and intentions

- The entity's past history in carrying out its stated intentions.
- The entity's reasons for choosing a particular course of action.
- The entity's ability to pursue a specific course of action.
- The existence or lack of any other information that might have been obtained during the course of the audit that may be inconsistent with management's judgment or intent.

Date of and Period(s) Covered by Written Representations

- The date of the written representations shall be as *near as practicable* to, but *not after*, the date of the auditor's *report* on the financial statements.
- The written representations shall be for *all financial statements* and *period*(s) *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 of the written representations 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.



SA 260 Communication With Those Charged With Governance

Scope

This SA deals with Auditor's Responsibility to communicate with TCWG in an audit of financial statements

Role of Communication

There must be two way communication. This two-way communication is important in assisting (basically now we are going to discuss importance of two way communication)

1. ***Constructive working relationship*** and understanding the matters related to audit. This relationship is developed while maintaining auditor's Independence and objectivity.
2. The auditor in ***obtaining*** from those charged with governance ***information*** relevant to the audit. For example those charged with governance may assist the auditor in understanding the entity and its environment in identifying appropriate sources of audit evidence and in providing information about specific transactions or events.
3. Those charged with governance in fulfilling their ***responsibility*** to ***oversee*** the ***financial reporting*** process thereby reducing the risk of material misstatement of the financial statements.

Communication

With whom? IDENTIFY

- The auditor shall ***determine*** the appropriate person(s) within the entity's governance structure with whom to communicate.

Communication with a Subgroup of Those Charged with Governance

- If the auditor *communicates* with a *subgroup* of those charged with governance, for example, an audit committee, or an individual, the auditor shall *determine* whether the auditor also *needs* to communicate with the governing body.

When All of Those Charged with Governance Are Involved in Managing the Entity

- In some cases, all of those charged with governance are involved in managing the entity,
- For example, a small business where a single owner manages the entity and no one else has a governance role. In these cases, if matters required by this SA are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again with those same person(s) in their governance role.
- The auditor shall be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity.

Matters to Be Communicated

The Auditor's Responsibilities in Relation to the Financial Statement Audit

- The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that:
  - The auditor is responsible for *forming* and *expressing* an opinion on the financial statements that have been *prepared* by *management with* the *oversight* of those charged with governance; and
  - The audit of the financial statements *does not relieve management* or those charged with governance of their responsibilities.

Planned Scope and Timing of the Audit

- The auditor shall communicate with those charged with governance an overview of the *planned scope* and *timing* of the audit, which includes communicating about the *significant risks* identified by the auditor.

Significant Findings from the Audit

The auditor shall communicate with those charged with governance

a. The auditor's views about significant *qualitative aspects* of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.
b. *Significant difficulties*, if any, encountered during the audit;
c. *Significant matters* arising during the audit that were discussed, or subject to correspondence, with management; and
d. *Written representations* the auditor is requesting;
e. *Circumstances* that affect the form and *content* of the auditor's report, if any; and
f. 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.

Communication of auditor's independence in case of listed entities

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

- We have *identified* and *considered* all *relationships* that may have an impact on Independence including the impact of non audit services.
- The *related safeguards* that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

The Communication Process

Establishing the Communication Process

The auditor shall communicate with those charged with governance the *form*, *timing* and *expected general* content of communications.

Forms of Communication
The auditor shall communicate in *writing* with those charged with governance regarding significant findings from the audit if, in the auditor's professional judgment, *oral communication* would *not* be *adequate*. Written communications need not include all matters that arose during the course of the audit.

Independence
The auditor shall communicate in *writing* with those charged with governance regarding auditor *independence* when required

Timing of Communications
The auditor shall communicate with those charged with governance on a *timely basis*.

Adequacy of the Communication Process (Adequate, Effect)
The auditor shall evaluate *whether* the two-way communication between the auditor and those charged with governance has been *adequate* for the purpose of the audit. If it has not, the auditor shall *evaluate* the effect, if any, on the *auditor's assessment* of the *risks* of material misstatement and ability to *obtain* sufficient appropriate audit evidence, and shall take appropriate action.

Documentation
Where matters required by SA 260 to be communicated are communicated orally, the auditor shall include them in the audit documentation, and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a *copy* of the *communication* as part of the audit documentation.

SA 265 Communicating Deficiencies in Internal Control To Those Charged With Governance and Management

Auditor's Responsibility
SA 265 deals with the auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements.

Deficiency in internal control
Deficiency in internal control
This exists when:

- A control is designed, implemented or operated in such a way that it is *unable* to *prevent*, or *detect* and *correct*, *misstatements* in the financial statements on a timely basis; or
- A control *necessary* to *prevent*, or *detect* and *correct*, *misstatements* in the financial statements on a timely basis is *missing*.

Significant deficiency in internal control
- A deficiency or combination of deficiencies in internal control that, in the auditor's professional *judgment*, is of sufficient *importance* to *merit* the *attention* of those charged with governance.
- The significance of a deficiency or a combination of deficiencies in internal control depends not only on whether a misstatement has actually occurred, but also on the *likelihood* that a misstatement could occur and the *potential magnitude* of the misstatement. Significant deficiencies may, therefore, exist even though the auditor has not identified misstatements during the audit.

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

Examples of indicators of significant deficiencies in internal control

Indicators of significant deficiencies in internal control include

- *Absence* of a *risk assessment process* within the entity where such a process would ordinarily be expected to have been established.
- Evidence of an *ineffective entity risk assessment process*, such as management's failure to identify a RMM that the auditor would expect the entity's risk assessment process to have identified.
- Evidence of *ineffective* aspects of the *control environment*.
- Evidence of an *ineffective response* to *identified significant risks*
- Evidence of *management's inability* to *oversee* the *preparation* of the financial statements.
- Misstatements detected by the auditor's procedures that were *not prevented*, or *detected* & *corrected*, by the *entity's internal control*.

Identification of deficiencies in internal Control

- The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control
- If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, *individually* or in *combination*, they *constitute significant deficiencies*.

Communication of significant deficiencies in internal control to those charged with governance

The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis

The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis

a. In *writing*, *significant deficiencies* in internal control that the auditor has communicated or intends to *communicate* to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and
b. *Other deficiencies* in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional *judgment*, are of sufficient *importance* to merit management's attention.

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 those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that
    i. The *purpose* of the audit was for the auditor to *express* an *opinion* on the financial statements;

ii. The audit included ***consideration*** of ***internal control*** relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of ***expressing*** an ***opinion*** on the ***effectiveness*** of ***internal control***; and

iii. The matters being reported are ***limited*** to ***those deficiencies*** that the auditor has ***identified*** during the audit and that the auditor has concluded are of ***sufficient importance*** to merit being reported to those charged with governance.

Chapter 8 - Audit Report

Objectives of the auditor as per SA 700

The objectives of the *auditor* as per SA 700 (Revised), "Forming An Opinion And Reporting On FSs" are:

- To *form* an *opinion* on the FSs based on an *evaluation* of the *conclusions* drawn from the *audit evidence obtained*; and
- To *express* clearly that *opinion* through a *written report*.

Definitions

General purpose FSs

FSs *prepared* in accordance with a general purpose framework.

General purpose framework

A financial reporting framework designed to meet the *common financial information needs* of a *wide range* of *users*. The financial reporting framework may be a fair presentation framework or a compliance framework.

Fair presentation framework

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

- *Acknowledges management* may *provide disclosures beyond* those specifically *required* by the framework; or
- Acknowledges management may *depart* from a *requirement* of the framework to achieve fair presentation of the FSs. Such departures are expected to be *necessary* only in extremely *rare* circumstances.

Compliance framework

The term "compliance framework" is used to refer to a financial reporting framework that *requires compliance* with the requirements of the framework, but does *not contain* the *acknowledgements* as above

Extra reading
SA 800 - Special Considerations - Audits of FSs Prepared in Accordance with Special Purpose Frameworks.

Example - Framework that does not comply with fundamental assumptions of general purpose framework. For example FSs prepared using a cash basis. Such FSs may be helpful for certain stakeholders that are interested in knowing the liquidity position of the entity like creditors.

Framework prepared according to taxation regulations ignoring normal accounting norms. Many times tax regulations contradict accounting norms. If FSs are prepared according to guidance provided by taxation authorities then it is a special purpose FS based on special purpose framework

Language to be used in Audit Report

Fair Presentation Framework

While expressing unmodified opinion auditor shall use the following

- In our opinion, the accompanying FS present fairly, in all material respects in accordance with the applicable financial reporting framework or
- In our opinion, the accompanying FSs give a true and fair view of State of affairs In accordance with applicable financial reporting framework

Compliance Framework

The accompanying FSs are prepared in all material respects in accordance with applicable Financial reporting framework.

Requirements

- Forming an Opinion on the FSs.

- Form of Opinion
- Auditor's Report
- Auditor's Report for Audits Conducted in Accordance with Standards on Auditing

The requirements of SA 700 are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally

SA 700 promotes consistency in the auditor's report but recognizes the need for flexibility to accommodate particular circumstances of individual jurisdictions.

Consistency in the auditor's report, when the audit has been conducted in accordance with SAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards.

It also helps to promote the user's understanding and to identify unusual circumstances when they occur

Forming an Opinion on the FSs.

The auditor shall form an *opinion* on whether the *FSs* are *prepared*, in all material respects, in accordance with the applicable financial reporting framework

In order *to form that opinion*, the auditor shall *conclude* as to whether the auditor has *obtained reasonable* assurance about whether the FSs as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall take into *account*:

- The auditor's conclusion, in accordance with SA 330, whether sufficient appropriate audit *evidence* has been obtained;
- The auditor's conclusion, in accordance with SA 450, whether uncorrected *misstatements* are material, individually or in aggregate and
- The *evaluations* as required

Evaluations by the Auditor

The auditor shall evaluate whether the FSs are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the *qualitative aspects* of the entity's accounting practices, including *indicators* of *possible bias* in *management's judgments*.

In particular, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework.

a. The FSs adequately *disclose* the *significant accounting policies* selected and applied;
b. The *accounting policies* selected and applied are *consistent* with the applicable financial reporting framework and are appropriate;
c. The *accounting estimates* made by management are reasonable;
d. The *information* presented in the FSs is relevant, reliable, comparable, and understandable;
e. The FSs provide *adequate disclosures* to enable the intended users to understand the effect of material transactions and events on the information conveyed in the FSs; and
f. The *terminology* used in the FSs, including the title of each FS, is appropriate.

When the *FSs* are *prepared* in accordance with a *fair presentation* framework, the *evaluation* shall also include whether the FSs *achieve fair presentation*. The auditor's evaluation as to whether the FSs achieve fair presentation shall include consideration of:

a. The overall *presentation*, *structure* and *content* of the FSs; and
b. Whether the FSs, including the related notes, *represent* the *underlying* transactions and events in a manner that achieves fair presentation.

The auditor shall evaluate whether the FSs adequately refer to or describe the applicable financial reporting framework.

Qualitative Aspects of the Entity's Accounting Practices

The objectives of the auditor as per SA 700, "Forming An Opinion And Reporting On FSs" are

a. To form an ***opinion*** on the FSs based on an evaluation of the ***conclusions*** drawn from the audit evidence obtained; and
b. To express ***clearly*** that opinion through a ***written report***.

The auditor shall form an opinion on whether the FSs are prepared, in ***all material respects***, in accordance with the applicable financial reporting framework.

In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained ***reasonable assurance*** about whether the FSs as a whole are ***free from material misstatement***, whether due to fraud or error.

For this auditor will interalia evaluate

- ***qualitative aspects*** of the entity's accounting practices, including
  - ***indicators*** of ***possible bias*** in management's judgments.

As per SA 260 The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and FS disclosures should be communicated to TCWG.

In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's iudgments.

Indicators of a ***lack of neutrality*** or possible bias in management's judgement may include the following.

1. The ***selective correction*** of ***misstatements*** brought to management's attention during the audit for example - Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.
2. ***Possible management bias*** in the making of ***accounting estimates***.

SA 540 also stipulates auditor to obtain sufficient appropriate audit evidence whether:

a. Accounting estimates, including fair value accounting estimates are reasonable; and
b. Related disclosures in the FSs are adequate.

Form of Opinion

The auditor shall express an ***unmodified opinion*** when the auditor concludes that the FSs are ***prepared***, in all material ***respects***, in accordance with the applicable financial reporting framework.
If the auditor

a. concludes that, based on the audit evidence obtained, the FSs as a whole are ***not free*** from material misstatement; or
b. is ***unable to obtain sufficient*** appropriate audit evidence to conclude that the FSs as a whole are free from material misstatement,

the auditor shall ***modify*** the ***opinion*** in the auditor's report in accordance with SA 705 - Modifications to the Opinion in the Independent Auditor's Report

If FSs prepared in accordance with the requirements of a fair presentation framework

- do not achieve fair presentation,
- the auditor shall discuss the matter with management and,
- shall determine whether it is necessary to modify the opinion in the auditor's report in accordance with SA 705

When the FSs are prepared in accordance with a compliance framework,

- the auditor is not required to evaluate whether the FSs achieve fair presentation.
- However, if in extremely rare circumstances the auditor concludes that such FSs are misleading,
  - the auditor shall discuss the matter with management and,

- depending on how it is resolved, shall determine whether, and how, to communicate it in the auditor's report.

Auditor's Report

- The auditor's report shall be in *writing*.
- This SA- 700 requires the use of specific headings, which are intended to assist in making auditor's report more recognizable, where audit is conducted in accordance with the relevant Standards on Auditing.

Auditor's Report for Audits Conducted in Accordance with Standards on Auditing

- Title
- Addressee
- Auditor's Opinion
- Basis for Opinion
- Going Concern
- Key Audit Matters
- Other Information
- Responsibilities for the FSs
- Auditor's Responsibilities for the Audit of the FSs
- Location of the description of the auditor's responsibilities
- Other Reporting Responsibilities
- Signature of the Auditor
- Place of Signature
- Date of the Auditor's Report

Elements of Audit Report

Title

The auditor's report shall have a title that *clearly indicates* that it is the *report* of an *independent* auditor.

Addressee

The auditor's report shall be addressed, as *appropriate*, based on the circumstances of the engagement. Law, regulation or the terms of the engagement may specify to whom the auditor's report is to be addressed.

The auditor's report is normally addressed to those *for whom* the *report* is *prepared*, often either to the *shareholders* or to *TCWG* of the entity whose financial statements are being audited.

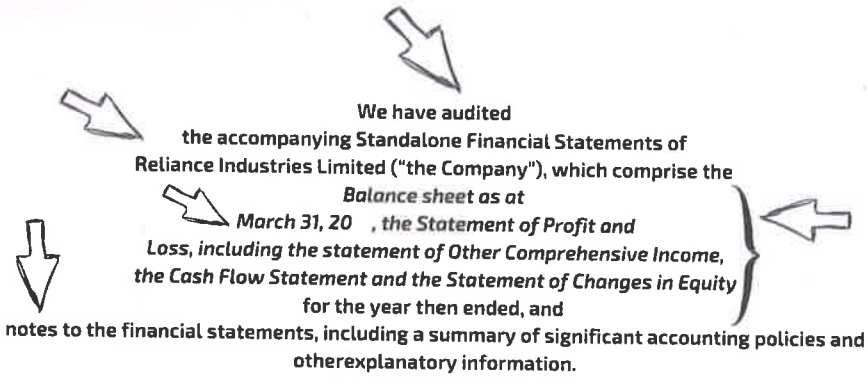
Auditor's Opinion

Auditor's Opinion: The first section of the auditor's report shall include the auditor's opinion, and shall have the heading *"Opinion."*

The Opinion section of the auditor's report shall also:

(a) *Identify* the *entity* whose financial statements have been audited;
(b) *State* that the financial statements have been audited;
(c) *Identify* the *title* of each statement comprising the financial statements;
(d) *Refer* to the *notes*, including the summary of significant accounting policies; and
(e) *Specify* the *date* of, or *period* covered by, each financial statement comprising the financial statements.

When the auditor expresses an *unmodified opinion*, it is *not appropriate* to use *phrases* such as "*with the foregoing explanation*" or "subject to" in relation to the opinion, as these suggest a conditional opinion or a weakening or modification of opinion.



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 *S*tandards on *A*uditing;
(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 and has *fulfilled* the auditor's other *ethical responsibilities* in accordance with these requirements.
(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.

Basis for Opinion

We conducted our audit of the Standalone Financial Statements in accordance with the Standards on Auditing specified under section 143(10) of the Act (SAs). Our responsibilities under those Standards are further described in the Auditor's Responsibility for the Audit of the Standalone Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by the Institute of Chartered Accountants of India (ICAI) together with the ethical requirements that are relevant to our audit of the Standalone Financial Statements under the provisions of the Act and the Rules made thereunder, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the ICAI's Code of Ethics. We believe that the audit evidence obtained by us is sufficient and appropriate to provide a basis for our audit opinion on the Standalone Financial Statements.

Going Concern

Where applicable, the auditor shall report in accordance with *SA 570.*

Key Audit Matters

The auditor shall communicate key audit matters in the auditor's report in accordance with *SA 701*.

When the auditor is otherwise required by law or regulation or decides to communicate key audit matters in the auditor's report, the auditor shall do so in accordance with SA 701.

Law or regulation may require communication of key audit matters for audits of entities other than listed entities.

Responsibilities for the FSs

The auditor's report shall include a section with a heading "*Responsibilities* of *Management* for the *FS*s."
This section of the auditor's report shall describe

- Management's responsibility for:
  - *Preparing* the *financial statements* in accordance with the applicable financial reporting framework,
    - and 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;
  - *Assessing* the
    - entity's *ability* to *continue* as a *going concern* and
    - *whether* the *use* of the going concern basis of accounting is *appropriate*
    - as well as disclosing, if applicable, matters relating to going concern.

Oversight of the financial reporting process. (Under Mgt. Respo only)

This section of the auditor's report shall also *identify*

- those *responsible* for the oversight of the financial reporting process,
- *when* those responsible for such oversight are *different* from Management.

In this case, the *heading* of this section *shall also refer* to "TCWG" or such term that is appropriate in the context of the legal framework applicable to the entity.

Auditor's Responsibilities for the Audit of the FSs

The auditor's report shall include a section with the heading "Auditor's Responsibilities for the Audit of the FSs."This section of the auditor's report shall:

(a) State that the *objectives* of the auditor are to
  (i) Obtain *reasonable assurance* about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and
  (ii) *Issue* an *auditor's report* that includes the *auditor's opinion*.

(b) 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

(c) State that *misstatements can arise* from fraud or error, and either:
  (i) Describe that they are *considered material* if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these FSs; or
  (ii) *Provide* a *definition* or description of *materiality* in accordance with the applicable financial reporting *framework*.

The Auditor's Responsibilities for the Audit of the FSs section of the auditor's report shall further:

(a) State that, as part of an audit in accordance with SAs, the auditor *exercises professional judgement* and *maintains professional skepticism* throughout the audit; and

(b) Describe an audit by stating that the auditor's responsibilities are:
  (i) To *identify* and *assess* the *risks* of *material misstatement* of the financial statements, whether due to fraud or error; to *design* and *perform* audit *procedures* responsive to those risks; and to *obtain audit evidence* that is sufficient and appropriate to provide a basis for the auditor's opinion.
  (ii) To obtain an *understanding* of *internal control* relevant to the audit in order to *design audit procedures* that are appropriate in the circumstances.
  (iii) 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 (based on the audit evidence obtained), and
    - whether 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.

The Auditor's Responsibilities for the Audit of the FSs section of the auditor's report also shall:

(a) State that the auditor communicates with TCWG regarding,
- among other matters,
- the planned scope and timing of the audit and
- significant audit findings,
- including any significant deficiencies in internal control that the auditor identifies during the audit;

(b) For audits of financial statements of listed entities,
- state that the auditor provides
- TCWG
- with a statement that the auditor has complied with relevant ethical requirements
- regarding independence and
- communicate with them
  - all relationships and
  - other matters that may reasonably be thought to bear on the auditor's independence,
  - and where applicable, related safeguards; and

(c) For audits of financial statements of listed entities and any other entities for which key audit matters are communicated in accordance with SA 701,
- state that, from the matters communicated with TCWG,
- the auditor determines those matters that were of most significance in the audit of the FSs of the current period and are therefore the key audit matters.
- The auditor describes these matters in the auditor's report unless law or regulation precludes public disclosure.

Location of the description of the auditor's responsibilities for the audit of the financial statements

The description of the auditor's responsibilities for the audit of the financial statements shall be included:
(a) Within the body of the auditor's report;
(b) Within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix; or
(c) 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 national auditing standards expressly permit the auditor to do so.

Other Reporting Responsibilities

If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibilities under the SAs, these other reporting responsibilities shall be addressed in a separate section in the auditor's report with a heading titled- "Report on Other Legal and Regulatory Requirements" or otherwise as appropriate to the content of the section.

Signature

The auditor's report shall be signed. The report is signed by the auditor (i.e. the engagement partner) in his personal name. Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm.

The partner/proprietor signing the audit report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India.

They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the audit reports

Place of Signature

The auditor's report shall name a specific location, which is ordinarily the city where the audit report is signed.

Date

The auditor's report shall 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 FSs, including evidence that:

(a) All the statements that comprise the financial statements, including the related notes, have been prepared; and

(b) Those with the recognized authority have asserted that they have taken responsibility for those FSs.

The date of the auditor's report informs the user of the auditor's report that the ***auditor*** has ***considered*** the ***effect*** of ***events*** and ***transactions*** of ***which*** the ***auditor became aware*** and that occurred up to that date.

The auditor's responsibility for events and transactions after the date of the auditor's report is addressed in SA 560.

UDIN

It was noticed that financial documents/ certificates attested by third person misrepresenting themselves as CA Members were misleading the Authorities and Stakeholders.

Unique Document Identification Number.
Chartered Accountants having full-time Certificate of Practice can register on UDIN Portal and generate UDIN by registering the certificates attested/certified by them. Accordingly, an auditor is required to mention the UDIN with respect to each audit report being signed by him, along with his membership number while signing an audit report.

For XYZ & Co

Chartered Accountants
(Firm's Registration No.)

Signature

(Name of the Member Signing the Audit Report)
(Designation)
(Membership No. XXXXX)

UDIN: 20037320AAAAAH1111

Auditor's Report Prescribed by Law or Regulation

If the auditor is required by law or regulation to use a specific layout, or wording of the auditor's report, the auditor's report shall refer to Standards on Auditing only if the auditor's report includes, at a minimum, each of the following elements.

(a) A title.
(b) An addressee, as required by the circumstances of the engagement.
(c) An Opinion section containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements.
(d) An identification of the entity's FSs that have been audited.
(e) A statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall refer to the Code of Ethics issued by ICAI.
(f) Where applicable, a section that addresses, and is not inconsistent with, the reporting requirements relating to going concern as per SA 570 (Revised).
(g) Where applicable, a Basis for Qualified (or Adverse) Opinion section that addresses, and is not inconsistent with, the reporting requirements relating to going concern as per SA 570 (Revised).
(h) Where applicable, a section that includes the information required by SA 701, or additional information about the audit that is prescribed by law or regulation and that addresses, and is not inconsistent with, the reporting requirements in that SA.

(i) A description of management's responsibilities for the preparation of the FSs and an identification of those responsible for the oversight of the financial reporting process that addresses, and is not inconsistent with, the requirements as contained in this SA 700.
(j) A reference to Standards on Auditing and the law or regulation, and a description of the auditor's responsibilities for an audit of the FSs that addresses, and is not inconsistent with, the requirements as contained in this SA 700.
(k) The auditor's signature.
(l) The Place of signature.
(m) The date of the auditor's report.

SA 705 - Modifications to the Opinion in the Independent Auditor's Report

Nature of Matter Giving Rise to the Modification	**Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the FSs**	
	Material but Not Pervasive	Material and Pervasive
FSs Are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

Objective of the Auditor

As per SA 705 "Modifications To The Opinion In The Independent Auditor's Report", the objective of the auditor is to express clearly an appropriately modified opinion on the FSs that is necessary when:

a) The auditor concludes, based on the ***audit evidence obtained***, that the FSs as a whole are ***not free*** from ***material misstatement***; or
b) The auditor is ***unable to obtain sufficient appropriate audit evidence*** to ***conclude*** that the FSs as a whole are ***free*** from ***material misstatement***.

Disclaimer of Opinion - Special Point

The auditor shall disclaim an opinion when,

- ➢ in extremely rare circumstances involving multiple uncertainties,
- ➢ the auditor concludes that,
- ➢ notwithstanding having obtained SAAE regarding each of the individual uncertainties,
- ➢ it is not possible to form an opinion on the FSs
  - due to potential interaction of the uncertainties and
  - their possible cumulative effect on the FSs

Circumstances when a Modification to the Auditor's Opinion is Required

- The auditor concludes that based, on the audit evidence obtained, the FSs as a whole are not free from material misstatement, may be due to following reasons:
  - Inappropriate Accounting Policies;
  - Inappropriate application of selected Accounting Policies;
  - Inappropriate or inadequate disclosures in FSs.
- The auditor is unable to obtain sufficient appropriate audit evidence to conclude may be due to following reasons:
  - Limitations imposed by management
  - Circumstances beyond entity control (🔥)
  - Circumstances related to Nature and Timing of auditor's work

Limitation after the auditor has Accepted the Engagement

Auditor Accepted the Engagement, Management Imposes certain Limitations on scope of audit. Request Management To Remove it (Limitation on scope)

- Management Refuses
  - Communicate to TCWG
  - Determine the possibility of performing alternative procedures to obtain SAAE
    - Unable to obtain SAAE
      - Determine Possible effect on FSs
        - Material BUT NOT PERVASIVE
          - Qualified Opinion
        - Material & PERVASIVE
          - Resign - if Possible
          - Not Possible
            - Communicate to TWG and Issue a Disclaimer Opinion

Form and Content of the Auditor's Report when the Opinion is modified

When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion," Adverse Opinion," or Disclaimer of Opinion," as appropriate , for the Opinion section.

When the auditor modified the opinion on the FSs, the auditor shall, in addition to the specific elements as required by SA 700:

a) ***Amend*** the heading "Basis for Opinion" to "Basis for Qualified Opinion," Basis for Adverse Opinion", or Basis for Disclaimer of Opinion," as appropriate; and
b) Within this section, include a ***description*** of the matter giving rise to the modification.

Language to be Used

Qualified Opinion

- When the auditor expresses a qualified opinion due to a material misstatement in the FSs, auditor shall state that, in the auditor's opinion, **except for the effects of the matter(s) described in the Basis for Qualified Opinion section**
  - When reporting in accordance with a fair presentation framework- the accompanying FSs present fairly, in all material respects (or give a true and fair view in accordance with applicable FRF).
  - When reporting in accordance with a compliance framework-the accompanying FSs have been prepared, in all material respects, in accordance with (the applicable FRF).
- When the modification arises from an inability to obtain SAAE, the auditor shall use the phrase "**except for the possible effects of the matter(S) in the Basis for Qualified Opinion section**

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 matters described in the Basis for Adverse Opinion section :

- When reporting in accordance with a fair presentation framework-the accompanying ***FSs do not present fairly (or give a true and fair view of) in accordance with the applicable FRF***
- When reporting in accordance with a compliance framework the Accompanying FSs have not been prepared, in all material respect in accordance with (the applicable FRF).

Disclaimer

When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall

- State that the ***auditor does not express*** an opinion on the FSs;
- 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 SAAE to provide a basis for an audit opinion on the FSs***; and
- Amend the statement in the Opinion Section,
  - which indicates that the FSs have been audited,
  - to state that the auditor was engaged to audit the FSs.

Considerations When the Auditor Disclaims an Opinion on the FSs.

Unless required by law or regulation, when the auditor disclaims an opinion on the FSs, the auditor's report shall not include a Key Audit Matters section in accordance with SA 701.

WHY?

Communication of any key audit matters other than the matter(s) giving rise to the disclaimer of opinion

- may suggest that the FSs as a whole are more credible
- than would be appropriate in the circumstances,
- and would be inconsistent with the disclaimer of opinion on the FSs as a whole.

Communication with TCWG

When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with TCWG the circumstances that led to the expected modification and the wording of the modification.

Description of Auditor's Responsibilities

When the auditor disclaims an opinion on the FSs 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 to include only the following

a. A statement that the auditor's responsibility is to conduct an audit of the entity's FSs 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 FSs*; and
c. The statement about auditor independence and other ethical responsibilities required by SA 700

(Example of statement about independence - We are independent of the entity in accordance with the ethical requirements in accordance with the requirements of the Code of Ethics issued by ICAI and the ethical requirements as prescribed under the laws and regulations applicable to the entity.)

SA 706 Emphasis of matter paragraphs & other matter paragraphs in the independent auditor's report

Objective of the auditor

To *draw users' attention*, when in the auditor's judgement it is necessary to do so, by way of clear *additional communication* in the auditor's report, to:

a. A *matter* appropriately *presented* or *disclosed* in the *FSs*, that is of such importance that it is *fundamental* to users' understanding of the FSs; or
b. Any *other matter* that is relevant to users' *understanding* of the audit, the auditor's responsibilities or the auditor's report.

Emphasis of Matter paragraph

If the auditor considers it necessary to draw *users' attention* to a matter *presented* or *disclosed* in the *financial statements* that, in the auditor's judgement, is of such importance that it is *fundamental* to users' understanding of the financial statements, the auditor shall include an *Emphasis* of *Matter* paragraph in the auditor's report.

Provided that *When SA 701 applies*, the *matter* communicated in EOM para has *not* been *determined* to be a *key audit matter* to be communicated in the auditor's report.

Separate section for Emphasis of Matter paragraph

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall

a. *Include* the *paragraph* within a *separate section* of the auditor's report with an *appropriate heading* that includes the term "Emphasis of Matter"

b. Include in the paragraph a clear *reference* to the *matter* being emphasized and to *where relevant disclosures* that fully describe the matter can be *found* in the FSs.
c. *Indicate* that the auditor's *opinion* is *not modified* in respect of the matter emphasized.

Emphasis of Matter paragraph is not a substitute

An Emphasis of Matter paragraph is *not a substitute* for:

a. A *modified* opinion in accordance with SA 705 (Revised) when required by the circumstances of a specific audit engagement;
b. *Disclosures* in the FSs that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation; or
c. Reporting in accordance with *SA 570* (Revised) when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern.

Other Matter paragraph

If the auditor considers it necessary to *communicate* a *matter other than* those that are *presented* or *disclosed* in the financial statements that, in the auditor's judgement, is *relevant* to users' *understanding* of the *audit*, the *auditor's responsibilities* or the *auditor's report*, the auditor shall include an Other Matter paragraph in the auditor's report provided

- This is *not prohibited* by law or regulation
- When SA 701 applies, the matter has *not* been *determined* to be a *key audit matter* to be communicated in the auditor's report.

Separate section for Other Matter paragraph

When the auditor includes an Other Matter paragraph in the auditor's report, the auditor shall include the paragraph within a *separate section* with the heading "Other Matter," or other appropriate heading.

Communication with TCWG

If the auditor expects to include an Emphasis of Matter or an Other Matter paragraph in the auditor's report, the auditor shall *communicate* with TCWG regarding this *expectation* and the *wording* of this paragraph

Placement of Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Auditor's Report

The placement of an Emphasis of Matter paragraph or Other Matter paragraph in the auditor's report

- depends on the *nature of the information* to be communicated,
- and the auditor's judgement
    - as to the *relative significance* of such information
    - With respect to *other elements* required to be reported in accordance with SA 700

Emphasis of Matter Paragraphs

When the Emphasis of Matter paragraph *relates* to the *applicable financial reporting framework*, the auditor may consider it necessary to place the paragraph *immediately* following the *Basis* of *Opinion* section to provide appropriate context to the auditor's opinion.

When a *Key Audit Matters* section is *presented* in the auditor's report,

- an Emphasis of Matter paragraph may be presented
- either directly *before* or *after* the Key Audit Matters section,
    - based on the auditor's *judgement*.

The auditor may also *add further context* to the heading "Emphasis of Matter",

- such as "Emphasis of Matter – Subsequent Event",
- to *differentiate* the Emphasis of Matter paragraph from the individual matters described in the Key Audit Matters section.

Other Matter Paragraphs

When an Other Matter paragraph is included to *draw* users' *attention* to a *matter* relating to *Other Reporting Responsibilities* addressed in the auditor's report, the paragraph may be *included* in the Report on Other Legal and Regulatory Requirements section.

When *relevant* to *all* the *auditor's responsibilities* or users' understanding of the auditor's report, the Other Matter paragraph may be included as a separate section *following* the Report on Other Legal and Regulatory Requirements.

When a *Key Audit Matters* section is presented in the auditor's report

- and an Other Matter paragraph is also considered necessary,
- the auditor may *add further context* to the heading "Other Matter", such as "Other Matter – Scope of the Audit",
- to *differentiate* the Other Matter paragraph from the individual matters described in the Key Audit Matters section.

SA 701 - Communicating Key Audit Matters in the Independent Auditor's Report

Scope

This Standard on Auditing (SA) deals with the auditor's *responsibility* to *communicate key audit matters* in the auditor's report.

Objective

The objectives of the auditor are

- To *determine key audit matters* and, having formed an opinion on the FSs,
- *Communicate* those matters by describing them in the auditor's report.

Key audit Matters

Those matters that,

- in the auditor's professional *judgement*,
    - were of *most significance*
        - in the audit of the FSs of the current period.
- Key audit matters are selected from *matters communicated* with *TCWG.*

Purpose

As per SA 701, "Communicating Key Audit Matters in the Auditor's Report", the purpose of communicating key audit matters is to

- enhance the *communicative value* of the auditor's report by providing greater *transparency* about the audit that was performed.
- Communicating key audit matters provides *additional information* to *intended users* of the FSs to assist them in *understanding* those matters that, in the auditor's professional judgement, were of most significance in the audit of the FSs of the current period.
- Communicating key audit matters may also assist intended users in understanding the *entity* and *areas* of significant *management judgement* in the audited FSs.
- The communication of key audit matters in the auditor's report may also provide intended users a *basis to further engage* with management and TCWG about
    - certain matters relating to the entity,
    - the audited FSs,
    - or the audit that was performed.

Applicability

This SA applies to

- audits of complete sets of general purpose FSs of *listed entities* and
- *circumstances* when the *auditor otherwise* decides to communicate key audit matters in the auditor's report.
- This SA also applies when the auditor is *required* by *law* or *regulation* to communicate key audit matters in the auditor's report.

However, SA 705 *prohibits* the auditor from *communicating key audit matters when* the auditor *disclaims* an opinion on the FSs, unless such reporting is required by law or regulation.

Determining Key Audit Matters

The auditor shall determine,

- from the matters communicated with TCWG,
- those matters that required significant auditor attention in performing the audit.
- In making this determination, the auditor shall take into account the following
    a. Areas of *higher assessed risk* of *material misstatement*, or significant risks identified in accordance with SA 315.
    b. Significant *auditor judgments* relating to *areas* in the FSs that involved *significant management judgement*, including *accounting estimates* that have been identified as having high *estimation uncertainty*.
    c. The effect on the audit of *significant events* or *transactions* that occurred during the period.

Communicating Key Audit Matters

The auditor shall

- *describe each* key audit matter,
- using an *appropriate subheading*,
- in a *separate section* of the auditor's report under the *heading* "*Key Audit Matters*".

The *introductory language* in this section of the auditor's report shall state that:

a. Key audit matters are those matters that, in the auditor's professional judgement, were of most significance in the audit of the FSs.
b. These matters were *addressed* in the *context* of the *audit* of the FSs as a whole, and in forming the auditor's opinion thereon, and the auditor *does not provide a separate opinion on these matters*.

Descriptions of Individual Key Audit Matters

The *description* of each key audit matter in the Key Audit Matters section of the auditor's report shall include a reference to the related disclosure(s), if any, in the FSs and shall address:

a. *Why* the *matter* was *considered* to be one of most significance in the audit and therefore determined to be a key audit matter; and
b. *How* the *matter* was addressed in the audit.

Communicating Key Audit Matters- not a substitute for disclosure in the FSs etc.

Communicating key audit matters in the auditor's report is *not*:

a. A *substitute* for *disclosures* in the *FSs* that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;
b. A substitute for the auditor expressing an *modified opinion* when required by the circumstances of a specifi c audit engagement in accordance with SA 705
c. A substitute for *reporting* in *accordance* with *SA 570* when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or
d. A *separate opinion* on individual matters.

Circumstances in Which a Matter Determined to Be a Key Audit Matter Is Not Communicated in the Auditor's Report

The auditor shall describe each key audit matter in the auditor's report unless

a. Law or regulation precludes public disclosure about the matter; or
b. 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.

KAM by Nature

A matter giving rise to a modified opinion in accordance with SA 705 (Revised), or a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised), are by their nature key audit matters.

These matters shall not be described in the Key Audit Matters section of the auditor's report and the requirements in Rather, the auditor shall

a. Report on these matter(s) in accordance with the applicable SA(s); and
b. Include a reference to
   - the Basis for Qualified (Adverse) Opinion or
   - the Material Uncertainty Related to Going Concern section(s) in the Key Audit Matters section.

If the auditor determines, depending on the facts and circumstances of the entity and the audit, that there are no key audit matters to communicate or that the only key audit matters communicated are those matters mentioned above, the auditor shall include a statement to this effect in a separate section of the auditor's report under the heading "Key Audit Matters."

Communication with TCWG

The auditor shall communicate with TCWG:

a. Those matters the auditor has determined to be the key audit matters; or
b. If applicable, depending on the facts and circumstances of the entity and the audit, the auditor's determination that there are no key audit matters to communicate in the auditor's report.

Documentation

The auditor shall include in the audit documentation:

a. The matters that required significant auditor attention as determined , and the rationale for the auditor's determination as to whether or not each of these matters is a key audit matter.
b. Where applicable, the rationale for the auditor's determination that there are no key audit matters to communicate in the auditor's report or that the only key audit matters to communicate are
   i. Modified Opinion
   ii. Material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and
c. Where applicable, the rationale for the auditor's determination not to communicate in the auditor's report a matter determined to be a key audit matter.

SA 710 "Comparative Information - Corresponding Figures And Comparative FSs

Scope

Deals with the auditor's responsibilities regarding comparative information in an audit of FSs.

Objectives

The objectives of the auditor are

- To obtain *sufficient appropriate audit evidence* about whether the *comparative information* included in the FSs has been *presented*, in *all material respects*, in *accordance* with the requirements for comparative information in the *applicable financial reporting framework*.
- To *report* in accordance with the auditor's reporting responsibilities.

Definitions

Comparative information

- The *amounts* and *disclosures*
  - included in the FSs
- in respect of *one* or *more prior periods*
  - in accordance with the applicable financial reporting framework.

Corresponding figures

- Comparative information where *amounts* and *other disclosures*
  - for the *prior period* are included as an *integral* part of the *current* period FSs, and
  - are *intended* to be *read only* in relation to the amounts and other disclosures relating to the current period .

Comparative FSs

Comparative information where *amounts* and *other disclosures*

- for the *prior period* are included for *comparison* with the FSs of the current period
- but, if audited, are referred to in the auditor's opinion.

Difference between Corresponding Figures and Comparative FS from reporting point of view.

- When corresponding figures are presented, the auditor's opinion shall *not* refer to the corresponding figures other than in exceptional cases.
- When comparative FSs are presented, the auditor's opinion shall refer to *each period* for which FSs are presented and on which an audit opinion is expressed.

Audit Procedures

Comparative Information Included and Appropriately Classified.

The auditor shall determine

- whether the FSs *include* the *comparative information* required by the applicable financial reporting framework and
- whether such information is appropriately *classified*. For this purpose, the auditor shall evaluate whether
  - The comparative information *agrees* with the *amounts* and *other disclosures presented* in the *prior period*; and
  - The accounting *policies* reflected in the comparative information are consistent with those applied in the current period or,
    - if there have been *changes* in accounting policies,
      - whether those changes have been
        - properly *accounted* for and adequately *presented* and *disclosed*.

(Summary - CI Included and Apt Classified - Evaluate - CI agree with A & D of PP and AP of PP consistent with CP, if not changes properly A_____, P_____, D_____.)

Possible material misstatement in the comparative information.

If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit,

- the auditor shall perform such *additional audit procedures* as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists.

- If the auditor had audited the prior period's FSs, the auditor shall also follow the relevant requirements of SA 560

(Summary - Become aware of Poss MMS in CI, AAP SAAE, MMS Exist? / Also follow requirement of SA 560 SE)

Written Representation

In the case of *comparative FSs*,

- the written representations are requested for *all periods* referred to in the auditor's opinion because management needs to re-affirm that the written representations it previously made with respect to the prior period remain appropriate.

In the case of *corresponding figures*,

- the written representations are requested for the FSs of the *current period only* because the auditor's opinion is on those FSs, which include the corresponding figures.

The auditor *may* requests a *specific written representation* regarding *any prior period item* that is separately disclosed in the current year's FS.

(CFI - All Period ref in opinion, to reaffirmWR appropriate, CF - CP only, may request for any PPI disclosed)

Audit Reporting

Corresponding Figures

Reference to corresponding figures

Audit *opinion not* to *refer* to *corresponding figures*, *EXCEPT*:

1. Auditor's report on *prior period* FS was *modified*
   Auditor's report on prior period FS was modified and the subject of *modification* is still *unresolved*
   - *Modify current audit report also.*

In the Basis for Modification paragraph in the auditor's report, the auditor shall:

- Refer to *both* the current period's figures and the corresponding figures in the description of the matter giving rise to the modification
  - when the *effects* or *possible effects* of the matter on the current period's figures are *material*; or (PP Opinion Modified because of misstatement and CP FS are also affected by the same misstatement)
- In *other cases*,
  - explain that the audit opinion has been modified
    - because of the *effects* or *possible effects* of the *unresolved matter*
      - on the comparability of the current period's figures and the corresponding figures. (PP Opinion is modified, Matter is not relevant/ immaterial to the current period figures in the FSs-but comparability is effected)

2. Audit evidence that a material misstatement exists in the prior period FSs on which an unmodified opinion has been previously issued
   If the auditor
   - obtains audit evidence that a material misstatement exists in the prior period FSs
   - on which an unmodified opinion has been previously issued,
   - the auditor shall verify whether the misstatement has been *dealt* with as *required* under the applicable financial reporting framework and,
     - if that is *not* the case,
     - the auditor shall *express* a *qualified* opinion or an *adverse* opinion in the auditor's report on the current period FSs,
       - modified with respect to the corresponding figures included therein.

Prior Period FSs Audited by a Predecessor Auditor

If the FSs of the prior period were audited by a predecessor auditor and

- the auditor is permitted by law or regulation to refer to the predecessor auditor's report on the corresponding figures and
- decides to do so,

the auditor shall state in an *Other Matter paragraph* in the auditor's report:

a. That the FSs of the prior period were *audited* by the *predecessor auditor*;
b. The *type* of *opinion* expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and
c. The *date* of that *report*.

Prior Period FSs Not Audited

If the prior period FSs were not audited,

- the auditor shall state in an *Other Matter paragraph* in the auditor's report that the corresponding figures are unaudited.
- Such a statement *does not*, however, *relieve* the auditor of the requirement to *obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements* that materially affect the current period's FSs.

Comparative FSs

Reference to each period

When comparative FSs are presented,

- the auditor's opinion shall
- refer to *each period* for which FSs are presented and on which an audit opinion is expressed.

Opinion Prior Period FS differ from previous opinion.

If the auditor's opinion on such prior period FSs differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an *Other Matter paragraph* in accordance with SA 706.

Prior Period FSs Audited by a Predecessor Auditor

If the FSs of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's FSs, the auditor shall state in an *Other Matter paragraph*

a. That the FSs of the prior period were *audited* by a *predecessor auditor*;
b. The *type* of *opinion* expressed by the predecessor auditor and, if the opinion was modified, the *reasons* therefore; and
c. The *date* of that *report*,

If the auditor concludes that a material misstatement exists that affects the prior period FSs on which the predecessor auditor had *previously reported without modification*, the auditor shall *communicate* the misstatement with the *appropriate level* of *management* and *TCWG* and request that the predecessor auditor be informed.

If the prior period FSs are *amended*, and the predecessor auditor agrees to issue a *new* auditor's *report* on the amended FSs of the prior period, the auditor shall report only on the current period.

Prior Period FSs Not Audited

The auditor shall state in an *Other Matter paragraph* that the comparative FSs are unaudited. Such a statement *does not*, however, *relieve* the auditor of the requirement to *obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements* that materially affect the current period's FSs.

SA 299 - Joint Audit

Joint Audit

Advantages

In specific terms the advantages that flow may be the following:

i) *Sharing* of *expertise*.
ii) Advantage of *mutual consultation*.
iii) *Lower workload*.
iv) Better *quality* of performance.
v) *Improved* service to the client.
vi) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.
vii) *Lower staff* development *costs*.
viii) *Lower costs* to carry out the work.
ix) A sense of *healthy competition* towards a better performance.

Disadvantages

The general disadvantages may be the following:

i) The *fees* being *shared*.
ii) *Psychological problem* where firms of different standing are associated in the joint audit.
iii) General *superiority complex* of some auditors.
iv) *Problems* of *co-ordination* of the work.
v) Areas of work of *common concern* being *neglected*.
vi) *Uncertainty* about the liability for the work done.

Audit Planning, Risk Assessment and Allocation of Work

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, and that guides the development of the audit plan.
3. *Prior* to the *commencement* of the audit, the joint auditors shall *discuss* and *develop* a *joint audit plan*. In developing the joint audit plan, the joint auditors shall
    a. Identify *audit area division* and *common areas* among joint auditors to define each joint auditor's scope.
    b. Ascertain engagement's reporting *objectives* to plan audit *timing* and required *communications*.
    c. Consider and communicate *significant factors* among joint auditors that guide the engagement team's efforts.
    d. Consider results of *preliminary engagement activities* and relevance of knowledge gained on previous similar engagements by respective engagement partner(s).
    e. Ascertain the nature, timing and extent of *resources* necessary to perform the engagement.
4. Each joint auditor should consider, assess, and communicate *risks of material misstatement* to others; *document* whether risks *pertain to* overall FSs or specific audit areas.
5. Joint auditors should discuss, document, and communicate nature, timing, and extent of *audit procedures* for common and specific audit areas to TCWG.
6. Joint auditors should obtain a common engagement letter and a common *management representation letter*.
7. Post work identification and allocation among joint auditors, the *work allocation document* should be signed by all joint auditors and communicated to TCWG.

Responsibility and Co-ordination among Joint Auditors

- In respect of audit work divided among the joint auditors, each joint auditor shall be *responsible only* for the *work allocated* to such joint auditor including proper execution of the audit procedures

- All the joint auditors shall be ***jointly*** and ***severally*** responsible for
  - the audit work which is ***not divided*** among the joint auditors and is carried out by all joint auditors;
  - ***decisions*** taken by ***all*** the joint auditors under audit planning in respect of common audit areas concerning the nature, timing and extent of the audit procedures to be performed by each of the joint auditors.
  - ***matters*** which are ***brought*** to the ***notice*** of the joint auditors by any one of them and on which there is an agreement among the joint auditors;
  - examining that the FSs of the entity comply with the ***requirements*** of the relevant ***statutes***;
  - ***presentation*** and ***disclosure*** of the FSs as required by the applicable financial reporting framework;
  - ensuring that the audit ***report*** complies with the requirements of the relevant ***statutes***, the applicable ***Standards*** on ***Auditing*** and the other relevant ***pronouncements*** issued by ***ICAI***.
- If a joint auditor encounters matters relevant to others' responsibilities, requiring their attention, disclosure, discussion, or judgment application, they should ***communicate*** these in writing to all other joint auditors before the audit completion.
- Each joint auditor is responsible for determining the nature, timing, and extent of audit procedures applied to their allocated work areas. They're individually responsible for studying and evaluating the internal control system and risk assessment related to their allocated work areas.

Audit Conclusion and Reporting

Reporting

- Joint auditors are expected to issue a ***common audit report.***
- In case of ***disagreement***, auditors ***can issue separate*** audit ***reports***.
- A joint auditor is ***not bound*** by the ***views*** of the ***majority*** of the ***joint auditors*** regarding the opinion or matters to be covered in the audit report and shall express opinion formed by the said joint auditor in separate audit report in case of disagreement.
- Audit reports by joint auditors shall make ***reference separate report***(s) issued by other joint auditor(s).
- Separate audit report(s) shall also ***reference*** to those issued by joint auditors.
- Such ***reference*** shall be made under the heading "***Other Matter Paragraph***" as per Revised SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report".

Reporting Requirements Under The Companies Act, 2013

Section 143 Powers and duties of auditors and auditing standards

143(1)

Every auditor of a company shall have a

- right of ***access***
  - ***at all times***
  - to the ***books of account*** and vouchers of the company,
  - whether kept at the registered office of the company or at any other place and
- shall be entitled to ***require***
  - from the officers of the company
  - such ***information*** and ***explanation*** as he may consider ***necessary*** for the performance of his duties as auditor and
- amongst other matters inquire into the following matters, namely:—
  a. whether ***loans*** and ***advances*** made by the company on the basis of ***security*** have been properly secured and whether the ***terms*** on which they have been made are ***prejudicial*** to the ***interests*** of the company or its members;
  b. whether transactions of the company which are ***represented*** merely by ***book entries*** are prejudicial to the interests of the company;
  c. 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. whether loans and advances made by the company have been shown as ***deposits***;
e. whether ***personal expenses*** have been charged to revenue account;
f. where it is stated in the books and documents of the company that any shares have been allotted for ***cash***, whether cash has ***actually*** been ***received*** in respect of such allotment, and if no cash has actually been so received, whether the ***position*** as stated in the account books and the balance sheet is ***correct***, regular and ***not misleading***

Provided that the auditor of a company which is a holding company shall also have the right of access to the records of all its subsidiaries and associate companies insofar as it relates to the consolidation of its FSs with that of its subsidiaries and associate companies.

143(2) Report To Members

The auditor shall

- make a ***report***
- to the ***members*** of the company
- on the ***accounts examined*** by him and on every FSs which are required by or under this Act to be laid before the company in general meeting and
- the report shall after taking into account
  - the provisions of this Act,
  - the accounting and
  - auditing standards and
  - matters which are required to be included in the audit report under the provisions of this Act or
  - any rules made thereunder or
  - under any order made under sub-section (11) and
  - to the best of his information and knowledge,
- the said accounts, FSs give a ***true*** and ***fair*** view of the state of the company's affairs at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

143(3) - Report on Other Elements

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 FSs;
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; (Books of accounts and return from branches)
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 ***b***alance ***s***heet and ***p***rofit and ***l***oss account ***dealt*** with in the report are in ***agreement*** with the books of account and returns;
e. whether, in his opinion, the FSs ***comply*** with the ***a***ccounting ***s***tandards;
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*** with reference to FSs in place and the operating effectiveness of such controls.
j. such ***other*** matters as may be prescribed

Reporting under clause(i) of Sec. 143(3) shall not apply to a private company:

- Which is a one-person company or a small company ; or
- Which has turnover less than Rs 50 crores as per latest audited FS And Which has aggregate borrowings from banks or financial institutions or any body corporate at any point of time during the financial year less than Rs 25 Cr.

Other Matters Prescribed-Rule 11 of Companies (Audit & Auditors) Rules , 2014

The auditor's report shall also include their views and comments on the following matters, namely:

1. Whether the company has disclosed the impact, if any, of ***pending litigations*** on its financial position in its FS;
2. Whether the company has made provisions, as required under any law or accounting standards, for ***material foreseeable losses***, if any, on long term contracts including derivative contracts;
3. Whether there has been any ***delay*** in transferring amounts, required to be transferred, to the ***Investor Education and Protection Fund*** by the company.
4.
    a. Whether the management has represented that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been advanced or loaned or invested (either from borrowed funds or share premium or any other sources or kind of funds) by the company to or in any other person(s) or entity(ies), including foreign entities ("Intermediaries"), with the understanding, whether recorded in writing or otherwise, 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 (" Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries;
    b. Whether the management has represented, that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been received by the company from any person(s) or entity(ies), including foreign entities (" Funding Parties"), with the understanding, whether recorded in writing or otherwise, 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 ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries; and
    c. 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 misstatement.
5. Whether the ***dividend*** declared or paid during the year by the company is in ***compliance*** with ***section 123*** of the Companies Act, 2013
6. 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.

Audit Trail means, a step-by-step sequential record which provides evidence of the documented history of financial transactions to its source. An auditor can trace every step of, the financial data of a particular transaction right from the general ledger to its source document with the help of the audit trail.

143(4) - Reasons

Where

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- any of the matters required to be included in the audit report
- under this section
- is answered in the negative
- or with a *qualification*,
- the report shall state the *reasons* therefor.

Branch Audit - 143(8)
Covered later in the chapter

143(9)
Every auditor shall *comply* with the *auditing standards*.

143(10)
The Central Government may prescribe the standards of auditing or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949 (38 of 1949), in consultation with and after examination of the recommendations made by the National Financial Reporting Authority:

Provided that until any auditing standards are notified, any standard or standards of auditing specified by the Institute of Chartered Accountants of India shall be deemed to be the auditing standards.

Reporting of Fraud - 143(12) read with Rule 13 of the Companies (Audit and Auditors) Rules
If an auditor of a company in the course of the performance of his duties as auditor, has *reason to believe* that an offence of fraud, which involves or is *expected* to involve individually an *amount of ₹ 1 crore or above*, is being or has been committed in the company by its officers or employees, the auditor shall *report* the matter to the *Central Government* within such time and in such manner as prescribed.

In case of a fraud involving lesser than the specified amount [i.e. *less than ₹ 1 crore*], the auditor shall *report* the matter to the *audit committee* constituted under section 177 or to the *Board* in other cases within such time and in such manner as prescribed.

143 (13)
No duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter referred to in sub-section (12) if it is done in good faith.

143(14)
The provisions of this section shall mutatis mutandis apply to—

a. the cost accountant conducting cost audit under section 148; or
b. the company secretary in practice conducting secretarial audit under section 204.

143(15)
If any auditor, cost accountant, or company secretary in practice does not comply with the provisions of sub-section (12), he shall,—

a. in case of a listed company, be liable to a penalty of five lakh rupees; and
b. in case of any other company, be liable to a penalty of one lakh rupees.]

CARO - COMPANIES (AUDITOR'S REPORT) ORDER, 2020

Section 143(11)
The Central Government may,

- in consultation with the National Financial Reporting Authority,
- by general or special order,
- direct, in respect of
  - such class or description of companies,

- as may be specified in the order,
- that the
  - auditor's report shall also include a statement on
  - such matters as may be specified therein

Applicability

It shall apply to *every company including* a *foreign company* as defined in clause (42) of section 2 of the Companies Act. 2013 *except*

- A *banking* company;
- An *insurance* company;
- 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 and 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 Rs 1 Cr.* as on the balance sheet date, and
  - Which does not have *total borrowings exceeding Rs 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 Rs. 10 Crore* during the financial year as per the FSs.

This Order shall NOT apply to the auditor's report on Consolidated FS except clause (xxi) of paragraph 3.

Paid up Share capital

- Paid up capital includes equity as well as preference.
- Amount originally paid up on forfeited shares should be added to the figure of paid up capital.
- Share Application money pending allotment - NO.
- Securities Premium - YES
- General Reserve - YES
- Reserves include Capital reserves, revenue reserves as well as Revaluation Reserves.
- Credit Balance of Profit and Loss Account will form part of the reserve.
- In case of debit balance of profit or loss, the same shall be netted for computing reserves & surplus.

Borrowings

- Loans from banks and financial institutions are to be considered in aggregate.
- Financial Institutions include NBFC.
- Loans may be in any form like term loan, demand loans, cash credit overdraft, export credit, bill purchased/discounted.
- Long term loans as well as short term loans, secured as well as unsecured will be considered .
- Outstanding dues, in respect of credit cards will also be considered.
- Interest accrued and also due will form part of loans and borrowings. If interest is only accrued it will not form part of loan
- Fund based facilities are counted in borrowings whereas non fund based facilities are not counted.
- Security amount is not to be adjusted
- Loans from other than banking and financial institutions shall not be considered
- Limit or actual Amount? -

Total Revenue

- Revenue from operations and other Income.
- Here revenue will also include revenue from discontinuing operations as specified in the Order.
- Other income shall consist of the following;
  - Interest Income (other than a finance company);

- ❖ Dividend Income;
- ❖ Net gain/loss on sale of investments;
- ❖ Other non-operating income (net of expenses directly attributable to such income).

- GST, Excise etc will not form part of revenue

Other Notes

Discussion on Small Company

A company is covered under the definition of small company; it will ***remain exempted from the applicability of the Order even if it falls under any of the criteria specified for private company.***

Definition of Small Company

Sec 2(85) of the Companies Act, 2013 defines a small company. As present, is a private company which satisfies both the following conditions

- ***Paid Up Share Capital ≤ 4 crores AND***
- ***Turnover ≤ 40 crores.***

The following 3 categories of Companies shall NOT be regarded as SMALL Companies:

1. A HOLDING company or a SUBSIDIARY company.
2. A company registered under SECTION 8. or
3. A company or body corporate governed by any SPECIAL ACT.

Para 2 - Auditor's report to contain matters specified in paragraphs 3 and 4.

- Every report made by the auditor under section 143 of the Companies Act on the accounts of every company audited by him, to which this Order applies, contain the matters specified in paragraphs 3 and 4, as may be applicable
- Provided this Order shall not apply to the auditor's report on consolidated FSs except clause (xxi) of paragraph 3.

Para 4 - Reasons to be stated for unfavourable or qualified answers.

- 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

- Where the auditor is unable to express any opinion on any specific matter,
- his report shall
  - indicate such fact
  - with the reasons as to why it is not possible for him to give his opinion On the same.

Para 3- Matters to be included in the auditor's report under CARO, 2020

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 -

Proper Records

Whether the company is maintaining ***proper records***

- showing ***full particulars***,
- including ***quantitative details*** and
- ***situation*** of Property, Plant and Equipment;

Proper records - Intangible assets
Whether the company is maintaining *proper records* showing full particulars of intangible assets;

Physical Verification
Whether these Property, Plant and Equipment have been *physically verified* by the *management* at reasonable intervals;

Material discrepancies
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
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 FSs 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 PPE / ITA
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 for benami property
- 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 FSs;

Para 3(ii) - Inventory
Physical Verification, Coverage and Procedure.
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*;

Discrepancies of 10% or more
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 limits
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) - Investment / Guarantee / Security / Loans and Advances

a. whether during the year the company has provided loans or provided advances in the nature of loans, or furnished guarantee, or provided security to any other entity [not applicable to companies whose principal business is to give loans], if so, indicate-
   - 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;
   - 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;

<table>
<tr><th colspan="6">Loan / Guarantee or security provided to any other entity</th></tr>
<tr><td rowspan="2">Whether Loan / Guarantee or security provided to any other entity</td><td rowspan="2">Yes</td><td rowspan="2">Whether Principal business is to give loans</td><td>Yes</td><td colspan="3">Not applicable</td></tr>
<tr><td rowspan="2">No</td><td rowspan="2">Indicate</td><td rowspan="2">aggregate amount during the year, and balance outstanding at the balance sheet date</td><td>to subsidiaries, joint ventures and associates;</td></tr>
<tr><td>No</td><td colspan="4">Report the same</td><td>Parties, other than subsidiaries, joint ventures and associates;</td></tr>
</table>

Para 3(iv) - Sections 185 and 186

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) - Deposit Accepted

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 Central Government under sub-section (1) of *section 148* of the Companies Act and
- whether such accounts and records have been so made and *maintained*.

Para 3 (vii) Statutory Dues

Undisputed statutory dues

a. whether the company is *regular* in depositing undisputed statutory dues
    - including Goods and Services 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 on the *last day* of the financial year concerned for a period of *more than six months* from the *date they became payable*, shall be indicated;

Disputed statutory dues

b. where statutory dues referred to in sub-clause (a) 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);

<table>
<tr><th colspan="4">Statutory Dues</th></tr>
<tr><td rowspan="2">Undisputed</td><td rowspan="2">Company is regular in depositing the undisputed statutiry dues?</td><td>Yes</td><td>Report company is regular</td></tr>
<tr><td>No</td><td>REPORT - outstanding statutory dues as on the last day of the financial year for a period of more than six months from the date they became payable, shall be indicated</td></tr>
<tr><td></td><td colspan="2">No</td><td>Report the same</td></tr>
<tr><td rowspan="2">Statutory Dues Not deposited on account of dispute</td><td colspan="3">Amount ₹</td></tr>
<tr><td colspan="3">Forum</td></tr>
</table>

Para 3(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 Loan Etc

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 - lender wise details to be provided in case of defaults to banks, financial institutions and Government	Amount not paid on due date	Whether principal or interest	No. of days delay or unpaid	Remarks, if any

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;

<table>
<tr><th colspan="8">Repayment of Loan etc.</th></tr>
<tr><td rowspan="7">Company Defaulted ?</td><td rowspan="7">Repayment of Loan or other borrowings or in payment of interest</td><td rowspan="6">Yes</td><td rowspan="6">Period and amount as per format</td><td colspan="3">Nature of borrowing, including debt securities</td></tr>
<tr><td>Name of lender</td><td colspan="2">lender wise details to be provided in case of defaults to banks, financial institutions and Government.</td></tr>
<tr><td colspan="3">Whether principal or interest</td></tr>
<tr><td colspan="3">Amount not paid on due date</td></tr>
<tr><td colspan="3">Remarks, if any</td></tr>
<tr><td colspan="3">No. of days delay or unpaid</td></tr>
<tr><td>No</td><td colspan="5">Report - The Company has not defaulted in repayment of loans or other borrowings or in the payment of interest thereon to any lender.</td></tr>
<tr><td>Company Declared Wilful defaulter?</td><td colspan="7">By any bank or financial institution or other lender;</td></tr>
<tr><td rowspan="3">Term loans</td><td rowspan="3">applied for the purpose for which the loans were obtained;</td><td colspan="6">Yes</td></tr>
<tr><td rowspan="2">No</td><td colspan="5">Amount</td></tr>
<tr><td colspan="5">Purpose</td></tr>
<tr><td rowspan="3">Funds raised on short term basis</td><td rowspan="3">Utilised for Long-term purpose</td><td rowspan="2">Yes</td><td colspan="5">Nature</td></tr>
<tr><td colspan="5">Amount</td></tr>
<tr><td>No</td><td colspan="5">Report</td></tr>
<tr><td rowspan="2">Funds from any person on account of or to meet</td><td rowspan="2">Obligation of</td><td rowspan="2">subsidiaries, joint ventures or associate companies</td><td rowspan="2">Details</td><td colspan="3">Nature</td></tr>
<tr><td colspan="3">Amount</td></tr>
<tr><td rowspan="3">Pledge of securities of subsidiaries, joint ventures or associate companies</td><td rowspan="2">Yes</td><td colspan="6">Details</td></tr>
<tr><td rowspan="2">Company defaulted on repayment</td><td colspan="5">Yes</td></tr>
<tr><td>No</td><td colspan="5">Report</td></tr>
</table>

Para 3(x) - IPO FPO etc

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;

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 noncompliance;

<table>
<tr><th colspan="6">IPO / FPO & Prefrential Allotment</th></tr>
<tr><td rowspan="2">Money Raised IPO / FPO (Including Debt)</td><td rowspan="2">applied for the purposes for which those are raised</td><td>Yes</td><td colspan="3">Report.</td></tr>
<tr><td>No</td><td rowspan="2">details</td><td colspan="2">delays or default</td></tr>
<tr><td>No</td><td colspan="3">Report the same</td><td>subsequent rectification, if any</td></tr>
<tr><td rowspan="4">Company has made any preferential allotment or private placement?</td><td rowspan="4">Yes</td><td rowspan="2">whether the requirements of section 42 and section 62 of the Companies Act, 2013 have been complied</td><td colspan="3">Yes</td></tr>
<tr><td>No</td><td>Details</td><td>Amount</td></tr>
<tr><td rowspan="2">funds raised have been used for the purposes for which the funds were raised</td><td colspan="3">Yes</td></tr>
<tr><td>No</td><td>Details</td><td>Amount</td></tr>
<tr><td>No</td><td colspan="4">Report the same</td></tr>
</table>

Para 3 (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.

3(xi) - Reporting on Fraud			
Fraud by the company Fraud on the company	Noticed?	Yes	Nature
			Amount
	Reported?	Yes	Nature
			Amount
Report under u/s 143(12)	Whether any report under sub-section 12) of section 143 of the Companies Act has been filed by the auditors in Form ADT-4?		
whistle-blower complaints	whether the auditor has considered whistle-blower complaints, if any, received during the year by the company?		

Para 3(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)

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 FSs, etc., as required by the applicable *a*ccounting *s*tandards

Para 3 (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)

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)

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;

Core Investment Companies

- Core Investment Companies (CICs) are specialized Non-Banking Financial Companies (NBFCs).
- A Core Investment Company registered with the RBI has an asset size of above Rs 100 crore.
- Their main business is acquisition of shares and securities with certain conditions.

Para 3(xvii) - Cash losses

- whether the company has incurred cash losses in the ***f***inancial ***y***ear and in the immediately ***p***receding ***f***inancial ***y***ear, if so, state the ***amount*** of cash losses

Para 3 (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)

- 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 FSs,
  - 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)

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 subsection (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 subsection (6) of section 135 of the said Act.

Para 3(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 ***c***onsolidated ***FS***s,
- if yes,
  - indicate the ***details*** of the companies and the paragraph numbers of the CARO report containing the qualifications or adverse remarks.

Audit of Branch Office Accounts

Books of accounts

At Registered Office, Accrual Basis, Double entry system of accounting

As per section 128(1) of the Companies Act, 2013,

- every company shall *prepare* and
- *keep* at its *registered office*
- *books* of *account* and other relevant *books* and *papers* and *FS* for every financial year
- which give a *true* and *fair* view of the state of the affairs of the company,
  - including that of its branch office or offices, if any, and
- *explain* the *transactions* effected both at the registered office and its branches and
- such books shall be kept on *accrual basis* and according to the *double entry system* of *accounting*.

Place other than Registered office

The Board of Directors may choose a different location within India for keeping books of account, and if so, the company must file with the Registrar a notice in writing giving the full address *within 7 days.*

Books of account kept at branch office

If a company with a branch office, either in or outside India, maintains proper books for branch transactions and keep it at branch office and sends summarized returns to its registered office, it shall be deemed to complied with sub-section (1).

Audit of Branch Accounts - Section 143(8)

Who can become branch auditor

- Branch *in India*
  - *Company Auditor*
  - Person *qualified* to be an auditor and appointed as per section 139
- Branch *outside India*
  - *Company auditor*
  - Any person *qualified* to act as an auditor in *accordance* with *laws* of *that country*

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 with it in his report in such manner as he considers necessary.

Duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor. - Rule - 12, Companies (Audit and Auditors) Rules, 2014

1. For the purposes of subsection (8) of section 143, the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be as contained in subsections (1) to (4) of section 143.
2. The branch auditor shall submit his report to the company's auditor.
3. The provisions of subsection (12) of section 143 read with rule 12 hereunder regarding reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

SA 600 - Using the Work of Another Auditor

Definitions

Principal auditor

means the auditor with responsibility for reporting on the financial information of an entity when that financial information includes the financial information of one or more components audited by another auditor. **(Jiski responsibility hai to report on FI of the entity, when that FI includes FI of Component(s))**

Other auditor
means an auditor, other than the principal auditor, with responsibility for reporting on the financial information of a component which is included in the financial information audited by the principal auditor. **(Responsibility to report on FI of Comp, Which is included in FI audited by PA)**

Component
means a division, branch, subsidiary, joint venture, associated enterprises or other entity ***whose financial information is included in the financial information audited by the principal auditor.***

The Principal Auditor's Procedures- Consideration by the Principal Auditor before and while using the work of Another Auditor.

1. The law may allow the principal auditor to review a component's accounts by visiting a component if necessary. Ordinarily, he can rely on another auditor's work, unless special circumstances require his direct review by visiting the component or to examine the books of accounts
2. When planning to use the work of another auditor, the principal auditor should ***consider*** the ***professional competence*** of the other auditor in the context of specific assignment if the other auditor is not a member of the Institute of Chartered Accountants of India.
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***. The principal auditor should ordinarily perform the following procedures
    a. advise the other auditor of the use that is to be made of the other auditor's work and report and
    b. make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit.
    c. The principal auditor would inform the other auditor of matters such as
        - areas requiring special consideration,
        - procedures for the identification of inter-component transactions that may require disclosure and
        - the time-table for completion of audit; and
    d. advise the other auditor
        - of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.
4. The principal auditor might
    a. ***discuss*** with the other auditor the audit procedures applied or
    b. ***review*** a written summary of the other auditor's procedure and findings which may be in the form of a completed questionnaire or checklist.
5. The principal auditor should ***consider*** the ***significant findings*** of the other auditor.
6. The principal auditor may consider it appropriate to ***discuss*** with the other auditor and the management of the component,
    a. the audit findings or other matters affecting the financial information of the components.
7. Principal auditor should ***document*** the
    a. ***significant findings*** of the component whose FSs was audited by the other auditor,
    b. ***name*** of the auditor,
    c. ***conclusions*** reached that the individual component is ***not material***,
    d. performed ***procedures*** and
    e. ***conclusions*** reached,
    f. how he ***deals*** with the ***qualifications*** or adverse remarks contained in the other auditor's report.

Chapter 9 - Special Features of Audit of Different Types Of Entities

Government Audit

Meaning

Objective, systematic, professional and independent examination, of

- financial, administrative and other operations of a public entity,
- for the purpose of evaluating and verifying them, and
- presenting a report on audit findings together
    - with conclusions and
    - recommendations, for future actions by the responsible officials, and
    - in the case of examination of FSs, expressing the appropriate professional opinion regarding the fairness of the presentation.

Objectives

Accounting for Public Funds

Government audit serves as a mechanism or process for public accounting of government funds.

Appraisal of Government policies

It also provides public accounting of the operational, management, programme and policy aspects of public administration as well as accountability of the officials administering them.

Base for Corrective actions

Audit observations based on factual data collection also serve to highlight the lapses of the lower hierarchy, thus helping supervisory level officers to take corrective measures.

Administrative Accountability

The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration.

Legal Framework and Comptroller & Auditor General

The Constitution of India contains specific provisions regarding the appointment, salary and duties and powers of the C&AG.

Appointment

The President of India shall appoint CAG.

Removal or resignation

- He can be removed from the office only on the ground of proven misbehaviour or incapacity.
- Moreover, he can be removed from office only when each house of parliament decides to do so by a majority of at least two third of members present and voting.

Remuneration

- The parliament is competent to make laws to determine salary and other conditions of service.
- As per The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 he shall be paid a salary which is equal to the salary of the Judge of the Supreme Court thereby further strengthening his independence.
- CAG shall hold office for six years or upto age of 65 years whichever is earlier.

Duties and Power

- Article 149 states that the C&AG shall perform such duties and exercise such powers in relation to the accounts of the Union and of the States and of any other authority or body as may be prescribed by or under any law made by the Parliament.

- *Article 150* of the Constitution provides that the *accounts* of the Union and of the States shall be kept in such *form* as the *President* may on the *advice* of the C&AG prescribe.

Reporting Procedures

- *Article 151* of the Indian Constitution states that the C&AG shall *report* on the *accounts* of the Union and of each of the States to the *President* or the *Governor* concern and the *report* to be *laid* before the *legislatures*.
- The reports should not only be presented to the legislatures but thereafter *also publicised adequately* in order to create a proper climate of *public opinion* for taking remedial action where necessary, on the findings of the Auditor General.

Duties of Comptroller & Auditor General

The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 lays down duties of the C&AG as under:

Compile and submit Accounts of Union and States

The C&AG shall be responsible for

- *compiling* the *accounts*
- of the Union and of each State and
- submit those accounts to the President or the Governor or Administrator.

General Provisions Relating to Audit

It shall be the duty of the C&AG -

- to *audit* and *report*
  - on all *expenditure*
    - from the *C*onsolidated *F*und of *I*ndia and of each *State* and of each *U*nion *T*erritory having a *L*egislative *A*ssembly and
    - to ascertain whether the *moneys* disbursed was *legally available* for and *applicable* to the *purpose* to which they have been applied and
    - whether the expenditure conforms to the *authority* which governs it;
- to *audit* and *report*
  - all *transactions* of the Union and of the States relating to *Contingency Funds* and *Public Accounts*;
- to *audit* and *report* on
  - all trading, manufacturing profit and loss accounts and balance-sheets and other *accounts kept* in any *department* of the *Union* or of a *State*.

Audit of Receipts and Expenditure of body or authority substantially financed CFI/S/UT-LA

- The C&AG shall, *Audit* and *report* on all *receipts* and *expenditure* of body or authority *substantially financed* by *grants* or *loans* from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly
- **Substantial Finance** - Grant or loans in a FY is not less than ₹ 25 lakhs and such grant or loan is not less than 75% of the total expenditure.

Audit of Grants or Loans

Where any *grant* or loan is given for any *specific purpose*

- from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly
- to any authority or *body*,
- the *C*omptroller and *A*uditor *G*eneral shall
  - *scrutinize* the *procedures* by which the *sanctioning authority satisfies* itself as to the *fulfilment* of the *conditions* subject to which such grants or loans were given and
  - shall for this purpose have right of *access*, after giving reasonable *previous notice*, to the *books* and *accounts* of that authority or body.

Audit of Receipts of Union or States

- It shall be the duty of the C&AG
- to audit all receipts
  - which are payable into
  - the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly
- and to satisfy himself that
  - the *rules* and *procedures* in that behalf are designed
    - to secure an effective check on the
      - *assessment*,
      - *collection* and
      - proper *allocation* of revenue and
    - are being duly *observed*

Audit of Accounts of Stores and Stock

The Comptroller and Auditor General shall have authority to *audit* and *report* on the *accounts* of *stores* and *stock* kept in any *office* or *department* of the Union or of a State.

Audit of Government Companies and Corporations

The *duties* and *powers* of the C&AG in relation to the audit of the accounts of *government companies* shall be *performed* and *exercised* by him in accordance with the *provisions* of the *Companies Act, 2013*.

Power of Comptroller and Auditor General of India in performance of duties.

Powers of the Comptroller and Auditor General of India in performance of duties: The Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 gives the following powers to the C&AG in connection with the performance of his duties-

Inspect

- To *inspect* any *office of accounts* under the control of the Union or a State Government including office responsible for the creation of the initial or subsidiary accounts.

Require (ABPO)

- To require that any *accounts*, *books*, *papers* and *other* documents which deal with or are otherwise relevant to the transactions under audit, be *sent* to *specified* places.

Put Question / Make Observations / Call Info

- To put such *questions* or make such *observations* as he may consider necessary
- *to* the *person in charge* of the office and to *call* for such *information* as he may require for the preparation of any account or report which is his duty to prepare.

Power to Dispense

- In carrying out the audit, the C&AG has the power to *dispense* with *any part* of *detailed audit* of any *accounts* or class of *transactions* and to *apply* such *limited checks* in relation to such accounts or transactions as he may determine.

Expenditure Audit

Audit of government expenditure is one of the *major components* of government audit conducted by the office of C&AG. Basic *standards set* for *audit* of *expenditure* are explained below

i) **Audit against Rules & Orders**. The auditor has to see that the
   - expenditure incurred
     - *conforms* to the relevant *provisions* of the statutory *enactment* and
     - is in *accordance* with the financial *rules* and *regulations* framed by the competent authority.

ii) **Audit of Sanctions**: The auditor has to ensure that each item of expenditure is *covered* by a *sanction*, either *general* or *special*, by the *competent authority*, authorising such expenditure.

iii) **Audit against Provision of Funds**: Its objective is to ensure whether the expenditure
- is made for the purpose for which the grant and appropriation has been provided.
- Does not exceed the appropriation made.

iv) **Propriety Audit**
- It is required to be seen that the expenditure is incurred with due regard to broad and general *principles* of *financial propriety*.
- The auditor aims to bring out cases of *improper*, *avoidable*, or in *fructuous* expenditure even though the expenditure has been incurred in *conformity* with the existing rules and regulations.
- Audit aims to secure a reasonably high standard of public *financial morality* by looking into the *wisdom*, *faithfulness* and *economy* of transactions.

v) **Performance Audit**
- This involves that the various *programmes*, *schemes* and *projects* where large financial expenditure has been incurred are being *run economically* and are yielding *results* expected of them.

Audit against Rules & Orders

- Audit against rules and orders aims to ensure that the expenditure *conforms* to the relevant *provisions* of the Constitution and of the *laws* and *rules* and *orders* issued by a competent authority.
- These rules, regulations and orders against which regularity audit is conducted mainly fall under the following categories:
  i) Rules and orders regulating the *powers to incur* and *sanction expenditure* from the Consolidated Fund of India or of a State.
  ii) Rules and orders dealing with the *mode* of *presentation* of *claims* in general the financial *rules prescribing* the detailed *procedure* to be *followed* by *government servants* in dealing with government transactions; and
  iii) Rules and orders regulating the *conditions of service*, *pay* and allowances, and pensions of government *servants*.

Function of Audit w.r.t rules and regulation

- It is the *function* of the *executive government* to *frame rules*, regulations and orders, which are to be *observed* by its *subordinate* authorities.
- The job of *audit* is to see that these *rules*, regulations and orders are *applied properly* by the *subordinate* authorities.
- It is, however, *not* the *function* of *audit* to prescribe *what* such *rules*, regulations and orders *shall be*.
- But, it is the *function* of *audit* to carry out *examination* of the various *rules*, regulations and orders issued by the executive authorities *to see* that:
  a) they are *not inconsistent* with any *provisions* of the *Constitution* or any *laws* made thereunder;
  b) they are *consistent* with the essential *requirements* of audit and accounts as determined by the *C&AG*;
  c) they do not come in *conflict* with the orders of, or *rules* made by, any *higher authority*; and
  d) in case they have not been separately approved by competent authority, the issuing authority possesses the necessary *rule-making power*.

Audit of expenditure against regularity is of a *quasi-judicial type* of work performed by the audit authorities. It *involves interpretation* of the Constitution, statutes, rules, regulations and orders. The *final power* of interpretation of these, however, *does not vest* with the C&AG.

Audit of sanctions

The auditor has to ensure that *each* item of *expenditure* is *covered* by a *sanction*, either *general* or *special*, of the competent *authority* by virtue of the powers vested in it by the provisions of the Constitution and of the law, rules or orders made thereunder, or by the rules of delegation of financial powers made by an authority competent to do so.

Audit against propriety

Audit against propriety seeks to ensure that expenditure *conforms* to these *principles* which have been stated as follows:

1. The expenditure should *not* be prima facie *more than* the *occasion demands.*
    - Every public officer is expected to exercise the same *vigilance* in respect of *expenditure* incurred from *public moneys* as a person of *ordinary prudence* would exercise in respect of expenditure of his own money.
2. *No* authority should exercise its powers of *sanctioning expenditure* to pass an order which will be directly or indirectly to its *own advantage*.
3. Public moneys *should not* be *utilized* for the *benefit* of a *particular person* or section of the *community unless*:
    - The amount of expenditure involved is *insignificant*; or
    - A claim for the amount could be *enforced* in a Court of law; or
    - The expenditure is in pursuance of a *recognized policy* or *custom*; and
    - The amount of *allowances*, such as travelling allowances, granted to meet expenditure of a particular type should be so *regulated* that the allowances are *not*, on the whole, *sources of profit* to the recipients

It is the responsibility of the executive departments to enforce economy in public expenditure. The function of audit is to bring to the notice of the proper authorities of wastefulness in public administration and cases of improper, avoidable and ineffective/unproductive expenditure

Audit against provision of funds

Its objective is to ensure whether the expenditure

- is made for the *purpose* for which the *grant* and *appropriation* has been *provided*.
- Does *not exceed* the *appropriation made*.

Performance audit / Full Scope Audit

The scope of audit has been extended to cover *efficiency*, *economy* and *effectiveness* audit or performance audit, or full scope audit

- *Efficiency* audit looks into whether the various *schemes/projects* are executed and their operations conducted *economically* and whether they are yielding the *results expected* of them,
- *Economy* audit looks into whether government have *acquired* the financial, human and physical *resources* in an *economical manner*, and whether the *sanctioning* and *spending authorities* have observed *economy*.
- *Effectiveness audit* is an appraisal of the performance of programmes, schemes, projects with reference to the *overall targeted objectives* as well as efficiency of the means adopted for the attainment of the objectives.

The procedure for conducting performance audit covers

- identification of *topic*,
- preliminary *study*,
- *planning*,
- *execution* of audit, and
- *Reporting*.

Audit of the accounts of stores and inventories

Audit of the accounts of stores and inventories has been developed as a *part* of *expenditure* audit with reference to the duties and responsibilities entrusted to C&AG. Audit is conducted:-

i) to ascertain whether the *Regulations* governing purchase, receipt and issue, custody, sale and inventory taking of stores are well *devised* and *properly carried out*.

ii) to bring to the notice of the government any *deficiencies* in *quantities* of stores held or any *defects* in the *system* of *control*.

iii) to verify that the purchases are properly *sanctioned*, made *economical* and in *accordance* with the *Rules* for purchase laid down by the competent authority.

iv) to ensure that the *prices* paid are *reasonable* and are in agreement with those shown in the *contract* for the supply of stores, and that the certificates of *quality* and *quantity* are furnished by the inspecting and receiving units.
- Cases of uneconomical purchase of stores and losses attributable to defective or inferior quality of stores are specifically brought to notice by the audit.

v) to check *accuracy*, *correctness* and *reasonableness* of balances in *inventories*
- Any *excess* or *idle* inventory is specifically mentioned in the report.
- The *valuation* of the *inventories* is seen carefully so that the value accounts tally with the physical accounts and that adjustment of profits or losses due to revaluation, inventory taking or other causes is carried out.

Audit of Receipts

Audit of receipts include checking:

i) whether all *revenues* or other debts due to government have been correctly *assessed*, *realised* and *credited* to government account by the designated authorities;

ii) whether adequate regulations and procedures have been framed by the concerned department/agency to secure an *effective check* on *assessment* and *collection*.

iii) whether such regulations and *procedures* are *actually* being *carried* out;

iv) whether adequate checks are imposed to ensure the prompt *detection* and *investigation* of *irregularities*, or other loss of revenue through fraud or wilful omission or negligence to levy or collect taxes or to issue refunds; and

v) review of *systems* and *procedures* to ensure *correct* and regular *accounting* of demands collection and refunds and pursuant of dues up to final settlement and to suggest improvement.

- The extent and quantum of audit required to be done under each category of audit are determined by the C&AG. These are neither negotiable nor questioned.
- Institutional mechanism provides for primary check by the auditor, test check by the supervisor and control and direction by the group leader.
- Planning, executing and reporting of work is directed and monitored at middle and top levels of the audit hierarchy. There are built-in arrangements within the C&AG to ensure that the work assigned to each employee is carried out as prescribed.
- The audit is conducted both centrally where accounts and original vouchers are kept and locally where the drawing and disbursing functions are performed depending on the organisational and institutional arrangements obtaining

Audit of Commercial Accounts

Public enterprises are required to maintain commercial accounts and are generally classified under three categories—

a. *departmental* enterprises engaged in commercial and trading operations, which are subject to the same laws, financial and other regulations as other government departments and agencies;
b. *statutory bodies*, corporations, created by specific statutes mostly financed by government in the form of loans, grants, etc.; and
c. *Government companies* set up under the Companies Act, 2013.

The audit of :-

a. departmental concerns is undertaken in the *same manner* as any *department* of *government* where commercial accounts are kept.
b. statutory bodies or corporations depends on the *nature* and *type* of the *statute* governing the bodies or corporations. Audit is conducted by the C&AG, functions, norms and standards of works usually followed by the professional auditors are adopted.
c. Government companies is conducted by their *own auditors* under the *statute appointed* by *C&AG*. In addition, the C&AG conducts a *supplementary test audit* of the accounts, as well as periodical financial audit and appraisal of performance. The C&AG also *issues direction* to the company auditors for reporting on

specific aspects of their audit work. C&AG has adopted the mechanism of an Audit Board - comprising of representatives of the audit and nominees of government including functional specialists to process reviews or appraisals on performance.

Role of C&AG under the Companies Act, 2013

Section 143(5)

- In the case of a Government company, C&AG shall appoint the auditor and 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 the ***CAG*** which, among other things, include the following:
    - ***directions***, if any, issued by the C&AG,
    - the ***action*** taken thereon and
    - its ***impact*** on the accounts and FS of the company.

Supplementary Audit Section 143(6)

- C&AG shall within ***60 days*** from ***date*** of ***receipt*** of the audit report have a right to,
    - conduct a ***supplementary audit*** of the FS of the company by such person as he may authorise; and for the purposes of such audit, require information or additional information to be furnished to any person, so authorised, in such form, as the C&AG direct; and
    - ***comment*** upon or supplement such audit report.
- Any comments given by C&AG upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited FS under section 136(1) and also be placed before the ***AGM*** of the company at the same time and in the same manner as the audit report.

Test Audit - Section 139(7)

- C&AG may, in case of Government Company and Government owned or controlled companies, if he considers necessary, by an order, cause test audit to be conducted of accounts of such company and the provisions of section 19A of the CAG (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.

Statutory auditors shall submit a ***copy*** of their audit ***report*** to the ***C&AG*** who shall have a right to ***comment*** upon or ***supplement*** the audit ***report*** in such manner as he may think fit. Section 134(3) of the Companies Act, 2013 imposes a duty on the BOD to give an ***explanation*** or comments on every reservation, or adverse remarks or disclaimer contained in the auditors' report. In the absence of similar provisions requiring the company to give reply on the reservation made by the C&AG, the BOD is not bound to give information or explanation in respect of such comments.

Audit of Local Bodies

Background

A municipality can be defined as a unit of local self- government in an urban area. By the term 'local self-government' is ordinarily understood the administration of a locality - a village, a town, a city or any other area smaller than a state - by a body representing the local inhabitants, possessing fairly large autonomy, raising at least a part of its revenue through local taxation and spending its income on services which are regarded as local and, therefore, distinct from state and central services.

Municipal government in India covers five distinct types of urban local authorities, viz., the municipal corporations, the municipal councils, the notified area committees, the town area committees and the cantonment committees.

Objective of Audit of Local Bodies

1. Reporting on the ***fairness*** of the ***content*** and ***presentation*** of ***FSs***;
2. Reporting upon the ***strengths*** and ***weaknesses*** of systems of financial control;
3. Reporting on the adherence to legal and /or ***administrative*** requirements;

4. Reporting upon whether *value* is being *fully received* on money spent; and
5. Detection and *prevention* of *error*; *fraud* and *misuse* of *resources*

This kind of audit focuses upon assessment of whether urban institutions are fulfilling their responsibilities with efficiency, economy and effectiveness (sometimes known as 'the three Es').

Audit Programme For Local Body

1. The *Local Fund Audit Wing* of the *State Govt*, is generally in charge of the audit of municipal accounts. Sometimes bigger municipal corporations e.g. Delhi, Mumbai etc have power to appoint their own auditors for regular external audit. So the auditor should ensure authenticity of his appointment.
2. The auditor while auditing the local bodies should report on the
    a. *fairness* of the *contents* and *presentation* of *FSs*,
    b. the *strengths* and *weaknesses* of the system of financial control,
    c. adherence to legal and/or *administrative* requirements;
    d. upon whether *value* is being *fully received* on money spent.
    e. His objective should be to *detect errors* and *fraud* and *misuse* of *resources*.
3. The auditor should ensure that the *expenditure* incurred conforms to the relevant provisions of the law and is in accordance with the financial rules and regulations framed by the competent *authority*.
4. He should ensure that all types of *sanctions*, either special or general, accorded by the competent *authority*.
5. He should ensure that there is a *provision* of *funds* and the expenditure is incurred from the provision and the same has been *authorised* by the competent *authority*.
6. The auditor should check that the different *schemes*, *programmes* and projects, where large financial expenditure has been incurred, are running *economically* and getting the *expected results*.

Features of Financial Administration of Local bodies

Salient Features of Financial Administration of Local Bodies

Budgetary Procedure

The objective of local bodies budgetary procedure are

- financial *accountability*,
- *control* of expenditure,
- and to ensure that *funds* are *raised* and *monies* are *spent* by the executive departments in accordance with the *rules* and regulations and within the *limits* of *sanction* and *authorisation* by the legislature or Council.

Expenditure Control

- At the *State* and *Central* level, there is a clear *demarcation* between the legislature and executive.
- In the *local* body, *legislative* powers are vested in the *Council* whereas *executive* powers are delegated to the *officers*, e.g., Commissioners.
- All matters of *regular revenue* and *expenditures* are generally delegated to the *executive* wing. For *special situations* like, reduction in property taxes, refund of security deposits, etc., sanction from the *legislative* wing is necessary.

Accounting System

- Municipal Accounting System has been conventionally prepared under the cash system.
- In the recent past however, it is being changed to the accrual system of accounting.
- The accounting system is characterized by
    - subsidiary and statistical *registers* for taxes, assets, cheques etc.,
    - *separate vouchers* for each type of transaction,
    - *compulsory* monthly bank *reconciliation*,
    - submission of *summary reports* on *periodical basis* to different authorities at *regional* and *state* level.

Types of Grants Received by Local Authority

Local bodies may receive different types of grants from the state administration as well. Broadly, the revenue grants are of three categories

1. **General purpose grants** - These are primarily intended to substantially *bridge* the gap between the *needs* and *resources* of the local bodies.
2. **Specific purpose grants** - These grants which are tied to the provision of *certain services* or performance of *certain tasks*.
3. **Statutory and compensatory grants** - These grants, under various *enactments*, are given to local bodies as *compensation* on account of loss of any *revenue* on taking over a tax by state government from local government.

Audit of NGO

Background

NGO		
Meaning	NGOs can be def ned as non-profit making organisations	which raise funds from members, donors or contributors
		apart from receiving donation of time, energy and skills
		for achieving their social objectives like imparting education, providing medical facilities, economic assistance to poor, managing disasters
Include	religious organisations, voluntary health and welfare agencies, charitable organisations, hospitals, old age homes, research foundations etc.	
Incorporated as	Society under the societies registration act, 1860	Auditors are appointed by management of society or trust
	Trust under India Trust Act, 1882	Auditors are appointed by management of society or trust
	Section 8 of the companies act, 2013	Auditors are appointed by Members of the company

NGOs registered under the Companies Act, 2013 must maintain their books of account under the accrual basis as required by the provisions of section 128 of the said Act. If the accounts are not maintained on accrual basis, it would amount to non-compliance of the provision of the Companies Act, 2013. The NGOs which are not registered under the Companies Act, 2013 are allowed to maintain accounts either on an accrual basis or cash basis.

Provisions Relating to Audit

- The auditors of an NGO registered under the Societies Registration Act, 1860 or the Indian Trusts Act 1882 are normally appointed by the Management of the Society or Trust.
- The auditors of NGO registered under section 8 of the Companies Act, 2013 are appointed by the members of the company.
- Companies Act, 2013, Foreign Contribution (Regulation) Act 2010, Income Tax Act 1961 required that the accounts of the NGO be audited and submitted to the prescribed authorities
- Foreign Contribution (Regulation) Act 2010 requires that the report be furnished to the Ministry of Home Affairs within 60 days from the close of the financial year i.e. by May 30 each year.

Planning the Audit

While planning the audit, the auditor may concentrate on the following

1. *Knowledge* of the NGO's work, its mission and vision, areas of operations and environment in which it operate.
2. *Updating* knowledge of relevant statutes especially with regard to recent amendments, circulars, judicial decisions viz. Foreign Contribution (Regulation) Act 1976, Societies Registration Act, 1860, Income Tax Act 1961 etc. and the Rules related to the statutes.
3. *Reviewing* the *legal form* of the Organisation and its MOA, AOA, Rules and Regulations.
4. *Reviewing* the NGO's Organisation chart, then Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.
5. Examination of *minutes* of the Board/Managing Committee/Governing Body/ Management and Committees thereof to ascertain the impact of any decisions on the financial records.
6. *Study* the accounting *system*, *procedures*, internal *controls* and internal *checks* existing for the NGO and verify their applicability.
7. *Setting* of *materiality* levels for audit purposes.
8. The nature and timing of *reports* or other communications.
9. The involvement of *experts* and their reports.
10. Review the *previous year's* Audit Report.

Assets, liabilities, income and expenditure to be included in Audit Programme

The audit programme should include in a sequential order all assets, liabilities, income and expenditure ensuring that no material item is omitted.

1. **Corpus Fund**: The contributions / grants received towards corpus be vouched with special reference to the letters from the donor(s). The interest income be checked with Investment Register and Physical Investments in hand.
2. **Reserves**: Vouch transfers from projects / programmes with donor letters and board *resolutions* of NGO. Also check the transfer of gross value of assets sold from capital reserve to general reserve and adjustments during the year.
3. **Ear-marked Funds**: Check requirements of *donors* institutions, board resolution of NGO, rules and regulations of the schemes of the ear-marked funds.
4. **Project / Agency Balances**: Vouch *disbursements* and *expenditure* as per agreements with donors for each of the balances.
5. **Loans**: Vouch loans with loan *agreements*, counterfoil of receipt issued.
6. **Fixed Assets**: Vouch all *acquisitions* / *sale* or disposal of assets including *depreciation* and the *authorisations* for the same. Also check the donor's letters/ agreements for the grant. In the case of immovable property check title, etc.
7. **Investments**: Check Investment *Register* and the investments *physically* ensuring that investments are in the name of the NGO. Verify further investments and dis - investments for approval by the appropriate *authority* and reference in the bank accounts for the principal amount and interest.
8. **Cash in Hand**: *Physically verify* the cash in hand and imprest balances, at the close of the year and whether it tallies with the books of account.
9. **Bank Balance**: Check the *b*ank *r*econciliation *s*tatements and ascertain details for old outstanding and unadjusted amounts.
10. **Inventory**: Verify inventory in hand and obtain *certificate* from the management for the quantities and valuation of the same.
11. **Programme and Project Expenses**: Verify *agreement* with donor/contributor(s) supporting the particular programme or project to ascertain the conditions with respect to undertaking the programme/project and accordingly, in the case of programmes/projects involving contracts, ensure that income tax is deducted, deposited and returns filed and verify the terms of the contract.
12. **Establishment Expenses**: Verify that provident fund, life insurance premium, employees state insurance and their administrative charges are deducted, contributed and deposited within the prescribed time. Also check other office and administrative expenses such as postage, stationery, traveling, etc.

Checking / Audit of Receipts of NGO

The receipt of income of NGO may be checked on the following lines:

i) **Contributions and Grants for projects and programmes:** Check *agreements* with donors and grants *letters* to ensure that *funds* received have been *accounted* for. Check that all *foreign contribution* receipts are *deposited* in the *foreign contribution bank account* as notified under the Foreign Contribution (Regulation) Act, 1976.

ii) **Receipts from fund raising programmes:** Verify in detail the *internal control* system and ascertain who are the *persons responsible* for *collection* of funds and mode of receipt. Ensure that *collections* are counted and **deposited** in the bank daily.

iii) **Membership Fees**: Check fees received with Membership *Register*. Ensure proper *classification* is made between *entrance* and *annual* fees and *life membership* fees. *Reconcile* fees received with fees to be received during the year.

iv) **Subscriptions**: Check with the subscription *register* and *receipts* issued. Reconcile *subscription* received with printing and dispatch of corresponding *magazine*/ circulars/periodicals. Check the *receipts* with the *subscription rate* schedule.

v) **Interest and Dividends**: Check the *interest* and *dividends* received and receivable with *investments* held during the year

Audit programme for audit of receipts of donations and remittance of the collected amount to different NGOs

Receipt of Donations

i) **Internal Control System**: Existence of internal control system particularly with reference to *division* of responsibilities in respect of authorised *collection* of donations, *custody* of *receipt* books and safe *custody* of *money*.

ii) **Custody of Receipt Books**: Existence of system regarding *issue* of receipt books, whether *unused* receipt books are *returned* and the same are verified physically including checking of number of receipt books and sequence of numbering therein.

iii) **Receipt of Cheques**: Receipt Book should have *carbon copy* for *duplicate* receipt and signed by a responsible official. All *details* relating to date of cheque, bank's name, date, amount, etc. should be clearly stated.

iv) **Bank Reconciliation**: Reconciliation of bank statements with reference to all cash deposits not only with reference to date and amount but also with *reference* to *receipt book*.

v) **Cash Receipts**: Register of cash donations to be vouched more *extensively*. If *addresses* are *available* of donors who had given cash, the same may be cross-checked by asking entity to *post* thank you letters mentioning *amount*, *date* and *receipt* number.

vi) **Foreign Contributions**, if any, to receive special attention to compliance with applicable *laws* and *regulations*.

Remittance of Donations to Different NGOs

i) **Mode of Sending Remittance:** All remittances are through *account payee cheques*. Remittances through Demand Draft would also need to be scrutinised thoroughly with reference to recipient.

ii) **Confirming Receipt of Remittance**: All remittances are *supported* by *receipts* and *acknowledgements*.

iii) **Identity**: Recipient NGO is a *genuine entity*. *Verify address*, *80G Registration* Number, etc.

iv) **Direct Confirmation Procedure**: Send confirmation letters to entities to whom donations have been paid.

v) **Donation Utilisation**: Utilisation of donations for *specified purpose* and not for any other purpose.

vi) **System of NGOs' Selection**: System for selecting NGO to whom donations *should* be *unbiased*.

Sources and Applications of Funds

The main sources of funds include grants and donations, fund raising programmes, advertisements, fees from the members, technical assistance fees / fee for services rendered, subscriptions, gifts, sale of produce or publications, etc.

1. Donations and grants received in the nature of *promoter's contribution* are in the nature of *capital receipts* and *shown* as *liabilities* in the Balance Sheet of NGO. These may either be in the form of *corpus contribution*

or a contribution towards *revolving fund*. A *contribution* made *towards* the *capital* or the corpus of an NGO is known as corpus contribution.

2. Section 11(1)(d) of the Income Tax Act 1961 also states that income in the form of voluntary contributions made with a specific direction that they shall form part of the corpus of the trust or institution shall *not* be *included* in the computation of *total income*.
3. The objective of a contribution or grant towards a *Revolving Fund* is to *rotate* the *amount* by giving *temporary loans* from the fund to other NGO or beneficiaries for their projects and then recover the loan so as to give temporary loans again and so on. However, any interest earned from the beneficiary on such temporary loans from the revolving fund could be either added back to the fund or credited to the Income and Expenditure Account as per the conditions or rules or regulation of NGO.
4. Donations and grants received for acquisition of specific *fixed assets*.
5. Many a times NGOs receive *contributions in kind*. These contributions include assets such as land, buildings, vehicles, office equipment, etc. and articles related to programmes / projects.

The areas of application of funds for an NGO include Establishment Costs, Office and Administrative Expenses, Maintenance Expenses, Programme / Project Expenses, Charity, Donations and Contributions given, etc.

Audit of a Sole Trader

- A sole trader is under *no* legal *obligation* to have his accounts audited.
- However, many such individuals get their financial statement audited due to regulatory requirements, such as on a specific instructions of the bank for approval of loans, etc.
- In case of sole proprietor the scope and other conditions of audit are stipulated by the sole proprietor.
- Auditors of sole proprietary concern shall be appointed by the sole proprietor *himself*.

Audit of Partnership Firms

Basics

- Appointed by the partners
  - either on the basis of a decision taken by them or
  - to comply with a condition in the partnership agreement.
- Remuneration also fixed by the partners.
- In case of change of auditor, it would be duty of incoming auditor to communicate with the previous auditor. (CA Final Professional Ethics)
- The auditor may, particularly, ensure application of accounting standards prescribed by the Institute.
- In case the firm is required to get its accounts audited under the requirements of any statute, the auditor will have to qualify the report in case of non-compliance with the accounting standards.
- Alternatively, only disclosure of non- compliance with the accounting standards, would be sufficient without making it a subject matter of qualification.

Matters to be considered before starting audit

Also, before starting the audit, he should examine the partnership agreement and note the provisions therein as regards the following matters:

1. The *name* and style under which the business shall be conducted.
2. The *duration* of the partnership, if any, that has been agreed upon.
3. The *amount* of *capital* that shall be contributed by each partner—whether it will be fixed or could be varied from year to year.
4. The *period* at the end of which the accounts of the partnership will be closed periodically and *profit* or *loss sharing ratio* of partners.
5. The provisions as regards *maintenance* of *books* of *account* and the *matters* which must be taken into *account* for determining the profits of the firm available for division among the partners e.g., creation of reserves, provision for depreciation, etc. also the period within which accounts can be reopened for correcting a error.
6. *Borrowing capacity* of the partnership (when it is not implied as in the case of non-trading firms).

7. The rate at which *interest* will be allowed on the *capitals* and *loans* provided by partners and the rate at which it will be charged on their drawings and current accounts.
8. Whether any salaries are payable to the partners or withdrawals are permitted against shares of profits and, if so, to what extent?
9. Duties of the partners as regards the management of business of the firm; also, the partners who shall act as managing partners.
10. Who shall operate the *bank account* of the firm? How will the surplus funds of the partnership be invested?
11. *Limitations* and *restrictions* that have been agreed upon, the *rights* and *powers* of partners and on their implied *authority* related to business of the firm.

Advantages of audit of accounts of a partnership firm

Advantages are as follows

1. Audited accounts provide a convenient and reliable means of *settling accounts* between the partners and thereby possibility of dispute among them is mitigated.
2. On the *retirement/death* of a partner, audited accounts constitute reliable evidence for computing the amount due to the *retiring partner* or *representative* of the *deceased* partner.
3. Audited accounts are generally accepted by the *Income tax authorities* for computing the assessable income.
4. Audited accounts are relied upon by banks for advancing *loans*.
5. Audited accounts can be helpful in the negotiation for sale or admission of a *new partner*.
6. It is an effective safeguard against any undue advantage being taken by a *working partner*

Important points which auditors will consider while conducting audit of accounts of a partnership firm are:

1. Confirming that the *letter* of *appointment*, signed by a partner, duly authorised, clearly states the *nature* and *scope* of audit contemplated by the partners, specially the *limitation*, if any, under which the auditor shall have to function.
2. Studying the *minute book*, if any, maintained to record the policy decision taken by partners specially the minutes relating to authorisation of extraordinary and capital expenditure etc
3. Verifying that the *business* in which the *partnership* is engaged is *authorised* by the partnership agreement
4. Examining whether *books of account* appear to be *reasonable* and are considered *adequate* in relation to the *nature* of the business of the partnership.
5. Verifying generally that the *interest* of *no partner* has suffered *prejudicially* by an *activity* engaged in by the *partnership* which, it was *not authorised* to do under the partnership deed.
6. Confirming that a provision for the firm's tax payable by the partnership has been made in the accounts before arriving at the amount of profit divisible among the partners.
7. Verifying that the *profits* and *losses* have been divided among the partners in their agreed profit-sharing ratio.

Audit of LLP

Basics

- LLP is *governed* by the Limited Liability Partnership Act 2008.
- It is a form of *business organisation* having the advantages of both the Company and Partnership forms of Organisation.
- *Minimum* of *2 Partners* can form an LLP and *at least two partners* would be *Designated Partners* who would be required to take *DPIN* (Designated Partner Identification Number)
- The Partners in an LLP and their *rights* and *duties* are governed by way of an *agreement* between them .

Definition of Small LLP

Any LLP

a) the *Contribution* of which, *does not exceed ₹ 25,00,000* or such higher amount, not exceeding ₹ 5 crore, as may be prescribed; and

b) the *Turnover* of which, as per the Statement of Accounts and Solvency for the immediately preceding financial year, *does not exceed ₹ 40,00,000* or such higher amount, not exceeding ₹ 50 crore, as may be prescribed;

Books of Accounts

LLP's are required to maintain books of accounts which shall contain-

1. Particulars of all sums of *money received* and *expended* by the LLP and the matters in respect of which the receipt and expenditure takes place,
2. A *record* of the *assets* and *liabilities* of the LLP
3. *Statements* of *costs* of goods purchased, inventories, work-in-progress, finished goods and costs of goods sold,
4. Any other *particulars* which the *partners* may *decide*

Audit of the Accounts of an LLP

- The accounts of every LLP shall be audited in accordance with Rule 24 of LLP, Rules 2009.
- LLP, whose
  - *turnover* does not exceed, in any financial year, forty lakh rupees, *or*
  - whose *contribution* does not exceed twenty five lakh rupees,
  - is *not required* to get its *accounts audited*.
- However, if the *partners* of such limited liability partnership *decide* to get the accounts of such LLP *audited*, the accounts shall be *audited* only in accordance with such rule.

Appointment of Auditor

- The auditor may be appointed by the designated partners of the LLP –
  a) At any time for the *first financial* year but *before* the *end* of *first financial year*,
  b) At *least thirty days* prior to the *end* of *each financial year*(other than the first financial year),
  c) To fill the *casual vacancy* in the office of auditor,
  d) To fill the *casual vacancy* caused by *removal* of auditor.
- The *partners* may appoint the auditors if the *designated* partners have *failed* to appoint them.

Auditor's Duty Regarding Audit of LLP

Engagement Letter

- The auditor should get *definite instructions* in *writing* as to the work to be performed by him.

Minutes Book

- If partners maintain *minute book* he shall refer it for any resolution passed regarding the accounts

LLP Agreement

The auditor should read the LLP agreement & note the following provisions

- *Nature* of the business of the LLP.
- Amount of *capital* contributed by each partner.
- *Interest* – in respect of additional capital contributed.
- *Duration* of partnership.
- *Drawings* allowed to the partners.
- *Salaries*, *commission* etc payable to partners.
- *Borrowing powers* of the LLP.
- *Rights* & *duties* of partners.
- Method of *settlement* of accounts between partners at the time of admission, retirement, admission etc.
- Any *loans* advanced by the partners.
- *Profit sharing* ratio

Reporting

The auditor should mention

- Whether the *records* of the firm appear to be *correct* & *reliable*.
- Whether he was *able* to *obtain all information* & *explanation* necessary for his work.
- Whether any *restriction* was *imposed* upon him.

Advantages / Purpose / Need of Audit

1. Detection of *errors* & *frauds*
2. Resolving *disputes* among the partners in relation to accounting matters.
3. Verification of FSs and better *reliability* for the purpose of taking *loans* etc.
4. Better *Compliance* and *Management*
    a. Periodical visits & suggestions by the auditor will be helpful in improving the management of the LLP.
5. *Reconstitution* :- For *settling accounts* between partners at the time of admission, death, retirement, insolvency, insanity, etc audited accounts are accepted by those concerned who have dealings with the LLP.

Returns to be maintained and filed by an LLP

- Every LLP would be required to file annual return in *Form 11* with ROC *within 60 days* of closer of financial year. The annual return will be *available* for *public inspection* on payment of prescribed fees to Registrar.
- Every LLP is also required to submit *Statement* of *Account* and *Solvency* in *Form 8* which shall be filed within a period of *30 days* from the end *of six months the financial year* to which the Statement of Account and Solvency relates.

Audit of Charitable Institution

In the case of audit of a charitable institution, attention should be paid to the following matters

General

Constitution

Studying the constitution under which the charitable institution has been set up.

Managed As Per Law

Verifying whether the institution is being managed in the manner prescribed by the law under which it has been set up.

Internal Check

Examining the system of internal check, especially as regards accounting of amounts collected.

Verify Income

Verifying in detail the income and confirming that the amounts received have been deposited in the bank regularly and promptly.

Trust Deed / Regulations

Examine the Trust Deed or the Regulations as laid down.

Subscriptions and donations

Change In Amount

Ascertaining, if any, the changes made in amount of annual or life membership subscription during the year.

Whether official receipts are issued

a. **CONTROL - UNUSED**
    - confirming that adequate control is imposed over unused receipt books;
b. **OBTAIN ALL**
    - obtaining all receipt books covering the period under review;

c. **COUNTERFOILS - CANCELLED SPECIALLY**
   - test checking the counterfoils with the cash book; any cancelled receipts being specially looked into;

d. **PRINTED LIST - S&D - Agreeing**
   - obtaining the printed list of subscriptions and donations and agreeing them with the total collections shown in the accounts;

e. **INTERNAL CHECK - BOX COLLECTION, FLAG DAY**
   - examining the system of internal check regarding moneys received from box collections, flag days, etc. paying special attention to the system of control exercised over collections and the steps taken to ensure that all collections made have been accounted for; and

f. **RECEIVED WITH PUBLISHED**
   - verifying the total subscriptions and donations received with any figures published in reports, etc. issued by the charity.

Legacies (Amount Received - Corresponding Figures, other information)

Verifying the amounts received by reference to correspondence with any figures and other available information.

Grants

1. Vouching the *amount received* with the relevant *correspondence*, *receipts* and *minute books*.
2. Obtaining a *certificate* from a responsible official showing the amount of grants received.

Investments Income

1. Vouching the amounts received with the dividend and interest *counterfoils*.
2. Checking the *calculations* of *interest* received on securities bearing fixed rates of interest.
3. Checking that the *appropriate dividend* has been *received* where any investment has been sold ex-dividend or purchased cum-dividend.
4. Comparing the amounts of *dividend* received with *schedule* of *investments* making *special enquiries* into any *investments* held for which *no dividend* has been received.

Rent

1. Examining the *rent roll* and inspecting *tenancy agreements*, noting in each case
   a. the *amounts* of the rent, and
   b. the *due dates*.
2. Vouching the *rent* on to the rent roll from the counterfoils of *receipt books* and checking the *totals* of the *cash book*.

Special functions, etc.

Vouching gross receipts and *outgoings* in respect of any special functions, e.g. concerts, dramatic performance, etc., held in aid of the charity with such *vouchers* and cash *statements* as are *necessary*. In particular, verifying that the proceeds of all *tickets* issued have been *accounted* for, after making the *allowance* for *returns*.

Income Tax Refunds

Where income-tax has been deducted from the Investment income, it *should* be *seen* that a *refund* thereof has been *obtained* since charitable institutions are *exempt* from payment of *Income-tax*. This involves

1. vouching the Income-tax refund with the correspondence with the Income- tax Department; and
2. checking the *calculation* of the repayment of claims.

Expenditure

1. Vouching *payment* of *grants*, also verifying that the grants have been paid only for a charitable purpose or *purposes* falling within the purview of the objects for which the charitable institution has been set up and that *no trustee*, director or member of the Managing Committee has *benefited* there from either *directly* or *indirectly*.

2. Verifying the schedules of securities held, as well as inventories of properties both movable and immovable by inspecting the securities and title deeds of property and by physical verification of the movable properties on a test- basis.
3. Check payment along with supporting documents in regard to salary and other expenses. Verify that all payments are made after proper sanction by appropriate authority.
4. Verifying the cash and bank payments.
5. Ascertaining that any funds contributed for a special purpose have been utilised for the purpose.

Audit of Educational Institution - School, College, University

The special steps involved in their audit are the following-

General

1. Examine the Trust Deed or Regulations, in the case of school or college and note all the provisions affecting accounts.
2. In the case of a university, refer to the Act of Legislature and the Regulation framed thereunder.
3. Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.

Fee from Students

1. Check names entered in the Students Fee Register for each month or term, with the respective Class Registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.
2. Check fees received by comparing counterfoils of receipts granted with entries in the Cash Book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.
3. Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and that the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.
4. Check admission fees with admission slips signed by the head of the institution and confirm that the amount has been credited to a Capital fund, unless the Managing Committee has taken a decision to the contrary.
5. See that free studentship and concessions have been granted by a person authorised to do so, having regard to the Rules prepared by the Managing Committee.
6. Confirm that fines for late payment or absence, etc. have been either collected or remitted under proper authority.
7. Confirm that hostel dues were recovered before student's accounts were closed and their deposits of caution money refunded.

Other Receipts/Grants & Donations

1. Verify rental income from landed property with the rent rolls, etc.
2. Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.
3. Verify any Government or local authority grant with the memo of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons thereof.

Expenditure

1. Verify that the Provident Fund money of the staff has been invested in appropriate securities.
2. Vouch donations, if any with the list published with the annual report. If some donations were meant for any specific purpose, see that the money was utilised for the purpose.
3. Vouch, all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.
4. Vouch, in the usual manner, all establishment expenses and enquire into any unduly heavy expenditure under any head. If there was any annual budget prepared, see that any excess under any head over the

budgeted amount was duly *sanctioned* by the Managing Committee. If not, bring it to the Committee's notice in your report.

5. See that increase in the *salaries* of the staff have been *sanctioned* and minuted by the Committee.

Assets & Liabilities

1. Report any *old heavy arrears* on account of *fees*, dormitory rents, etc. to the Managing Committee.
2. Confirm that *caution money* and other deposits paid by students on admission, have been shown as *liability* in the balance sheet not transferred to revenue, unless they are not refundable.
3. See that the investments representing *endowment funds* for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.
4. Ascertain that the system ordering *inspection* on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.
5. Verify the *inventories* of furniture, stationery, clothing, provision and all equipment etc. These should be checked by reference to Inventory Register or corresponding inventories of the previous year and values applied to various items should be test checked.

Compliances

1. Confirm that the *refund* of *taxes deducted* from the income from investment (interest on securities etc.) has been *claimed* and *recovered* since the institutions are generally exempted from the payment of income-tax.
2. Finally, verify the annual statements of account and, while doing so see that separate statements of account have been prepared as regards Poor Boys Fund ●, Games Fund, Hostel and Provident Fund of staff, etc.

Audit of Hospital

The special steps involved in such an audit are as follows:

Register of Patients

- Vouch the *Register* of *patients* with copies of bills issued to them.
- Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared.
- Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

Cash Collection

- Check cash collections as entered in the Cash Book with the *receipt*, *counterfoils* and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.

Property and Investment

- See by reference to the Property and Investment *Register* that all income that should have been received by way of rent on properties, dividends and interest on securities settled on the hospital has been collected.

Specific Purpose Legacies and Donations

- Ascertain that legacies and donations received for a *specific purpose* have been applied in the manner agreed upon.

Collection From Cash Book To Register

- Trace all collections of *subscription* and *donations* from the Cash Book to the respective *Registers* *Reconcile* that total *subscriptions due* (as shown by the Subscription Register and the amount collected and that still outstanding).

Purchases and Expenses

- Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior *sanction* of the Trustees or the Managing Committee and that *appointments* and *increments* to staff have been duly *authorised*.

Grants From Government and Refund Of Taxes

- Verify that grants, if any, received from *Government* or local authority have been duly *accounted* for. Also that *refund* in respect of taxes deducted at source has been *claimed*.

Compare Actual Vs. Budgeted

- Compare the totals of various items of expenditure and income with the amount budgeted for them and *report* to the Trustees or the Managing Committee significant variations which have taken place.

Internal Check For Receipts and Issues

- Examine the internal check as regards the receipts and issue of *stores*; *medicines*, apparatus, clothing, instruments, etc. so as to insure that purchases have been properly recorded in the Stock Register and that issues have been made only against proper authorisation.

Depreciation - Appropriate Rates

- See that *depreciation* has been written off against all the assets at the appropriate rates.

Bonds, Shares, Properties (Inspect and Compare)

- Inspect the *bonds*, share scripts, title deeds of properties and *compare* their particulars with those entered in the Property and Investment *Register*.

Inventories

- *Obtain* inventories, specially of stocks and stores as at the *end* of the year and *check* a percentage of the items *physically*, also *compare* their total values with respective *ledger* balances.

Audit of Club

The special steps involved in such an audit are stated below-

Entrance Fee

Vouch the receipt on account of entrance fees with members' *applications*, *counterfoils* issued to them, as well as on a reference to *minutes* of the Managing Committee.

Subscriptions

Vouch members' subscriptions with the *counterfoils* of receipt issued to them, trace receipts for a selected period to the Register of Members; also *reconcile* the *amount* of total subscriptions *due* with the amount *collected* and that *outstanding*.

Arrears of Subscriptions

Ensure that arrears of subscriptions for the previous year have been *correctly brought over* and arrears for the year under audit and subscriptions received in advance have been correctly *adjusted*.

Arithmetical accuracy

Check *totals* of various *columns* of the *Register* of members and tally them across.

Irrecoverable Member Dues

See the Register of Members to ascertain the Member's dues which are in *arrear* and enquire whether necessary *steps* have been taken for their *recovery*; the amount considered irrecoverable should be mentioned in the Audit Report.

Pricing
Verify the *internal check* as regards members being charged with the price of foodstuffs and drinks provided to them and their guests, as well as, with the fees chargeable for the special services rendered, such as billiards, tennis, etc.

Member Accounts
Trace debits for a selected period from *subsidiary registers* maintained in respect of supplies and services to members to confirm that the account of every member has been debited with amounts recoverable from him.

Purchases
Vouch purchase of sports items, furniture, crockery, etc. and trace their *entries* into the respective inventory registers.

Margins earned
Vouch purchases of *foodstuffs*, cigars, wines, etc., and test their sale price so as to confirm that the normal rates of gross profit have been earned on their sales. The *inventory* of unsold provisions and stores, at the end of year, should be verified *physically* and its valuation checked.

Inventories
Check the inventory of furniture, sports material and other assets *physically* with the respective inventory *registers* or inventories prepared at the end of the year.

Investments
Inspect the share scrips and bonds in respect of investments, check their *current values* for disclosure in final accounts; also ascertain that the arrangements for their safe *custody* are satisfactory.

Management Powers
Examine the *financial powers* of the secretary and, if these have been exceeded, report specific case for confirmation by the Managing Committee.

Audit of Cinema

The special steps involved in its audit are as follows:-

1. Verify
   a. that *entrance* to the cinema hall during show is only *through* printed *tickets*;
   b. that they are *serially numbered* and bound into *books*;
   c. that tickets for each *class* is *different*.
   d. that for *advance* booking a *separate series* of tickets is issued;
   e. and that the *stock* of *tickets* is kept in the *custody* of a responsible official.
2. Confirm that at the end of show, a statement of *tickets sold* is prepared and *cash collected* is agreed with it.
3. Verify that a *record* is kept of the *'free passes'* and that these are issued under proper *authority*.
4. Reconcile the amount of *Tax* collected with the total number of tickets issued for each class and vouch and verify the tax returns filed each month
5. Verify the charges *collected* for *advertisement* slides by reference to the Register of *Slides* kept at the cinema as well with the agreements, entered into with advertisers in this regard.
6. Vouch the *expenditure* incurred on advertisement, repairs and maintenance. No part of such expenditure should be capitalised except redecoration, and that should be adjusted as deferred revenue expenditure the expenditure on extensive redecoration, and that should be adjusted as deferred revenue expenditure.
7. Confirm that depreciation on machinery and furniture has been charged at an appropriate rate.
8. Vouch *payments on account of film hire* with bills of *distributors* and in the process, the agreements concerned should be referred to.
9. Examine *unadjusted balance* out of advance *paid* to the *distributors* against film hire contracts to see that they are *good* and *recoverable*. If any film in respect of which an advance was paid has already run, it should

be enquire as to why the advance has not been adjusted. The management should be asked to make a provision in respect of advances that are considered irrecoverable.

10. The arrangement for collection of the share in the restaurant income should be enquired into either a fixed sum or a fixed percentage of the taking may be receivable annually. In case the restaurant is run by the Cinema, its accounts should be checked. The audit should cover sale of various items of foodstuffs, purchase of foodstuffs, cold drink, cigarettes, etc. as in the case of club.

Auditing of Leasing Transaction

In respect of leasing transaction entered into by the leasing company, the following procedures may be adopted by the auditor.

1. The object clause of leasing company to see that the goods like capital goods, consumer durables etc. in respect of which the company can undertake such activities. Further, to ensure that whether company can undertake financing activities or not.
2. Whether there exists a procedure to ascertain the credit analysis of lessee like lessee's ability to meet the commitment under lease, past credit record, capital strength, availability of collateral security, etc.
3. The lease agreement should be examined and the following points may be noted:
    a. the description of the lessor, the lessee, the equipment and the location where the equipment is to be installed. (The stipulation that the equipment shall not be removed from the described location except for repairs. For the sake of identification, the lessor may also require plates or markings to be attached to the equipment).
    b. the tenure of lease, dates of payment, late charges, deposits or advances etc. should be noted.
    c. whether the equipment shall be returned to the lessor on termination of the agreement and the cost shall be borne by the lessee.
    d. whether the agreement prohibits the lessee from assigning the subletting the equipment and authorises the lessor to do so.
4. Examine the lease proposal form submitted by the lessee requesting the lessor to provide him the equipment on lease.
5. Ensure that the invoice is retained safely as the lease is a long-term contract.
6. Examine the acceptance letter obtained from the lessee indicating that the equipment has been received in order and is acceptable to the lessee.
7. See that the copies of the insurance policies have been obtained by the lessor for his records.

Types of Lease Agreements

Finance Lease

An arrangement with the following attributes qualifies as a Finance Lease

- The lease arrangement transfers ownership of the asset to the lessee at the end of the lease term;
- The lease term is for the major part of the economic life of the asset even if title is not transferred;
- At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- the leased assets are of such a specialized nature that only the lessee can use them without major modifications

Operating Lease

- An arrangement that does not transfer substantially all the risks and rewards incidental to ownership qualifies as an Operating Lease. In other words, an operating lease is a lease arrangement "Other than finance lease".

Auditing of Hire Purchasing Companies

Hire-purchase agreement means an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement

While checking the hire- purchase transaction, the auditor may examine the following

1. Check Memorandum of Association - *Object clause* to ascertain whether the hire purchase business can be carried on by company
2. Hire purchase agreement is in *writing* and is *signed* by all parties.
3. Before signing the HP agreement *credit worthiness* must be evaluated, auditor will check whether proper policy and procedure exist for the same and whether they are followed are not.
4. Hire purchase *agreement* specifies clearly-
    a. The hire-purchase *price* of the goods to which the agreement relates;
    b. The *cash price* of the goods, that is to say, the *price* at which the goods may be purchased by the hirer for cash;
    c. The *date* on which the *agreement* shall be deemed to have commenced;
    d. The *number* of instalments by which the hire- purchase price is to be paid, the *amount* of each of those instalments, and the *date*, upon which it is payable, and the *person* to whom and the *place* where it is payable.
5. Ensure that *instalment payments* are being received regularly as per the agreement
6. Ensure that adequate *resolution* has been passed *authorizing* a *particular director* to execute the hire purchase agreement.
7. Explain the adequacy of *provision* for *doubtful debts* against the hire purchase debtors
8. Examine the case of *repossession* of goods and their *treatment afterwards*. Check how and when they were sold or disposed.
9. Check whether *accounting treatment* of amount due, amount received, loss on repossession and other related items are done as per applicable financial reporting framework.

Auditor should also understand the following w.r.t Hire Purchase and design his audit procedures accordingly

1. Possession of goods is delivered by the owner thereof to a person on condition that such person pays the agreed amount in *periodical instalments*,
2. The *property* in the *goods* is to pass to such person on the payment of the *last* of such instalments.
3. Such person has a *right* to *terminate* the agreement at any time before the property so passes

Auditing of Hotels

The special considerations in a hotel audit can be summarised as follows

Internal Controls

Pilfering

- Pilfering is a major problem in hotels, making internal control crucial.
- *Management* is *responsible* for introducing controls to minimise leakage.

Trading Accounts and Profit Percentages

- Regular trading accounts for each sales point help monitor success.
- The auditor should *review* these accounts, *examining deviations* and *obtaining explanations*.

Revenue Cycle Controls

- Auditors should verify restaurant bills with *K.O.T.* (Kitchen Order Tickets) or basic records, ensuring proper controls are in place.

Tax Compliance

- Auditors need to ensure *taxes collected* on food and occupation are paid to proper authorities.

Auditor's Challenges

- Weak internal controls pose a serious problem for auditors.
- They must rely on the gross margin shown by accounts, which may lead to increased audit tests and possible report *qualifications* if discrepancies remain unexplained.

Room Sales & Hall Bookings

Room Sales and Guest Bills

- Room sales charges are posted by receptionists, front office, or night managers in large hotels.
- Audit tests should ensure correct guest numbers are charged for the correct period.
- *Investigating differences* between charged and standard room rates to ensure that they have been properly authorised

Housekeeper's Daily Report

- Housekeepers prepare *daily reports* of occupied rooms and beds.
- Auditors need *sufficient* reports to test against guest registers and individual bills.

Valuation of Occupancy-in-Progress

- Auditors should ensure *proper valuation* of occupancy-in-progress at the balance sheet date.

Records for Booking Halls and Premises

- Proper *records* for booking halls and premises for special parties should be maintained.
- Auditors must ensure *recovery* is based on the tariff.

Inventories

Inventory Control and Documentation

- Inventories in hotels, especially food and beverage, are portable and saleable, requiring proper *documentation* for control.
- Auditors should *test* documentation *accuracy* for inventory movements and transfers.

Inventory Security and Valuation

- Locked storage areas should be *supervised* by the departmental manager to *prevent* *unauthorized* access.
- Auditors should assess the *reasonableness* of inventory figures, considering independent valuations, and perform *pricing* and *calculation* *tests* during physical inventory taking.

Fixed Assets

Fixed Assets Accounting Policies

- Hotels may have different accounting policies for fixed assets like silverware and cutlery.
- Auditors should ensure detailed definitions of inventory items and test adherence to these definitions.

Expenditure Classification

- Auditors should verify that costs for repairs, minor renovations, and redecoration are treated as *revenue* expenditure.
- Costs for major alterations and additions to the hotel building and facilities should be *capitalized*.

Casual Labour

Casual Labour in Hotel Trade

- The hotel industry heavily relies on casual labour with often inadequate wage payment records.
- Auditors should ensure no defalcation occurs by suggesting proper controls to management

Travel Agents & Shops

Ledgers from Travel Agents and Booking Agencies

- Auditors must ensure that money is recovered from travel agents or booking agencies according to the *terms* of *credit* allowed.
- Commission paid to these agents should be checked by referring to the relevant *agreements*.

Audit of Co-Operative Society

Background

A. Cooperative Societies
- Autonomous associations of persons united voluntarily
- Jointly-owned enterprises meeting common economic, social, and cultural needs
- Governed by Co-operative Societies Act, 1912, and specific state Acts

B. Auditor's Responsibility
- Familiarity with the governing Act for the society under audit

C. Co-operative Society
- Business organization with a special mode of operation
- Cooperative pooling of production means
- Elimination of middlemen and exploitation

D. Chartered Accountant's Role
- Significant contribution to cooperative organizations' development

E. Professional Services Offered
1. Guidance in accounts writing
2. Installation of accounting system
3. Internal audit
4. Management accounting services
5. Taxation

F. Audit Guidelines
- Focus on general guidelines for audit of co-operative societies
- Special features of audit applicable to all societies
- Audit programs for specific types of societies

<table>
<tr><th colspan="3">Audit of CoOperative Society</th></tr>
<tr><td>Background</td><td colspan="2">The Co-operative Societies Act, 1912, a Central Act, contains the fundamental law regarding the formation and working of the cooperative societies in India and is applicable in many states with or without amendments. In many states, viz., Maharashtra, West Bengal, Orissa, the co-operative societies are governed by specific state Acts.</td></tr>
<tr><td rowspan="3">What is cooperative society</td><td colspan="2">Co-operative society is a business organisation</td></tr>
<tr><td rowspan="2">with a special mode of doing business,</td><td>by pulling together all the means of production cooperatively,</td></tr>
<tr><td>elimination of middlemen and exploitation from outside forces.</td></tr>
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Audit as per Section 17 of the Co-Operative Societies Act, 1912

A. Registrar's Responsibility
1. Audit accounts of every registered society ***annually***
2. Authorize a person for conducting the audit

B. Audit Scope
1. ***Examination*** of ***overdue*** ***debts***
2. ***Valuation*** of ***assets*** and ***liabilities***

C. Access to Records
1. Registrar, Collector, or authorized person has ***access*** to ***all*** books, accounts, papers, and securities
2. Society officers to ***furnish*** ***required*** ***information*** on transactions and working.

Key Points for Co-operative Society Audit

1. Qualifications of Auditors
2. Appointment of the Auditor
3. Books, Accounts, and Other Records

- Maintenance of Books and Accounts

4. Restrictions on Share Holdings
5. Restrictions on Loans
6. Restrictions on Borrowings
7. Investment of Funds
8. Appropriation of Profits
9. Contributions to Charitable Purposes
10. Investment of Reserve Fund
11. Contribution to Education Fund
    - Compliance with Bye-laws, Rules, and Regulations

Qualifications of Auditors

- *Chartered Accountant* as per Chartered Accountants Act, 1949
- *Government diploma* in co-operative accounts or co-operation and accountancy
- Experience as an auditor in the co-operative department of a government

Appointment of the Auditor

- Appointed by the *Registrar* of Co-operative Societies
- Conducts audit on *behalf* of the Registrar
- Submits *report to* both Registrar and society
- Audit *fees* paid by the society based on statutory scale prescribed by the Registrar

Books, Accounts, and Other Records

- Section 43(h) The Co-operative Societies Act, 1912 (Central Act) allows *state government* to frame rules for books and accounts to be kept by co-operative societies
- Maintenance of Books and Accounts
    - Sums of *money* received and expended
    - *Sales* and *purchases* of goods
    - *Assets* and *liabilities* of the society
    - *Additional records* according to convenience and clarity

Restrictions on Share Holdings

- Watch for breaches relating to holding of shares
- *No* member of a society other than a registered society can hold such portion of the share capital of the society as would exceed a *maximum of 20%* of the total number of shares or of the value of shareholding to *₹ 1,000*
- Ensure bye-laws are not contrary to statutory provisions

Restrictions on Loans

- Loans *only to members* or *other registered societies* with special sanction from the Registrar
- Examine State Government *restrictions* on loaning powers

Restrictions on Borrowings

- Accept loans and deposits from non-members subject to bye-laws restrictions and limits

Investment of Funds

- Funds can be invested in *various options* as per the Central or State Act.
- According to section 32 of the Central Act, a society may invest its funds in any one or more of the following:
    - In the Central or State Co-operative *Bank*.
    - In any of the *securities specified* in section 20 of the Indian Trusts Act, 1882.

- In the shares, securities, bonds or debentures of any other society with limited liability.
- In any co-operative bank, other than a Central or State co-operative bank, as approved by the Registrar on specified terms and conditions.
- Other investment instruments as permitted by the Central or State Government.

- In the principal provision relating to the investments of funds of a co-operative society, the Central as well as State Acts does not mention anything about the investment of reserve fund outside the business specifically.

Appropriation of Profits

- Transfer a prescribed percentage of profits to Reserve Fund before distribution as dividends or bonus to members

Contributions to Charitable Purposes

- Registered society may, with the sanction of the Registrar, contribute up to 10% of net profits remaining after the compulsory transfer to the reserve fund for any charitable purpose to charitable purposes.

Investment of Reserve Fund

- Use Reserve Fund in the business, invest as per provisions of the Act, or for public purposes promoting the object of the society

Contribution to Education Fund

- Contribute annually towards the Education Fund of the State Federal Society, as per the class of the society
- Contribution to Education Fund is a charge on profits and not an appropriation.
- Compliance with Bye-laws, Rules, and Regulations
  - Ensure strict compliance with State Act, Rules, and Regulations
  - Appropriations of profits must be approved by the General Body of the society
  - Point out contradictions between statutory provisions and generally accepted accounting principles. For Example
    - According to certain State Acts, transfers to Dividend Equalization Reserve and Share Capital Redemption Fund are stated as charges against profits. According to the generally accepted principles of accountancy these items are not charges, but appropriation of profits.

The auditor should ensure compliance with the relevant provisions of the Co-operative Societies Act, 1912, and the specific State Acts, while auditing the accounts of co-operative societies.

Special Features of Co-Operative Audit

Here are the special features of co-operative audit to be considered while conducting the audit:

1. Examination of overdue debts
2. Overdue Interest
3. Certification of Bad Debts
4. Valuation of Assets and Liabilities
5. Adherence to Co-operative Principles
6. Observations of the Provisions of the Act and Rules
7. Verification of Members' Register and examination of their passbooks
8. Special report to the Registrar
9. Audit classification of society
10. Discussion of draft audit report with managing committee

Examination of Overdue Debts in Credit Societies

1. Classification of Overdue Debts:
   - 6 months to 5 years
   - More than 5 years

2. Implications of Overdue Debts:
    - Affects working capital position
    - Impacts credit society's operations
3. Analysis of Overdue Debts:
    - Assess chances of recovery
    - Classify as good or bad debts
4. Auditor's Responsibilities:
    - Ensure proper provisions for doubtful debts
    - Evaluate the adequacy of provisions

Overdue Interest

1. Exclusion of Overdue Interest:
    - Exclude from interest outstanding and accrued due
    - Affects profit calculation
2. Definition of Overdue Interest:
    - Interest accrued or accruing on overdue principal amounts
3. Practical Approach:
    - Creation of an overdue interest reserve
    - Reduction of overdue interest credited to interest account

Certification of Bad Debts

1. Maharashtra State Co-operative Rules, 1961:
    - Writing off bad debts requires auditor's certification
2. Bad Debts and Irrecoverable Losses:
    - Must be certified as bad debts or irrecoverable losses by the auditor, if required by law
    - If not required by law, managing committee of the society must authorize the write-off

Valuation of Assets, Liabilities

1. Valuation of Assets:
    - Follow general accounting and auditing principles
    - Verify existence, ownership, and valuation
    - Fixed assets: cost less adequate provision for depreciation
    - Current assets: cost or market price, whichever is lower
    - Note on market value, if significant difference
2. Valuation of Liabilities:
    - Ensure all known liabilities are accounted for
    - Disclose contingent liabilities as a note

Adherence to Co-operative Principles

1. Adherence to Co-operative Principles:
    - Assess achievement of co-operative organization's objectives
    - Focus on extending benefits to members
    - Consider social benefits and sales at lower prices
2. Adoption of Modern Techniques:
    - Cost accounting methods, store control, standard costing, budgetary control
    - Address gaps between goals and actual achievements
3. Auditing Expenses:
    - Ensure economical spending and no wastage of funds
    - Avoid middlemen commissions
    - Follow principles of propriety audit

Observations of Provisions of the Act, Rules, and Bye-Laws

1. Auditor's Responsibilities:
   - Identify infringements of Co-operative Societies Act, Rules, and bye-laws
   - Assess financial ***implications*** of such infringements
   - Report infringements and their ***consequences***
2. Dividend Restrictions:
   - Be ***aware*** of ***restrictions*** on dividend payments in certain State Acts
   - Ensure ***compliance*** with such restrictions

Verification of Members' Register and Examination of Pass Books

1. Importance of Examination:
   - Ensures loan ***entries*** and ***repayments*** are ***accurate***
   - Confirms loan balances in ***person***
   - Protects against manipulation in books of accounts
2. Rural and Agricultural Credit Societies:
   - Additional ***safeguard*** for less literate members
3. Test Basis Checking:
   - Auditors use their ***judgement*** to determine the extent of examination.

Special Report to the Registrar

1. Purpose of Special Report:
   - Report ***serious*** ***irregularities*** in the society's working
   - Alert Registrar for necessary ***action***
2. Instances Requiring Special Report:
   - ***Personal Profiteering***:
     i. By ***managing committee*** members in society transactions
     ii. ***Detrimental*** to society's ***interest***
   - ***Fraud Detection:***
     i. In expenses, purchases, property, and stores of the society
   - ***Mismanagement***:
     i. Decisions against co-operative principles
     ii. Specific examples of mismanagement
   - ***Urban Co-operative Banks:***
     i. Disproportionate advances to vested interest groups
     ii. Deliberate negligence in recovery
     iii. Reckless advancing with inadequate security and safeguards.

Audit Classification of Society

1. Auditor's Responsibility:
   - Award a ***class*** to the society based on overall performance
   - Use ***criteria*** specified by the ***Registrar***
2. Appeal Process:
   - Society can ***appeal*** to the Registrar if dissatisfied with audit class
   - Registrar may direct a ***review*** of audit classification
3. Auditor's Consideration:
   - Exercise ***caution*** while determining the society's class

Discussion of Draft Audit Report with Managing Committee

1. Auditor's Responsibility:
   - Request ***Secretary*** to ***convene*** managing committee ***meeting***
   - ***Discuss*** ***draft*** audit ***report*** with the committee

2. Importance of Discussion:
   - Avoid finalizing audit report without committee input
   - Settle and rectify minor irregularities
   - Discuss policy matters in detail

The Multi-State Co-operative Societies Act, 2002

- The Multi-State Co-operative Societies Act, 2002 applies to co-operative societies whose objects are not confined to one State.
- The Act contains detailed provisions regarding registration, membership and management of such societies.
- The funds of a Multi-State co-operative society cannot be utilised for any political purpose. The Act contains detailed provisions regarding the investment of funds and restrictions on loans, borrowings, etc.

Books of Accounts

As per Multi-State Co-operative Society Rules 2002, every Multi- State Co-operative society shall keep books of account with respect to

a. all sum of money received and expended and matters in respect of which the receipt and expenditure take place;
b. all sale and purchase of goods;
c. the assets and liabilities;
d. in the case of a Multi-State Co-operative society engaged in production, processing and manufacturing, particulars relating to utilization of materials or labour or other items of cost as may be specified in the bye-laws of such a society

Audit of Multi-State Co-operative Society

Qualification of Auditors

- Section 72 of the Multi-State Co-operative Societies Act, 2002 states that a person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 can only be appointed as auditor of Multi-State co-operative society.
- However the following persons are not eligible for appointment as auditors of a Multi- State co-operative society-
  - A body corporate.
  - An officer or employee of the Multi-State co-operative society.
  - A person who is a member or who is in the employment, of an officer or employee of the Multi-State co-operative society.
  - A person who is indebted to the Multi-State co-operative society or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the Multi-State co-operative society for an amount exceeding ₹ 1,000

If an auditor becomes subject, after his appointment, to any of the disqualifications specified above, he shall be deemed to have vacated his office as such.

Appointment of Auditors

- Section 70 of the Multi-State Co-operative Societies Act, 2002 provides that the first auditor or auditors of a Multi-State cooperative society shall be appointed by the
  - board within one month of the date of registration of such society and the auditor so appointed shall hold office until the conclusion of the first annual general meeting.
  - If the board fails, society may appoint the first auditor at general meeting
- The subsequent auditor is appointed at each annual general meeting. The auditor so appointed shall hold office from the conclusion of that meeting until the conclusion of the next annual general meeting.

Power and duties of Auditors Section 73

Every auditor of a Multi-State co-operative society shall have a

- *right of access*
  - *at* all times
  - *to* the books accounts and vouchers of the Multi-State co-operative society,
  - whether *kept at* the head office of the Multi-State co-operative society or elsewhere, and
- shall be *entitled to require*
  - *from* the officers or other employees of the Multi- State co-operative society
  - *such* information and explanation
  - *as* the auditor may think necessary for the performance of his duties as an auditor.

As per section 73(2), the auditor shall make following inquiries:

a. Whether *loans* and *advances* made by the Multi-State co-operative society on the basis of security have been properly *secured* and whether the *terms* on which they have been made are *not prejudicial* to the interests of the MultiState co- operative society or its members,
b. Whether *transactions* of the Multi-State co-operative society which are represented merely by *book entries* are not prejudicial to the interests of the Multi-State co-operative society,
c. Whether *personal expenses* have been charged to revenue account, and
d. Where it is Stated in the books and papers of the Multi-State co-operative society that any *shares* have been *allotted* for *cash*, whether cash has actually, been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet as correct regular and not misleading.

Content of Auditor's Report

The auditor shall make a report

- to the *members* of the Multi-State co-operative society
- on the *accounts* examined by him and on every *balance-sheet* and *profit* and *loss* account and on every other *document* required to be part of or *annexed* to the balance-sheet or profit and loss account,
- which are *laid* before the Multi-State co-operative society in general meeting during his tenure of office,
- and the report shall *state whether*, in his opinion and to the best of his information and according to the explanation given to him,
- the said account
  - give the *information* required by this act in the manner so required,
  - and give a *true* and *fair* view:
    - In the case of the balance-sheet, of the state of the Multi-State co-operative society's affairs as at the end of its financial year; and
    - In the case of the profit and loss account, of the profit or loss for its financial year.
    - The auditor's report shall also state
      - Whether he has obtained all the *information* and *explanation* which to the best of his knowledge and belief were necessary for the purpose of his audit.
      - Whether, in his opinion, *proper books* of *account* have been *kept* by the Multi- State co-operative society so far as appears from his examination of these books and *proper returns* adequate for the purpose of his audit have been *received* from branches or offices of the Multi-State cooperative society not visited by him.
      - Whether the *report on* the *accounts* of any *branch* office audited by a person other than the Multi-State co-operative society's auditor has been *forwarded* to him and *how* he has *dealt* with the same in preparing the auditor's report.
      - Whether the Multi-State co-operative society's *balance sheet* and *profit* and *loss* account dealt with by the report are in *agreement* with the *books* of *account* and *return*.

Where any of the *matters* referred above is answered in the *negative* or with a qualification, the auditor's report shall *state* the *reason* for the answer.

Power of Central Government to direct special audit in certain cases - Section 77

Where the Central Government is of the opinion

- that the affairs of any Multi-State co-operative society are not being managed in accordance with self-help and mutual deed and co-operative principles or prudent commercial practices or with sound business principles; or
- that any Multi-State co-operative society is being managed in a manner likely to cause serious injury or damage to the interests of the trade industry or business to which it pertains; or
- that the financial position of any Multi-State co-operative society is such as to endanger its solvency.

Central Government's Order

The Central Government may at any time by order direct that a special audit of the Multi-State co-operative society's accounts for such period or periods as may be specified in the order shall be conducted.

Appointment of the Auditor

It may appoint either a chartered accountant or the Multi-State co-operative society's auditor himself to conduct the special audit.

Shareholding Restriction

CG shall order for special audit only if that Government or the State Government either by itself or both hold 51% or more of the paid-up share capital in such Multi-State co-operative society.

Special Auditor's Powers , Duties & Report

- The special auditor shall have the same powers and duties in relation to the special audit as an auditor of a MultiState co-operative society has under section 73.
- A special auditor makes the report to the Central Government
- The report of the special auditor shall include all the matters required to be included in the auditor's report under section 73 and any other matter as directed by the Central Government.

Action by the Central Government

- On receipts of the report of the special auditor the CG may take such action on the report as it considers necessary in accordance with the provision of the Act or any law for the time being in force.
- However, if the CG does not take any action on the report within 4 months from the date of its receipt, that Government shall send to the MultiState Co- operative society either a copy of, or relevant extract from, the report with its comments thereon and require the Multi-State Co-operative society either to circulate that copy or those extracts to the members or to have such copy or extracts read before the Multi-State Co-operative society at its next general meeting.

Expenses pertaining to the Special Audit

The expenses of, and incidental to, any special audit under this section (including the remuneration of the special auditor) shall be determined by the Central Government which determination shall be final and paid by the Multi-State Co-operative society and in default of such payment, shall be recoverable from the Multi-State Co-operative society as an arrear of land revenue.

Inquiry by Central Registrar under Section 78

When & Who?

The Central Registrar may, on a request from :-

- a federal co-operative to which a Multi- State Co-operative society is affiliated or
- a creditor or
- not less than one-third of the members of the board or
- not less than one-fifth of the total number of members of a Multi-state co-operative society,
- Hold an inquiry or
- direct some person authorized by him
  - by order in writing in his behalf
  - to hold an inquiry into the

- constitutions,
- working and
- financial condition of a Multi-State Co-operative society.

Opportunity of being Heard - OOBH

However, before holding such inquiry fifteen days notice must be given to the Multi-State co-operative society.

Powers in case of investigation

The Central Registrar or the person authorized by him shall have the following powers, namely:

Free access and Summon

- he shall at all reasonable times have free access
- to the books, accounts, documents, securities, cash and other properties belonging to or in the custody of the Multi-State co-operative society and
- may summon any person in possession or responsible for the custody of any such books, accounts, documents, securities, cash or other properties to produce the same at any place specified by him.

Call General Meeting

- He may,
  - notwithstanding any bye-law specifying the period of notice for a general meeting of the Multi-State co-operative society,
- require the officers of the society to call a general meeting of the society
- by giving notice of not less than seven days
  - at such time and place at the headquarters of the society
- to consider such matters as may be directed to him, and where the officers of the society refuse or fail to call such a meeting, he shall have power to call it himself.

Summon

- he may summon any person
  - who is reasonably believed by him to have any knowledge
  - of the affairs of the Multi-State co-operative society
- to appear before him
- at any place
  - at the headquarters of the society or
  - any branch thereof and
- may examine such person on oath.

Follow up

The Central Registrar shall,

- within a period of 3 months of the date of receipt of the report,
- communicate the report of inquiry
  - to the MultiState co-operative society,
  - the financial institutions, if any, to which the society is affiliated,
  - and to the person or authority, if any at whose instance the inquiry is needed.

Inspection of Multi-State Co-operative societies under - Section 79

When & Who?

The Central Registrar may, on a request from

- federal co-operative to which a Multi- State Co-operative society is affiliated or
- a creditor or
- not less than one-third of the members of the board or
- not less than one-fifth of the total number of members of a Multi-State co-operative society

By general or special *order* in *writing* in this behalf *inspect* or *direct* any *person* *authorized* by him by order in writing in this behalf to make an *inspection* into the *constitution*, *working* and *financial* condition of a Multi- State co-operative society.

Opportunity of Being heard

No inspection shall be made unless a notice of not less than *15 days* has been given to the multi-state co-operative society.

Powers available

The Central Registrar or the person authorized by him shall have the following powers:

Access, Taking into custody , Verify, Calling of Meeting

He shall at all times

- have *access* to *all* books, accounts, papers, vouchers, securities, stock and other property of that society and may,
- in the event of serious irregularities discovered during inspection, take them into custody and
- shall have *power* to *verify* the *cash* balance of the society and subject to the general or special order of the central registrar to call a meeting of the society where such general meeting is, in his opinion necessary.

Entitled to Required Information

Every officer or member of a Multi-State Co-operative society shall furnish such information with regard to the working of the society as the central registrar or the person making such inspection may require.

Inspection Report

A copy of the report of inspection under this section shall be communicated to

- the Multi-State Co-operative society
- within a period of *3 months* from the date of completion of such inspection.

Audit of Trusts & Societies

Legal Framework of Charitable Entities

- The legal framework governing the charitable institution will depend on the form of business organization the charitable institution takes.
    - If the charitable institution is formed as a Public Trust, it will be governed by the Public Trust Act applicable in the relevant State. However, if no Public Trust Act exists in that state, then the applicable legislation will be the Indian Trusts Act, 1882.
    - If the charitable institution is formed as a Society, it will be governed by the Societies Registration Act, 1860.
    - The charitable institution can also be formed as a non-profit company under section 8 of the Companies Act, 2013.
- Apart from the above legislations,
    - Income Tax Act 1961 will be applicable to charitable institutions and
    - Foreign Contribution (Regulation) Act, 2010 will be applicable in the case of foreign contributions

Books of Account

The Auditor is required to report whether the Trust has maintained proper books of accounts, including the following, namely: -

i) *cash* book;
ii) *ledger*;
iii) *journal*;
iv) *copies* of *bills*, whether machine numbered or otherwise serially numbered
v) *original bills* wherever issued to the person and receipts in respect of payments made by the person;

vi) any *other* book that may be required to be maintained in order to give a true and fair view of the state of the affairs of the person and explain the transactions effected;

FSs

- Every year the trust has to prepare FS like the Balance sheet and Income and expenditure statements based on its books of accounts.
- The format for preparation and presentation of FS is prescribed under respective state laws.
- Charitable Organisations are governed by different laws as well as different forms of organisations also necessitate different accounting aspects to be complied.

Auditor's responsibility

- The auditor should obtain the *list* of the books and records maintained by the Trust. The list should be matched with the requirement for maintaining mandatory books and records as may be applicable in each case.
- The auditor has to *comply* with the *A*ccounting *S*tandards (AS) and *S*tandards on *A*uditing (SA) prescribed and made mandatory by ICAI.
- The auditor shall use his professional *skill* and *expertise* and apply such audit tests as the circumstances of the case may require.
- The auditor shall conduct the audit by applying the *generally accepted* auditing *procedures*.
- The auditor can apply the *test checks* depending on the evaluation of internal control procedures
- The auditor shall keep in mind the concept of *materiality* depending upon the circumstances of each case.
- The auditor should keep detailed notes about the evidence on which he has relied upon and also maintain all his *working papers*.

Notes forming part of Working papers

Working papers should include notes on the following, amongst other matters:

a) *work done* while conducting the audit and *by whom*;
b) *explanation* and information given to him during the course of the audit and by whom;
c) *decision* on the various points taken;
d) judicial *pronouncements* relied upon by him while drafting the audit report; and
e) *certificates* issued by the client / management letters.

Nature of Working Papers

It is important that the audit working papers prepared and/or obtained by the auditor provide evidence that

i) the *opinion* expressed by the auditor is based on the *examination* made by him;
ii) in arriving at his opinion, the auditor has given *due cognizance* to the information and explanations given by the assessee and that his opinion is not arbitrary;
iii) the information and explanations obtained were full and *complete* that is, the auditor has called for all the information and explanations which were *necessary* to be considered before arriving at his opinion; and
iv) the auditor did not merely rely upon the information or explanations given by the assessee but that he subjected such information and explanations to *reasonable tests* to verify their *accuracy* and *completeness*

Points that should be taken into account while conducting audit of Trusts

a) Whether *accounts* are maintained *regularly* and in accordance with the provisions of the applicable Act and the rules;
b) Whether *receipts* and disbursements are properly and *correctly shown* in the accounts and donations received is being *applied* as per the *objects* of the trust and as per the specific direction by the donor, if any.
c) Whether the cash balance and vouchers in the custody of the manager or trustee on the date of audit were in *agreement with* the *accounts*;
d) Whether *all* books, deeds, accounts, vouchers or other documents or records required by the auditor were produced before him;

e) Whether a register of movable and immovable properties is maintained, the changes therein are communicated from time to time to the regional office, and the defects and inaccuracies mentioned in the previous audit report have been duly complied with and rectified.
f) Whether the manager or trustee or any other person required by the auditor to appear before him did so and furnished the necessary information required by him;
g) Whether any property or funds of the Trust were applied for any object or purpose other than the object or purpose of the Trust;
h) Amounts of outstanding for more than one year and the amounts written off, if any;
i) Whether any money of the public trust has been invested contrary to the provisions of applicable Act which have come to the notice of the Auditor
j) Ascertain all cases of irregular, illegal or improper expenditure, or failure or omission to recover monies or other property belonging to the public trust or of loss or waste of money or other property thereof, and whether such expenditure, failure, omission, loss or waste was caused in consequence of breach of trust or misapplication or any other misconduct on the part of the trustees
k) Whether the maximum and minimum number of the trustees is maintained;
l) Whether the meeting are held regularly as provided in such instrument
m) Whether the minute books of the proceedings of the meeting is maintained
n) Whether any of the trustees has any interest in the investment of the trust
o) Whether any of the trustees is a debtor or creditor of the trust.
p) Whether anonymous donations received are properly accounted for and donations in cash are not received by the Trust over and above the prescribed limit of accepting cash donations.
q) Whether the irregularities pointed out by the auditors in the accounts of the previous year have been duly complied with by the trustees during the period of audit
r) Any special matter which the auditor may think fit or necessary to bring to the notice of the Deputy or Assistant Charity Commissioner

Points that should be taken into account while conducting audit of Societies

a) The auditor should ascertain governing legislation of society i.e. Societies Registration act, 1860 or any applicable state law under which it has been registered.
b) Object of society needs to be ascertained from its memorandum of association/bye laws.
c) Ascertain whether society has obtained registration under Foreign Contribution (Regulation) Act, 2010 in case of foreign contributions.
d) Ascertain whether it is also registered under relevant provisions of Income Tax Act which may make it eligible for tax exemption on its income.
e) Obtain an understanding of internal control to design audit procedures with special reference to donations and various expenditures incurred.
f) Evaluate appropriateness of accounting policies with special reference to donations and grants.
g) In case some expenses incurred by society are reimbursed by donors, determine how these are recognized in FSs.
h) Ascertain, if any inquiry has been held by Registrar under applicable law in the working or financial condition of society and its implications for auditor's opinion.
i) Ascertain all cases of irregular, illegal or improper expenditure or failure or omission to recover monies or other property belonging to society or of loss or waste of money or other property thereof and whether such expenditure was caused in consequence of breach of trust or misapplication or any other misconduct on the part of governing body

Chapter 10 - Audit of Banks

Types of bank

Commercial banks

The *most widespread* banking institutions in India, that provide a *number* of *products* and *services* to the general public and other segments of the economy. Two of its main functions are:-

a. *accepting* deposits and
b. *granting* advances.

Regional Rural Banks

known as *RRBs* are the banks that have been set up in *rural areas* in different states of the country to cater to the *basic banking* and financial needs of the rural communities. Examples are :- Punjab Gramin Bank , Tripura Gramin Bank , Allahabad UP Gramin Bank , Andhra Pradesh Grameen Vikas Bank, etc.

Co-operative Banks

function like Commercial Banks only but are set up on the basis of *Cooperative Principles* and registered under the Cooperative Societies Act of the respective state or the Multistate Cooperative Societies Act and usually cater to the needs of the agricultural and rural sectors. Examples are :- The Gujarat State Co-operative Bank Ltd. , Chhatisgarh Rajya Sahakari Bank Maryadit , etc.

Payments Banks

are a new type of banks which have been recently introduced by RBI. They are allowed to *accept restricted deposits* but they cannot *issue loans* and credit cards. However , customers can open Current & Savings accounts and also avail the facility of ATM cum Debit cards , Internet-banking & Mobile Banking. Examples are :- Airtel Payments Bank , India Post Payments Bank, Paytm Payments Bank , etc.

Development Banks

It has been conceptualised to provide funds for *infrastructural facilities* important for the economic growth of the country. Examples are:- Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), Small Industries Development Bank of India (SIDBI) , etc.

Small Finance Banks

have been set up by RBI to make available *basic* financial and banking *facilities* to the *unserved* and *unorganised sectors* like small marginal farmers, small & micro business units, etc. Examples are:- Equitas Small Finance Bank , AU Small Finance Bank , etc.

Regulating Body - Reserve Bank of India

- The functioning of the banking industry in India is regulated by the Reserve Bank of India (RBI) which acts as the *Central Bank* of our country.
- RBI is responsible for
    - *development* and *supervision* of the constituents of the Indian financial system (which comprises banks and non-banking financial institutions) as well as
    - for determining, in conjunction with the Central Government, the *monetary* and *credit policies* keeping in with the need of the hour.
- Important functions of RBI are
    - *issuance* of currency;
    - *regulation* of currency issue;
    - acting as *banker* to the *central* and *state* governments;
    - and acting as banker to *commercial* and *other* types of banks including term-lending institutions.
- Besides, RBI has also been entrusted with the responsibility of
    - regulating the activities of commercial and other banks.
    - No bank can
        - commence the business of banking or

    - open new branches without obtaining a licence from RBI.
  - The RBI also has the power to inspect any bank.

Independent audit of financial statements of banks is important for a healthy, safe and sound banking system.

Regulatory Framework

- Reserve Bank of India Act, 1934
- Banking Regulation Act, 1949.
- State Bank of India Act, 1955.
- Companies Act, 2013.
- State Bank of India (Subsidiary Banks) Act 1959.
- Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970.
- Regional Rural Banks Act, 1976.
- Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.
- Information Technology Act, 2000.
- Prevention of Money Laundering Act, 2002.
- Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.
- Credit Information Companies Regulation Act, 2005.
- Payment and Settlement Systems Act, 2007.

Banking Operations - Conducted only at Branches

Banking operations are conducted only at the branches,

- while other offices act as controlling authorities or administrative offices
- that ***lay*** down ***policies***, ***systems*** and internal ***control procedures*** for ***conduct*** of business, in compliance with the statutory/ regulatory impositions and in compliance of accepted accounting principles and practices that cover all transactions and economic events.

These controlling/ administrative offices also

- stipulate the ***delegation*** of ***powers*** and ***fix responsibilities*** and ***accountability*** and
- these are involved generally in effective ***supervision***, ***monitoring*** and ***control*** over the business activities and operations, including seeking faithful compliance of the bank's laid down policies/ procedures /controls and deal with deviations therefrom.

Some of the different features of Bank

- ***Huge*** volumes and complexity of transactions,
- Wide geographical spread of banks' ***network***,
- Large ***range*** of ***products*** and services offered,
- Extensive use of ***technology***,
- Strict ***vigilance*** by the banking regulator etc.

Types of Bank Audit Reports to be issued

Presently, the Statutory Central Auditors (SCAs) have to furnish the following reports in addition to their main audit report:

1. Report on ***adequacy*** and ***operating effectiveness*** of ***Internal Controls over Financial Reporting*** in case of banks which are registered as companies under the Companies Act in terms of Section 143(3)(i) of the Companies Act, 2013 which is normally to be given as an Annexure to the main audit report as per the Guidance Note on Audit of Internal Financial Controls over Financial Reporting issued by the ICAI.
2. ***Long Form Audit Report.*** (LFAR)
3. Report on compliance with ***SLR requirements***. (Statutory Liquidity Ratio Statutory Liquidity Ratio or SLR is a minimum percentage of deposits that a commercial bank has to maintain in the form of liquid cash, gold or other securities. It is basically the reserve requirement that banks are expected to keep before offering credit to customers.)

4. Report on whether the ***treasury operations*** of the bank have been conducted in accordance with the instructions issued by the RBI from time to time.
5. Report on whether the ***income recognition***, ***asset classification*** and provisioning have been made as per the guidelines issued by the RBI from time to time.
6. Report on whether any ***serious irregularity*** was noticed in the working of the bank which requires immediate attention.
7. Report on status of the ***compliance*** by the bank with regard to the implementation of recommendations of the ***Ghosh Committee*** relating to frauds and malpractices and of the recommendations of Jilani Committee on internal control and inspection/credit system.
8. Report on instances of ***adverse credit-deposit ratio*** in the rural areas.

Understanding the Accounting System in Banks

There is a sea change in banking

- as use of technology
- and its continuous evolution has
    - enabled banks to reach their customers
    - providing them the convenience and
    - comfort of
        - anytime-anywhere-banking
            - by letting them access their information/data
                - on real time basis,
                - as stored in a safe and secure environment
                - on the bank's servers.

The transactions in banks have become voluminous and

- it needs to be ensured that in the
- system of
    - recording ,
    - transmission and
    - storage of information/ data
        - is optimally maintained and
- control systems
    - ensure that
    - the same is
    - free of risks of
        - errors, omissions, irregularities and frauds;

In the computerised environment, it is imperative that the auditor is familiar with and satisfied that all the norms/parameters as per the ***latest applicable RBI guidelines*** are incorporated and built into the system that generates information/data having a bearing on the classification/ provisions and income recognition.

The auditor should ***not go*** by the ***assumption*** that the system generated ***information*** is ***correct*** and can be relied upon without evidence that demonstrates that the system driven information is based on the required parameters.

He should use Professional ***Skepticism*** and ***Prudence*** wherever he feels that something manually needs to be performed to check the authenticity and consistency of the information obtained from the systems and document the results of such activities performed.

Categories of bank on the basis of computerisation

Banks may be divided into three broad categories based on the level of computerisation:

1. **Non-computerised banks :-** Transactions can be done only at bank branches during ***working hours*** using paper and pen.

2. **Partially computerised banks** :- *Some* transactions are *computerised* while *major* are *non-computerised*.
3. **Fully computerised banks**:- Core banking allows *inter-connectivity* between branches of the same bank and with CBS , customers can operate their accounts as well as avail banking services from any branch of the bank over the network

Form and Content of Financial Statements

- Sub-sections (1) and (2) of section 29 of the *Banking Regulations Act, 1949* deal with the form and content of financial statements of a banking company and their authentication.
- These sub-sections are also applicable to *nationalised banks, State Bank of India, subsidiaries of the State Bank of India, and Regional Rural Banks.*
- 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.
- Every banking company needs to *comply* with the *disclosure requirements* under the various Accounting Standards, as specified under section 133 of the Companies Act, 2013, read with Rule 7 of the Companies (Accounts) Rules 2014, in so far as they apply to banking companies or the Accounting Standards issued by the ICAI.

Audit of Accounts

Sub-section (1) of section 30 of the 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.

Eligibility, Qualifications And Disqualifications Of Auditor

As per section 141 of The Companies Act, 2013

Appointment of auditor

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 bank concerned
  - acting through its *Board of Directors.*
- In either case, *approval* of the *Reserve Bank* is *required* before the appointment is made.
- The auditors of the *State Bank of India*
  - are to be *appointed* by the *Comptroller and Auditor General* of India
  - in *consultation* with the *C*entral *G*overnment.
- The auditors of the *subsidiaries* of the State Bank of India are to be appointed
  - by the *State Bank of India*.
- The auditors of *regional rural banks* are to be appointed
  - by the *bank* concerned with the *approval* of the *C*entral *G*overnment.

Remuneration of Auditor

The remuneration of an auditor of a *banking company* is to be fixed in accordance with the provisions of *section 142* of the Companies Act, 2013 (i.e., by the company in general meeting or in such manner as the company in general meeting may determine). The remuneration of auditors of *nationalised banks* and *State Bank of India* is to be fixed by the *Reserve Bank of India* in consultation with the *C*entral *G*overnment.

Powers of Auditor

The auditor of a banking company or of a nationalised bank, State Bank of India, a subsidiary of State Bank of India, or a regional rural bank has the same powers as those of a ***company auditor*** in the matter of access to the books, accounts, documents and vouchers.

Auditor's Report

In the case of a nationalised bank, the auditor is required to make a report to the Central Government in which he has to state the following:

a. whether,in his opinion,
   - the balance sheet is a
     - full and fair balance sheet
       - ➢ containing all the necessary particulars and
       - ➢ is properly drawn up
       - ➢ so as to exhibit a true and fair view of the affairs of the bank,
   - and in case he had called for any ***explanation or information,***
     - whether it has been given and
     - whether it is satisfactory;

b. whether or not the ***transactions*** of the bank,
   - which have come to his notice,
     - have been within the ***powers*** of that bank

c. whether or not the
   - returns
     - received from the offices and branches of the bank
       - ➢ have been found adequate for the purpose of his audit; (***Returns from branch are adequate or not***)

d. whether the
   - profit and loss account
     - shows a true balance of profit or loss for
       - ➢ the period covered by such account; and

e. any
   - other matter which
     - he considers
       - ➢ should be brought to the notice of the Central Government.

The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalised bank.

Format of Report

The auditors,

- central as well as branch,
  - should also ensure that the audit report issued by them
    - ***complies*** with the requirements of
      - Standards on Auditing on Audit Report.

The auditor should ensure that

- information relating to number of ***unaudited branches*** is given
- quantification of
  - advances,
  - deposits,
  - interest income and
  - Interest expense for such unaudited branches has also been disclosed in the audit report.

Long Form Audit Report

- Besides the audit report as per the statutory requirements discussed above, 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 matters which the banks require their auditors to deal with in the long form audit report have been specified by the ***Reserve Bank of India***.
- The LFAR is to be submitted before ***30th June every year***.
- To ensure timely submission of LFAR, proper planning for completion of the LFAR is required.

Reporting to RBI

- The RBI issued a Circular relating to implementation of recommendations of the Committee on Legal Aspects of Bank Frauds applicable to all scheduled commercial banks (excluding Regional Rural Banks). Regarding liability of accounting and auditing profession, the said circular provided as under:
- "If an accounting professional, whether in the course of internal or external audit or in the process of institutional audit finds anything susceptible to be fraud or fraudulent activity or act of excess power or smell any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action".
- As per the above requirement, the member shall be required to report the kind of matters stated in the circular to RBI.
- Auditor should also consider the provisions of ***SA 250***, "Consideration of Laws and Regulations in an Audit of Financial Statements". The said Standard explains that the duty of confidentiality is over-ridden by statute, law or courts.
- ***SA 240***, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" states that an auditor conducting an audit in accordance with SAs is responsible for obtaining ***reasonable*** assurance that the financial statements taken as a whole are ***free from material misstatement***, whether caused by fraud or error.
- It must be noted that auditor is ***not expected*** to ***look*** into ***each*** and ***every transaction*** but to ***evaluate the system as a whole***. Therefore, if the auditor while performing his normal duties comes across any instance, he should report the matter to the RBI in addition to Chairman/Managing Director/Chief Executive of the concerned bank.

Duty to report on Frauds under the Companies Act, 2013

- As per sub-section 12 of section 143 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 of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the ***Central Government*** within such time and in such manner as may be prescribed.
- The member shall be required to report the matters to ***RBI***.
- It must be noted that auditor is ***not expected*** to ***look*** into ***each*** and ***every transaction*** but to ***evaluate the system as a whole***
- Therefore, if the auditor while performing his normal duties comes across any instance, he should report the matter to the RBI in addition to Chairman/Managing Director/Chief Executive of the concerned bank.

Bank Audit Approach

Drawing an Audit Plan

An audit plan should be drawn up based on :-

- the nature and level of ***operations***,
- ***level*** of ***compliance*** based on previous reports and
- ***audit risks*** based on inadequacy in or breach of internal controls and the familiarisation exercise carried out

Control Environment at the Bank

- Check whether the bank have appropriate controls to mitigate 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 up limits*,
- reporting and approval of *exceptions*,
- *physical security* and
- *contingency* planning.

The following are certain common questions /steps, which have to be kept in mind while undertaking/ performing control activities

Who	• Who performs the control? • Does the above person have requisite *knowledge* and *authority* to perform the control?
What	• What *evidence* is available to demonstrate /prove that the control is performed?
When	• When and with what *frequency* is the control performed? • Is the *frequency enough* to prevent, detect and correct?
Where	• Where is the *evidence* of *performance* of the control retained? • For how long is the evidence retained? • Is the evidence accessible/ available for audit?
Why	• Why is the control being performed? • What type of *errors* are *prevented* or *detected* through the performance of the control?
How	• How is the control performed? • What are the control *activities*? (SOD, Approval, Reconciliation etc) • Can these activities be bypassed? • Can the bypass, if any, be detected? • How are *exceptions* / deviations resolved on identification? • What is the *time frame* for resolving the exceptions

Engagement Team Discussions

- All personnel performing an engagement, including any experts contracted by the firm in connection with that engagement are known to be the " Engagement Team".
- The engagement team should hold discussions
  - to gain better understanding of the bank and its environment, including internal control, and also
  - to assess the potential for material misstatements of the financial statements.
- All these discussions should be appropriately documented for future reference.
- These discussions are ordinarily done at the *planning stage* of an audit.

Engagement team discussion ordinarily includes

The engagement team discussion ordinarily includes a discussion of the following matters:

a. *Errors* that may be more *likely* to occur;
b. *Errors* which have been identified in *prior years*;
c. Method by which *fraud* might be perpetrated by bank personnel or others within particular account balances and/or disclosures;
d. Audit *responses* to Engagement Risk, Pervasive Risks, and Specific Risks;
e. Need to maintain *professional skepticism* throughout the audit.
f. *Need to alert* for information or other conditions that indicate that a material misstatement may have occurred (e.g., the bank's application of accounting policies in the given facts and circumstances).

Advantages of such a discussion :-

- Specific *emphasis can be provided to the susceptibility of the bank's financial statements to material misstatement due to fraud*, that enables the engagement team to consider an appropriate response to fraud risks, including those related to engagement risk, pervasive risks, and specific risks.
- It further enables the audit engagement partner to *delegate* the *work* to the experienced engagement team members, and to determine the procedures to be followed when fraud is identified.
- Further, audit engagement partners may review the *need for specialists* to address the issues relating to fraud.

Conducting an Audit

The audit of banks or their branches involves the following stages –

Initial consideration by the statutory auditor

Declaration of Indebtedness

- The RBI has advised that the banks, *before appointing* their statutory central/branch auditors,
  - should obtain a declaration of indebtedness.
- Indebtedness refers to the situation of owing money to the bank in any case , whatsoever.

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 , like Concurrent audits (Internal Audit of Banks conducted monthly during the year)

Planning

Standard on Auditing (SA) 300, "Planning an Audit of Financial Statements" requires that the auditor shall undertake the following activities prior to starting an initial audit

- Performing *procedures required* by *SA 220*, "Quality Control for Audit Work" regarding the acceptance of the client relationship and the specific audit engagement; and
- Establish understanding of *terms* of *engagement* as per SA 210, "Agreeing the Terms of Audit Engagements".

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 in writing. He should get a *NO Objection Certificate* (NOC) from the previous auditor through this communication as to know whether he has any objections to such an appointment made, for any valid reasons.

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.

Initial Engagements

- The auditor needs to perform the *audit procedures* as mentioned in SA 510 "Initial Audit Engagements-Opening Balances" and
- if after performing that procedures,
  - the auditor concludes that the *opening balances* contain *misstatements* which *materially affect* the financial statements for the current period and
    - the *effect* of the same is *not properly accounted* for and
    - adequately *disclosed*,
      - the auditor should express a *qualified opinion* or an adverse opinion, as appropriate.

Assessment of Engagement Risk

- 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
    - since it *affects* the *decision* of *accepting* the engagement and
    - *also* in *planning decisions* if the audit is accepted.

Establish the Engagement experienced 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 size, nature and complexity of the bank's operation.

Understanding the Bank and its Environment

SA 315 "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" lays down that the auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to *identify* and *assess* the *risks* of material misstatement of the financial statements whether due to fraud or error and sufficient to design and perform further audit procedures.

Identifying and Assessing the Risks of Material Misstatements

SA 315 requires the auditor to *identify* and *assess* the *risks* of material misstatement at the financial statement level and the assertion level for classes of transactions, account balances and disclosures to provide a basis for designing and performing further audit procedures.

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* so as to determine the operating effectiveness of the controls and to *address* the specific risks.

Understanding the Bank's Accounting Process

The accounting process produces *financial* and *operational* information for management's use and it also *contributes* to the bank's *internal control.*

Thus, 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.

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:

1. **Oversight and involvement in the control process by those charged with governance (Control Environment)**
   - ➢ *T*hose *c*harged *w*ith *g*overnance (Board of Directors/Managing Director) 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 risk it regards as acceptable.

2. **Identification, measurement and monitoring of risks (Risk assessment)**
   - ➢ Risks that could significantly impact the achievement of a bank's goals should be *identified*, *measured* and *monitored* against *pre-approved limits and criteria.*

3. **Control activities**
   - ➢ A bank should have *appropriate controls* to mitigate 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 up limits, reporting and approval of exceptions, physical security and contingency planning.

4. **Monitoring activities**
   - ➢ Risk management *models*, *methodologies* and *assumptions* used to measure and mitigate risk should be regularly assessed and updated. This function may be conducted by the *independent risk management unit.*

5. **Reliable information systems**
   - ➢ 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 *bank's risk profile*.

Engagement Team Discussions

The engagement team should hold discussions to gain better *understanding* of banks and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements.

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.

Develop the Audit Plan

SA 300 deals with the *auditor's responsibility* to plan an audit of financial statements in an *effective manner*. It requires the involvement of all the key members of the engagement team while planning an audit.

Audit Planning Memorandum

The auditor should summarise the 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.

Determine Audit Materiality

The auditor should consider the *relationship* between the audit *materiality* and audit *risk* when conducting an audit. The determination of audit materiality is a matter of professional judgement and depends upon the knowledge of the bank, assessment of engagement risk and the reporting requirements for the financial statements.

Consider Going Concern

While 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.*

Assess the Risk of Fraud including Money Laundering

As per *SA 240* "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the auditor's objective is

- to *identify* and *assess* the *risks* of material misstatement in the financial statements due to fraud,

- to *obtain sufficient appropriate audit evidence* on those identified misstatements and to *respond* appropriately.

The attitude of *professional skepticism* should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud.

The RBI has from time to time issued guidelines ("*Know Your Customer Guidelines* – Anti Money Laundering Standards"), requiring banks to establish policies, procedures and controls to *deter* and to recognise and *report money laundering activities*.

Assess Specific Risks

The auditors should *identify* and *assess* the *risks* of material misstatement at the financial statement level which refers to risks that relate *pervasively* to the financial statements as a whole and potentially affect many assertions.

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, a number of risks associated with outsourcing of activities by banks and therefore, it is quintessential for the banks to effectively manage those risks.

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. The auditor should *design* and *perform further audit procedures* whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.

Stress Testing

Stress testing is a software testing activity that determines the robustness of software by testing beyond the limits of normal operation. Stress testing is particularly important for "mission critical" software, but is used for all types of software. (Source – Wikipedia)

RBI has required that all commercial banks shall put in place a Board approved *'Stress Testing framework'* to suit their individual requirements which would integrate into their risk management systems.

BASEL III framework

The set of agreements by the BCBS (Basel Committee on Banking Supervision), which mainly focuses on risks to banks and the financial system are called Basel accord.

The Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB) has undertaken an extensive review of the regulatory framework in the wake of the subprime crisis.

In the document titled 'Basel III: A global regulatory framework for more resilient banks and banking systems', released by the BCBS in December 2010, it has inter alia proposed certain minimum set of criteria for inclusion of instruments in the new definition of regulatory capital. (Items to be included while calculating the capital adequacy ratio)

Reliance on / review of other reports

The auditor should take into account the *adverse* comments, if any, on advances appearing in the following-

- *Previous year's audit reports.*
- *Latest* internal *inspection reports* of bank officials.
- *Reserve Bank's latest inspection report*.
- *Concurrent / Internal audit report*.
- Report on *verification* of *security*.

- Any other internal reports specially related to particular accounts.
- Manager's charge-handing-over report when incumbent is changed.

The above reports should be reviewed in detail. The Statutory Central Auditors must review the Annual Financial Inspection report of RBI relating to the bank and ensure that the variations in provisions, etc. reported by RBI have been properly considered by the bank management.

Substantive procedures

In carrying out his substantive procedures,

- the auditor should examine all large advances while other advances may be examined on a sampling basis.
- The accounts identified to be problem accounts, however, need to be examined in detail unless the amount involved is insignificant.
- The extent of sample checking would also depend on the auditor's assessment of efficacy of internal controls.

What constitutes a 'large advance' would need to be determined in the context of volume of operations of the branch e.g. an advance may be considered to be a large advance if the year-end balance is in excess of ₹ 2 crore or 5% of the aggregate year-end advances of the branch, whichever is less.

Advances

What are advances?

- Advances are amounts of money or credit, given as a loan from a bank to another party with an agreement that the money will be repaid.
- Bank charges interest on advances as the consideration for advances.
- Biggest item on the asset side.
- Major source of income for banks

Auditor's View

Auditors must have sound knowledge of the

- various functional areas of the bank/branches,
- its processes, procedures, systems
- Guidelines, rules and regulation and
- prevailing internal controls with regard to advances.

Type of Advances

- Funded
- Non-Funded

<table>
<tr><th colspan="4">Types of Advances</th></tr>
<tr><td rowspan="7">Funded</td><td rowspan="7">actual transfer of funds</td><td colspan="2">Term Loans</td></tr>
<tr><td>Cash Credits</td><td>Cash Credit is a short term loan approved by banks for businesses, financial institutions and companies to meet their working capital requirements. The borrowing company can take money, even without a credit balance.</td></tr>
<tr><td colspan="2">Overdraft</td></tr>
<tr><td colspan="2">Demand Loan</td></tr>
<tr><td colspan="2">Bills Discounted</td></tr>
<tr><td colspan="2">Participation on risk sharing basis</td></tr>
<tr><td colspan="2">Interest bearing staff loan</td></tr>
<tr><td>Non- Funded</td><td>do not involve such transfer</td><td colspan="2">Examples of non-funded loans are Letters of credit, Bank guarantees, etc.</td></tr>
</table>

Classification of Advances

SECTOR WISE

Priority Sector

RBI issues common guidelines for lending to the Priority Sector which banks are required to follow. These guidelines cover rate of interest; service charges, receipt, sanction, rejection, disbursement Register; issue of Loan Application Acknowledgement. RBI also issues targets for banks for lending to the Priority Sector.

Examples of Priority Sectors are Agriculture , MSME , Education , Housing , etc.

SECURITY WISE

Banks ask Security or Collateral while lending to assure that the Borrower will return the money to bank in prescribed time else the Banks have legal authority to sell the collateral to recover its money.

Primary Security

Primary security refers to the security offered by the borrower for bank finance or the ***one against which credit has been extended*** by the bank. This security is the ***principal security*** for an advance.

Collateral security

It is an ***additional security***. Security can be in any form i.e. tangible or intangible asset, movable or immovable asset.

Examples of Security

Examples of most common types of securities accepted by banks are the following:

- Personal Security of Guarantor
- Goods/Stocks/Debtors/Trade Receivables
- Gold Ornaments and Bullion
- Immovable Property
- Plantations (For Agricultural Advances) Third Party Guarantees
- Bankers General Lien The term lien refers to a legal claim or legal right which is made against the assets that are held as security for satisfying a debt
- Life Insurance Policies
- Stock Exchange Securities and Other Instruments.

Mode of Creation of Security

Depending on the nature of the item concerned, creation of security may take the form of a mortgage, pledge, hypothecation, assignment, set-off or lien.

Mortgage

Mortgages are of several kinds but the most important are the

- Registered Mortgage and
- Equitable Mortgage.

- **Registered Mortgage**
  - It can be affected by a registered instrument called the '*Mortgage Deed*' signed by the mortgagor.
  - It registers the property to the mortgagee as a security.

- **Equitable Mortgage**. (Equitable mortgage is also known as Mortgage by deposit of title deeds)
  - Equitable mortgage, on the other hand, is effected by a *mere delivery* of *title deeds* or other documents of title with intent to create security thereof.

Pledge

- A pledge involves *bailment or delivery of goods* by the borrower to the lending bank with the intention of creating a charge thereon as security for the advance.
- The legal *ownership* of the goods *remains* with the *pledger* while the lending banker gets certain defined interests in the goods.
- The pledge of goods constitutes a specific (or fixed) charge.

Hypothecation

- The hypothecation is the creation of an equitable charge, in favour of the lending bank *by execution of hypothecation agreement* in respect of the *moveable securities* belonging to the borrower.
- *Neither ownership nor possession is transferred to the bank.*
- However, the *borrower holds the physical possession of the goods as an agent/trustee of the bank*.
- The borrower periodically submits statements regarding quantity and value of hypothecated assets (stocks, debtors, etc.) to the lending banker on the basis of which the drawing power of the borrower is fixed.

Assignment

Assignment represents a *transfer* of an *existing* or *future debt*, right or property belonging to a person in favor of another person.

Only actionable claims (i.e., claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of moveable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment.

An assignment gives the assignee absolute right over the money/debts assigned to him.

Set-off

Set-off is a *statutory right* of a *creditor* to *adjust*, *wholly* or *partly*, the *debit balance* in the *debtor's account* against any credit balance lying in another account of the debtor.

The right of set-off enables a bank to combine two accounts (a deposit account and a loan account) of the same person provided both the accounts are in the same name and same right (i.e., the capacity of the account holder in both the accounts should be the same).

For the purpose of set-off, all the branches of a bank are treated as one single entity. The right of set-off can be exercised in respect of time-barred debts also.

Lien

Lien is creation of a *legal charge* with *consent* of the *owner*, which gives the lender a legal right to seize and dispose / liquidate the asset under lien.

Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances

Non-performing Assets

An asset becomes an NPA when it ceases to generate income for the Bank.

A non-performing asset (NPA) is a loan or an advance where -:

- *interest* and/ or *instalment* of principal remain *overdue* for a *period* of *more than 90 days* in respect of a term loan;
- the account remains 'out of order' in respect of an Overdraft/Cash Credit (OD/ CC);
- the bill remains overdue for a period of *more than 90 days* in the case of bills purchased and discounted.

Out of order

An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power for *90 days.*

In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but

- there are *no credits continuously for 90 days* as on the date of Balance Sheet or
- credits are *not enough to cover the interest debited* during the same period, these accounts should be treated as 'out of order'.

Overdue

Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.

Provision Requirement

Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.

Categories of Non-Performing Assets	Provision required
• Substandard Assets: Would be one, which has remained NPA for a period less than or equal to 12 months.	15%
• Doubtful Assets: Would be one, which has remained in the substandard category for a period of 12 months.	(Secured + Unsecured)
Sub-categories: Doubtful up to 1 Year (D1) Doubtful 1 to 3 Years (D2) Doubtful more than 3 Years (D3)	 25% + 100% 40% + 100% 100% + 100%
• Loss Assets: Would be one, where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.	100%

Other points w.r.t Provisioning

Basis of classification

- Classification as NPA should be based on the *record of recovery*. Availability of *security* or net worth of borrower/guarantor is *not* to be *taken* into *account* for the purpose of treating an advance as NPA or otherwise.

Borrower-wise and not facility-wise

- Asset classification would be ***borrower-wise and not facility-wise.***
- For Example :- Mr. Raman has availed two Loan facilities - a Car Loan as well as a Housing Loan from XYZ Bank Ltd. He is regular in depositing the Housing loan EMI but has not deposited the last 4 EMI's of the Car Loan due to paucity of funds. Hence , in this case , not only the Car loan but the Housing Loan would also be treated as an NPA, although it is going good and there are no irregularities because the NPA classification is Borrower wise (Mr. Raman) and not Facility wise (Car & Housing Loan individually).

Accounts regularised near the Balance Sheet Date

- The asset classification of borrower accounts where a solitary or a few credits are recorded before the balance sheet should be handled with care and without scope for subjectivity. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as NPA.

Government Guaranteed advances

- ***C**entral **G**ovt. **guaranteed*** Advances, where the guarantee is ***not invoked/ repudiated*** would be classified as ***Standard Assets,*** but regarded as ***NPA*** for ***Income Recognition purpose***.
- The situation would be different if the advance is guaranteed by the ***S**tate **G**overnment*, where advance is to be considered NPA if it remains overdue for ***more than 90 days*** for ***both*** Provisioning and Income recognition purposes.

Advances under consortium

Basics

Consortium advances mean ***advancing loans to a borrower by two or more Banks jointly*** by forming a Consortium.

This will help the Banks

- to consolidate the ***appraisal benefit*** of different Banks and
- reduce the ***risks*** and
- also help the Banks to keep the ***exposure*** within the permissible limit

Joint appraisal, control and monitoring will facilitate for ***exchange*** of ***valuable information*** among the Banks

Usually, a Bank with a ***higher share*** will lead the consortium. It will be called - ***Lead Bank.***

Asset classification

- Asset classification of accounts under consortium should be based on the ***record*** of ***recovery*** of the ***individual*** member banks.
- Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is ***not parting*** with the ***share*** of other member banks, the ***account*** will be treated as ***not serviced*** in the books of the other member banks and therefore, be ***treated*** as ***NPA***.
- The ***banks participating*** in the consortium should, therefore, ***arrange*** to get their share of recovery transferred from the lead bank or get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

Drawing Power

- The ***Lead Bank*** would be responsible for computing the drawing power (DP) of the borrower and allocate the same to member banks.
- In certain special circumstances, at the request of the Borrower, the Lead Bank may allot a higher or lower share of drawing power to the member bank, as against their share of advances.

Accounts where there is erosion in the value of security / frauds committed by borrowers

Erosion means the gradual destruction or diminution of something. It should be straight-away classified as doubtful or loss asset as appropriate as follows :-

- *Realisable value of the security is less than 50 per cent*
- Erosion in the value of security can be reckoned as significant when the realisable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI at the time of last inspection, as the case may be.
- Such NPAs may be straight-away classified under *doubtful category* and provisioning should be made as applicable to doubtful assets.
- *Realisable value of the security is less than 10 per cent of the outstanding in the borrowal accounts*
- If the realisable value of the security, as assessed by the bank/ approved valuers/ RBI is *less than 10 percent of the outstanding in the borrowal accounts*, the existence of security should be ignored and the asset should be straight-away classified as *loss asset*. It may be either written off or fully provided for by the bank.

Advances Against Term Deposits, NSCs, KVPs/ IVPs, etc.

Advances against Term Deposits, NSCs eligible for surrender, KVP/IVP and life policies need not be treated as NPAs, provided *adequate margin* is available in the accounts.

Agricultural Advances Affected by Natural Calamities

Master Circular issued by the RBI deals elaborately with the classification and income recognition issues due to impairment caused by natural calamities.

Banks may *decide on their own relief measures* for example

- conversion of the *short term production loan into a term loan* or
- *reschedulement* of the repayment period and the sanctioning of fresh short term loan,

subject to the guidelines contained in RBI's latest Master Circular on Prudential Norms on Income Recognition, Asset Classification and provisioning pertaining to Advances.

In such cases, the NPA classification would be governed by such rescheduled terms.

Advances to Staff

Interest-bearing staff advances as a *banker* should be *included* as part of the *advances portfolio* of the bank.

In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first instalment onwards.
Such loans/advances should be classified as NPA *only* when there is a *default* in *repayment* of *instalment* of *principal* or payment of *interest* on the respective due dates.

The staff advances by a bank as an *employer* and *not* as a *banker* are required to be included under the sub-head *'Others'* under the schedule of Other Assets.

Agricultural Advances

As per the guidelines, Agricultural Advances are of two types:

1. Agricultural Advances for "long duration" crops; and
2. Agricultural Advances for "short duration" crops.

The "long duration" crops would be crops *with a crop season longer than one year* and crops, which are not "long duration" crops would be treated as "short duration" crops.

The crop season for each crop, which means the *period up to harvesting of the crops raised*, would be determined by the State Level Bankers' Committee in each State.

The following NPA norms would apply to agricultural advances (including Crop Term Loans):

- A loan granted for *short duration crops* will be treated as *NPA*, if the instalment of principal or interest thereon remains overdue for *two crop seasons*; and
- A loan granted for *long duration crops* will be treated as *NPA*, if the instalment of principal or interest thereon remains overdue for *one crop season*.

Audit of Advances

Advances generally constitute the major part of the assets of the bank. There are a large number of borrowers to whom a variety of advances are granted. The audit of advances requires the major attention from the auditors.

In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following

1. *Amounts* included in the balance sheet in respect of advances are *outstanding* at the date of the balance sheet.
2. Advances represent the *amount due to the bank*.
3. There are *no unrecorded advances.*
4. The stated basis of *valuation of advances* is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation.
5. Amounts due to the bank are appropriately *supported by Loan documents* and *other documents as applicable to the nature of advances.*
6. Appropriate *provisions* towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.
7. The advances are *disclosed, classified* and *described* in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.
8. *Internal controls* for sanctioning advances and reviewing them are designed, operating effectively, throughout the period.
9. Carrying out appropriate *analytical procedures*.

In carrying out his substantive procedures, the auditor should examine all large advances while other advances may be examined on a sampling basis.

The accounts identified to be problem accounts however need to be examined in detail unless the amount involved is insignificant.

Advances which are sanctioned during the year or which are adversely commented on by RBI inspection team, concurrent auditors, bank's internal inspection, etc. should generally be included in the auditor's review.

The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

- examining the validity of the recorded *amounts*;
- examining loan *documentation*;
- reviewing the *operation* of the accounts;
- examining the existence, enforceability and valuation of the *security*;
- checking compliance with *RBI* norms including appropriate classification and provisioning; and
- carrying out appropriate *analytical procedures*.

Evaluation of Internal Controls over Advances:

The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures.

In general, the internal controls over advances should include, inter alia, the following:

CREDIT WORTHINESS and Sanction

The bank should make an advance only after satisfying itself as to the ***credit worthiness*** of the borrower and after obtaining ***sanction*** from the appropriate ***authorities*** of the bank.

DOCUMENTS

All the ***necessary documents*** (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.

COMPLIANCE

The ***compliance*** with the ***terms*** of sanction and ***end use*** of funds should be ensured.

SUFFICIENT MARGIN

- Sufficient margin as specified in the sanction letter should be kept against securities taken so as to ***cover*** for any ***decline*** in the value thereof.
- The availability of sufficient margin needs to be ensured at regular intervals.

SECURITIES OWNERSHIP

If the securities taken are in the nature of shares, debentures, etc., the ***ownership*** of the same should be ***transferred*** in the name of the ***bank*** and the effective control of such securities be retained as a part of documentation.

SECURITIES REGISTRATION

All securities requiring registration should be ***registered*** in the ***name*** of the ***bank*** or otherwise accompanied by documents sufficient to give title to the bank.

CONTENTS OF THE PACKAGE

In the case of goods in the possession of the bank, ***contents*** of the packages should be ***tested*** at the time of receipt. The godowns should be frequently ***inspected*** by ***responsible officers*** of the branch concerned, in addition to the inspectors of the bank.

DRAWING POWER REGISTER

Drawing Power Register should be ***updated every month*** to record the value of securities hypothecated. These entries should be checked by an officer.

LIMIT

The accounts should be kept within ***both the drawing power*** and the ***sanctioned limit.***

IRREGULAR ACCOUNTS

All the accounts which exceed the sanctioned limit or drawing power or are otherwise ***irregular*** should be brought to the ***notice*** of the controlling authority regularly.

REVIEW

The operation of each advance account should be reviewed ***at least once a year,*** and at more frequent intervals in the case of large advances.

COMPUTATION OF DRAWING POWER

- Drawing Power generally addressed as "DP" is an important concept for ***Cash Credit*** (CC) facility available from banks and financial institutions.
- Drawing power is the limit up to which a firm or company can withdraw from the working capital limit sanctioned.

Sanctioned limit is the total exposure

- The Sanctioned limit is the ***total exposure*** that a bank can take on a particular client for facilities like cash credit, overdraft, export packing credit, non-funded exposures etc.

Drawing Power = value of primary security less margin

- Drawing Power refers to the amount calculated based on ***primary security less margin*** as on a particular date.
- All accounts should be kept within ***both*** the drawing power and the sanctioned limit at all times. The accounts which exceed the sanctioned limit or drawing power or are against unapproved securities or are otherwise ***irregular*** should be brought to the ***notice*** of the Management/Head office regularly.

Ensure drawings are covered by the adequacy of the current assets

- Banks should ensure that drawings in the working capital account are covered by the adequacy of the current assets.
- Drawing power is required to be arrived at based on the ***current stock statement.***
- However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power ***should not be older than three months*** otherwise it will be deemed as irregular.

Auditor's Concern

- The ***stock statements, quarterly returns and other statements*** submitted by the borrower to the bank should be scrutinised in detail.
- The ***audited Annual Report*** submitted by the borrower should be scrutinised properly.
- The audited statements and records submitted by the borrower should be ***compared*** and the reasons for deviations, if any, should be ascertained.

Computation of DP

- It needs to be ensured that the drawing power is calculated as per the extant ***guidelines*** formulated by the ***Board of Directors*** of the respective bank and agreed upon by the concerned statutory auditors.
- Special consideration should be given to ***proper reporting*** of ***sundry creditors*** for the purposes of calculating drawing power.

Stock Audit

- The stock audit should be carried out by the bank for all accounts having funded exposure of ***more than 5 crores.***
- Auditors can also advise for stock audit in other cases if the situation warrants the same.
- Branches should obtain the stock audit reports from lead banks in the cases where the Bank is not the leader of the consortium of working capital.
- The report submitted by the stock auditors should be ***reviewed*** during the course of the audit and special focus should be given to the ***comments*** made by the stock auditors on valuation of security and calculation of drawing power.

Audit of Revenue Items (Income)

Items which are included in the income of the bank

Interest Earned

- Interest/Discount on Advances/Bills
- Interest Income on Investments
- Interest on Balances with RBI and Other Inter-bank Funds
- Others: This includes any other interest/discount income not included in the above heads

Other Income

- Commission, Exchange and Brokerage - This item comprises of the following:
  - Commission on bills for collection.
  - Commission/exchange on remittances and transfers, e.g. demand drafts, NEFT, RTGS, etc.
  - Commission on letters of credit and guarantees, letter of comforts.
  - Loan processing, arranger and syndication fees.

  - Mobile banking fees.
  - Credit/Debit card fee income including annual fee income, merchant acquiring income, interchange fees, etc.
  - Rent from letting out of lockers
  - Commission on Government business.
  - Commission on other permitted agency business including consultancy and other services. (j) Brokerage on securities.
  - Fee on insurance referral.
  - Commission on referral of mutual fund clients.
  - Service/transaction banking charges including charges levied for transaction at other branches.
  - Income from rendering other services like custodian, demat, investment advisory, management and other based services.
- Profit on Sale of Investments
- Profit/Loss on Revaluation of Investments
- Profit on sale of Land, Buildings and Other Assets:
- Profit/Loss on Revaluation of Fixed Assets
- Profit on exchange transactions
- Income earned by way of dividends, etc.
- Miscellaneous income.

Audit Approach and Procedures For Income

Auditor's Concern

In carrying out audit of income, the auditor is primarily concerned with obtaining reasonable assurance that the recorded income arose from transactions, which ***took place during the relevant period*** and ***pertained*** to the bank, there is no ***unrecorded income*** and the income is recorded at ***appropriate amounts***.

RBI's Directions - Accrual basis and Receipt Basis.

- RBI has advised that in respect of any income which ***exceeds one percent of the total income*** of the bank if the income is reckoned on a gross basis or ***one percent of the net profit before taxes*** if the income is reckoned net of costs, should be considered on ***accrual as per Accounting Standard 9***.
- Other income may be recognised when received and the auditors need not qualify their report in that situation.

Materiality:

- If any item of income is ***not*** considered to be ***material*** as per the above norms, it may be recognised when received and the auditors need ***not qualify*** their report in that situation.

Revenue Certainty:

- Banks recognise income (such as interest, fees and commission) on ***accrual basis***, i.e., as it is earned. It is an essential condition for accrual of income that it should ***not*** be ***unreasonable*** to ***expect*** its ***ultimate collection***.
- In modern day banking, the entries for interest income on advances are automatically generated through a batch process in the CBS system.

Revenue Uncertainty:

- In view of the ***significant uncertainty*** regarding ***ultimate collection*** of income arising in respect of non-performing assets, the guidelines require that banks should not recognize income on non performing assets ***until it is actually realised***.
- When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realized should be reversed or provided for.
- This will apply to ***Government guaranteed*** accounts also.

Renegotiations:

- Fees and commissions earned by the banks as a result of re-negotiations or rescheduling of outstanding debts should be recognised on an *accrual basis* over the period of time covered by the re-negotiated or rescheduled extension of credit.
- *Test check* the *interest* earned by the banks for the sample selected. Test check the *fees* and *commissions* earned by the banks made for commission on bills for collection, letters of credit and bank guarantees

NPA

- Banks should not recognize income on non performing assets *until it is actually realised*.
- This will apply to Government guaranteed accounts also.

Advances against Securities

Interest on advances against Term Deposits, National Savings Certificates (NSCs), Indira Vikas Patras (IVPs), Kisan Vikas Patras (KVPs) and Life policies may be taken to income account on the due date, provided *adequate margin* is available in the accounts.

Bills Purchased

- In the case of bills purchased outstanding at the close of the year the discount received thereon should be properly accounted for in the correct accounting periods.
- Interest (discount) component paid by Bank/Branch on rediscount of bills from other financial institutions, is *not to be netted off* from the discount earned on bills discounted.

Bills for Collection

- In the case of bills for collection, the auditor should also *examine* the *procedure* for crediting the party on whose behalf the bill has been collected.
- The procedure is usually such that the customer's account is credited only after the bill has actually been collected from the drawee either by the bank itself or through its agents, etc.
- The commission of the branch becomes *due only* when the *bill* has been *collected*.

Rescheduling of outstanding debts

- Fees and commissions earned by the banks as a result of re-negotiations or rescheduling of outstanding debts should be recognised on an *accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit.*
- Test check the interest earned by the banks for the sample selected.
- Test check the fees and commissions earned by the banks made for commission on bills for collection, letters of credit and bank guarantees.

Reversal of Income:

If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the *entire interest accrued and credited to income account in the past periods,* should be *reversed* or provided for if the same is not realised. This will apply to *Government guaranteed accounts* also.

In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

Furthermore, the auditor should inquire if there are any large debits in the Interest Income account that have not been explained. It should be enquired whether there are any communications from borrowers pointing out differences in interest charge and whether appropriate action has been taken in this regard.

On leased assets

The component of finance income (as defined in AS 19 Leases) on the leased asset which was accrued and credited to the income account before the asset became non-performing and remaining unrealised, should be reversed or provided for in the current accounting period.

On Take-out finance

- A takeout loan is a method of financing whereby a loan that is procured later is used to replace the initial loan.
- Takeout loans are commonly used in property development (Source :- Investopedia) In the case of take-out finance, if based on record of recovery, the account is classified by the lending bank as NPA, it should not recognize income unless realised from the borrower/taking-over institution (if the arrangement so provides).

All types of borrowers can get a take-out loan from a credit issuer to pay off past debts. Take-out loans can be used as a long-term personal loan to pay off previous outstanding balances with other creditors. They are most commonly used in real estate construction to help a borrower replace a short-term construction loan and obtain more-favourable financing terms. The take-out loan's terms can include monthly payments or a one-time balloon payment at maturity.

Take-out loans are an important way of stabilising your financing by replacing a short-term, higher-interest-rate loan with a long-term, lower-interest-rate one.

Example of a Take-Out Loan - Note for exams. - Source Investopedia
Assume XYZ company has received approval for plans to build a commercial real estate office building over 12 to 18 months. It may obtain a short-term loan for the financing it needs to build the property, with full repayment required in 18 months. The property plans are achieved ahead of schedule and the building is completed in 12 months. XYZ now has more negotiating power, because the fully complete property is able to be used as collateral. Thus, it decides to obtain a take-out loan, which provides it with the principal to pay off the previous loan six months early.

The new loan allows XYZ to make monthly payments over 15 years at an interest rate that is half of that of the short-term loan. With the take-out loan, it can repay its short-term loan six months early, saving on interest costs. XYZ now has 15 years to pay its new take-out loan at a much lower rate of interest, using the completed property as collateral.

Income Recognition On Partial Recoveries in NPAs:

- Interest partly/fully realised in NPAs can be taken to income.
- It should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned.
- In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards principal or interest due), ***banks are required to adopt an accounting policy and exercise the right of appropriation of recoveries in a uniform and consistent manner.***
- The appropriate policy to be followed is to recognise income as per AS 9 when certainty attaches to realisation and accordingly amount reversed/derecognised or not recognised in the past should be accounted for.

Memorandum Account

- On an account turning NPA, banks should reverse the interest already charged and not collected by debiting Profit and Loss account and stop further application of interest.
- However, banks may continue to record such accrued interest in a Memorandum account in their books for control purposes.
- For the purpose of computing Gross Advances, interest recorded in the Memorandum account should not be taken into account.

Income from Investments

Interest Income on Investments

This includes all income derived from Government securities, bonds and debentures of corporates and other investments by way of interest and dividend, except income earned by way of dividends, etc., from subsidiaries and joint ventures abroad/in India. (Such dividends from subsidiaries are shown separately and not as income from investments.)

Profit on Sale of Investments

Investments are dealt in the course of banking activity and hence the net profit or loss on sale of investments is taken to profit and loss account.

Profit/Loss on Revaluation of Investments

In terms of guidelines issued by the RBI, investments are to be valued at periodical intervals and depreciation or appreciation in valuation should be recognised and taken to profit and loss account.

EXPENSES

Categories

Expenditure is to be shown under three broad heads:

1. Interest expense.
2. Operating expense.
3. Provisions and contingencies.

Audit Approach and Procedures Interest Expense

In carrying out an audit of interest expense, the auditor is primarily concerned with

- **Reasonableness of amount of interest.**
  - Assessing the overall *reasonableness* of the amount of interest expense
    - by analysing
      - ratios of interest paid on different types of deposits and borrowings
      - to the average quantum of the respective liabilities during the year.
  - The auditor should obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate (Rate of interest for different categories).
  - The auditor may then *compare* this rate with the actual average rate of interest paid on the relevant deposits.
  - If any material *difference* is found *material* then it should be further *enquired* into by the auditor.
- **Comparison with previous year interest**
  - auditor should also compare the average rate of interest paid on the relevant deposits with the *corresponding figures* for the *previous years* and *analyse* any material *differences*.
- **Comparison with budget**
  - The auditor should also *compare* the interest expenses with the *budgeted figures* and should enquire into material differences.
  - Auditors should also obtain *understanding* of the budgeting procedures.
- **Verify the calculation of Interest**
  - The auditor should, on a *test check* basis, verify the calculation of interest and ensure that:
    - Interest has been provided on all deposits upto the date of the balance sheet;
    - Interest rates are in accordance with the bank's internal regulations, the RBI directives and agreements with the respective deposit holder;
    - Interest amounts credited on various deposits are in accordance with the rules framed by the bank/RBI on this behalf.
    - Interest on inter–branch balances has been provided at the rates prescribed by the head office/RBI.

- **Changes in the interest rate**
  - The auditor should ascertain whether there are any *changes* in *interest rate* on *saving accounts* and *term* deposits during the period.
  - The auditor should obtain the interest rate card for various types of deposits and analyse the interest cost for the period accordingly.
- **Completeness**
  - The auditor should examine the *completeness* that interest has been *accrued* on the entire borrowing portfolio and the same should *agree* with the general ledgers.

Operating expenses

For audit of operating expenses, the auditor should

- **IC**
  - *Study* and *evaluate* the system of internal *control* relating to expenses, including *authorization* procedures in order to determine the nature, timing and extent of his other audit procedures.
- **Changing Trends**
  - The auditor should *examine* whether there are any *changing trends* in respect of major items of expenses.
- **Substantive analytical procedures in respect of expenses**
  - The auditor should perform *substantive analytical procedures* in respect of these expenses. e.g. assess the *reasonableness* of expenses by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years.
- **Verify expenses from documents and check calculations**
  - The auditor should also verify expenses with reference to *supporting documents* and *check* the *calculations* wherever required.

Audit of Provisions and contingencies

- **Ensure compliance with regulatory requirements**
  - The auditor should ensure that the *compliances* for various *regulatory requirements* for provisioning as contained in the various circulars have been fulfilled.
- **Understanding the computation of provision and classification of assets**
  - The auditor should obtain an *understanding* as to how the bank computes provision on *standard assets and non-performing assets.*
  - It will primarily include checking the basis of *classification* of loans and receivables into standard, sub-standard, doubtful, loss and nonperforming assets.
- **Verify the classification on sampling basis**
  - The auditor may verify the loan classification on a *sample basis*.
  - The auditor should obtain the *detailed breakup* of standard loans, nonperforming loans and agree the outstanding balances with the general ledger.
- **Check the computation of Tax Provision**
  - The auditor should obtain the *tax provision computation* from the bank's management and verify the nature of items debited and credited to the profit and loss account to ascertain that the same are *appropriately considered* in the tax provision computation.
- **Examining other provisions**
  - The *other provisions* for *expenses* should be *examined* according in the light of
    - circumstances warranting the provisioning and
    - the *adequacy* of the same
      - by discussing and obtaining the *explanations* from the bank's management.

Expenditure is to be shown under three broad heads:

- Interest expense
  - Interest on Deposits
  - Interest on Reserve Bank of India/Inter–Bank Borrowings

- Others
- Operating expense
  - Payments to and Provisions for Employees
  - Rent, Taxes and Lighting
  - Printing and Stationery
  - Depreciation on Bank's Property
  - Directors' Fees, Allowances and Expenses
  - Auditors' Fees and Expenses
  - Legal expenses,
  - Postage, Telegrams, Telephones, etc.
  - Repairs and Maintenance
  - Insurance
  - Marketing Expenses
  - Other Expenses
- Provisions and contingencies
  - Provisions made in respect of the Non-performing assets.
  - Provisions for Taxation
  - Provisions for Diminution in the value of investments
  - Provisions for contingencies

Disclosure of the prior period items

Since the format of the profit and loss accounts of banks prescribed in Form B under Third Schedule to the Banking Regulation Act, 1949 does not specifically provide for disclosure of the impact of prior period items on the current year's profit and loss, such disclosures, wherever warranted, may be given.

Chapter 11 - Ethics and Terms of Audit Engagements

Meaning of Ethics

- *Moral* principles which govern a *person's behaviour* or his *conducting* of an activity. It is the branch of knowledge that deals with moral principles.
- Ethical behavior stems from personal *values* and must become a habit to create a strong ethical culture.
- These principles impose obligations on individuals.

Need for Professional Ethics For CAs

The auditing profession, like law and medicine, adheres to a strict code of ethics. This is crucial as society, governments, clients, taxing authorities, employees, investors, and the business community place immense trust in Chartered Accountants' services.

Professional ethics, based on morality, are vital for a profession's respect and confidence. Adhering to these ethics through self-discipline protects the profession's interests and commands respect.

Chartered Accountants, in practice or service, must follow the Code of Ethics. Deviating from ethical responsibilities triggers disciplinary actions like fines, suspension, or removal of membership.

Principles Based Approach Vs Rules Based Approach

Principles-based approach

- Compliance with the spirit.
- Use of professional *judgement*.
- *Flexible*, so can be applied to new, unusual or rapidly changing situations.
- Principles may be applied across national boundaries where laws may not.

Rule Based Approach

- *Strictly* follows clearly established rules.
- Lead to a *narrow* outlook and spirit of ethics may be overlooked while strictly adhering to rules.
- Further, rules- based approach is somewhat *rigid* as it may not be possible to deal with every practical situation relying upon rules.
- Therefore, it is necessary that spirit of code is followed.

Fundamental Principles of Professional Ethics

The fundamental principles of ethics establish the standard of behaviour expected of a professional accountant. A professional accountant shall comply with each of the fundamental principles. The fundamental principles of professional ethics are as under: -

- Integrity
- Objectivity
- Professional competence and due care
- Confidentiality
- Professional Behaviour

Integrity

- A professional accountant shall comply with the principle of integrity, which requires an accountant to be *straightforward* and *honest* in all professional and business relationships.
- Integrity implies *fair* dealing and *truthfulness*.
- 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.
- If a professional accountant provides a modified report in respect of such a report, return, communication or other information, the accountant is not in breach.
- When a professional accountant becomes aware of having been associated with information as described the accountant shall take steps to be disassociated from that information.

Objectivity

- 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.
- A professional accountant shall not undertake a professional activity if a circumstance or relationship unduly influences the accountant's professional judgment regarding that activity.

Professional Competence and Due Care

- A professional accountant shall comply with the principle of professional competence and due care, which requires an accountant to:
  - 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
  - Act diligently in accordance with applicable technical and professional standards.
- Maintaining professional competence requires a continuing awareness and an understanding of relevant technical, professional and business developments.
- Diligence includes the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.
- 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.
- Where appropriate, a professional accountant shall make clients, the employing organization, or other users of the accountant's professional services or activities, aware of the limitations inherent in the services or activities.

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

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.

Independence of Auditor

- The auditor's independence safeguards the auditor's ability to form an audit opinion without being affected by any influences.

- Independence enhances the auditor's ability to act with *integrity*, to be *objective* and to maintain an attitude of professional *skepticism*.

Independence implies that the judgement of a person is *not subordinate* to the wishes or direction of another person who might have engaged him.

It is *not* possible to *define* "independence" *precisely*. Rules of professional conduct dealing with independence are framed primarily with a certain objective. The *rules themselves cannot create or ensure the existence of independence*. Independence is a condition of mind as well as personal character. It should not be confused with the superficial and visible standards of independence which are sometimes imposed by law.

There are two interlinked perspectives of independence of auditors,

1. *independence of mind*; and two,
2. *independence in appearance*.

The Code of Ethics for Professional Accountants issued by International Federation of Accountants (IFAC) defines the term 'Independence' as follows:
"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 it should also *appear* to exist to all reasonable persons. (होनी भी चाहिये, दिखनी भी चाहिये)

Threats to Independence

The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats. These are:

Self-interest threats

Occur when an auditing firm, its partner or associate could benefit from a *financial interest* in an audit client. Examples include

- direct *financial interest* or materially significant indirect financial interest in a client,
- loan or guarantee to or from the concerned client,
- *undue dependence* on a client's *fees* and, hence, concerns about losing the engagement,
- *close business relationship* with an audit client,
- *potential employment* with the client, and
- *Contingent fees* for the audit engagement.
- audit firm unduly relies on fees from a client, it may result in threat to self interest of auditor and he may not work objectively for the fear of losing client.

Self-review threats

- Where non-audit work is provided to an audit client and is then subject to audit, the auditor will be *unlikely* to *admit* to *errors* in their *own work*, or may not identify the errors in their own work.
- or when a member of the audit team was *previously* a *director* or *senior employee* of the client.
- Instances where such threats come into play 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.

Advocacy threats

- *Promoting* the position of a *client* or representing them in some way would mean the audit firm is seen to be *'taking sides'* with the client.
- Example - when an auditor deals with *shares* or securities of the audited company, or becomes the client's advocate in *litigation* and third party disputes.
- In such situations, auditor can be perceived as backing and championing causes of auditee clients and it may lead to belief that the auditor is not acting and working objectively.
- Remember that auditor has not only to be independent but also appear to be acting so.

Familiarity threats

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.

Intimidation threats

- 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 or being threatened with litigation. Such threats attempt to intimidate auditors to deter them from acting objectively.

Safeguards to Independence

- Safeguards are actions, individually or in combination, that the professional accountant takes that effectively *reduce threats* to comply with the fundamental principles to an acceptable level.
- To address the issue, the following guiding principles are to be applied: -
  - For the public to have confidence in the quality of audit, it is essential that auditors should always be and *appears* to be independent of the entities that they are auditing.
  - Before taking on any work, an auditor *must conscientiously* consider whether it involves *threats* to his independence.
  - When such threats 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.
  - All such safeguards measures need to be recorded in a form that can serve as evidence of compliance with due process.
  - If the auditor is *unable* to fully implement *credible* and adequate *safeguards*, then he *must not accept the work.*

Professional Skepticism

The auditor is responsible for maintaining an attitude of professional skepticism throughout the audit. Do you agree with the statement?

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

- Professional skepticism is 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.***

This includes

- Questioning
  - ***contradictory*** audit ***evidence*** and - जो मिला
  - the ***reliability*** of ***documents*** and - जो दिखा
  - ***responses*** to ***inquiries*** and - जो कहा,
  - Condition that may indicate possible ***fraud*** - जो हुआ
  - Circumstances that suggest the ***need*** for ***a***udit ***p***rocedures in ***addition*** to those required by the ***SAs***. जो होगा

(Critical assessment of audit evidence) Checking whether audit evidence obtained by auditor is sufficient and appropriate as per the circumstance.

Why Professional Skepticism?

(Risk को कम करना चाहते है !) कौन से Risk को - Overlooking and Over Generalising and inappropriate assumptions के Risk को

- Maintaining professional skepticism throughout the audit is necessary to ***reduce*** the risks of
  - ***Overlooking*** unusual circumstances,
  - ***Over generalising*** when drawing conclusions.
  - Using ***inappropriate assumptions*** in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.
- Further, while obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit,
  - considering the potential for ***management override*** of ***controls*** and (कहीं मैनज्मेंट override तो नहीं कर रही कंट्रोल्ज़ को)
  - recognizing the fact that ***audit procedures*** that are effective for detecting ***error*** may not be effective in detecting ***fraud***. (एरर तो पकड़ सकते है लेकिन फ़्रॉड नहीं)
- Therefore, we do agree with the statement.
- The auditor ***cannot*** be ***expected*** to ***disregard past experienc***e of the ***honesty*** and ***integrity*** of the entity's ***management*** and ***t***hose ***c***harged ***w***ith ***g***overnance. Nevertheless, a belief that management and those charged with governance are honest and have integrity ***does not relieve the auditor*** of the ***need*** to maintain professional ***skepticism*** or ***allow*** the auditor to be ***satisfied*** with ***less-than-persuasive audit evidence*** when obtaining reasonable assurance.

SA 210 - Agreeing the terms of Audit Engagement

Objective of the 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*** and
b. Confirming that there is a ***common*** ***understanding*** between the ***auditor*** and ***management*** and, where appropriate, ***t***hose ***c***harged ***w***ith ***g***overnance of the terms of the audit engagement.

Preconditions for an audit

In order to establish whether the preconditions for an audit are present, the auditor shall:

a. Determine whether the financial reporting framework is ***acceptable*** and
b. Obtain the ***agreement*** of ***management*** that it ***acknowledges*** and ***understands*** its responsibility:

i. For the preparation of the financial statements in accordance with the applicable financial reporting framework including where relevant their fair representation;
ii. For such internal control as management considers 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 all information of which management is aware that is relevant to the preparation of the financial statements 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.

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

Agreement on Audit Engagement Terms

- It is important, both for the auditor and client, that each party should be clear about the nature of the engagement. It must be reduced to writing and should exactly specify the scope of the work.
- The audit engagement letter is sent by the auditor to his client.
- According to SA 210 "Agreeing the Terms of Audit Engagements", the auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate.
- In the case of partnerships, a few more precautions are needed. The appointment of the auditor is normally governed by the partnership deed. The accountant, when he is approached for undertaking a professional assignment by a firm or a partner of a firm, should first get a clear idea of the nature of the service required and then ensure, with reference to the terms of partnership agreement that his appointment is valid.

Content of Audit Engagement Letter

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 financial statements
- The responsibilities of the auditor
- The responsibilities of management
- Identification of the applicable financial reporting framework for the preparation of the financial statements and
- 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.

If law or regulation prescribes in sufficient detail the terms of the audit engagement, 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.

Limitation on Scope Prior to Audit Engagement Acceptance

If

- management or those charged with governance
- 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 financial statements,
  - the auditor
  - shall not accept such a limited engagement as an audit engagement,
  - unless required by law or regulation to do so.

Acceptance of a change in engagement

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.

If auditor concludes that there is reasonable justification for changing the terms of audit engagement then auditor must do his work as per the new terms of engagement and ***must*** issue a ***report*** in accordance with the ***new terms*** of engagement.

(A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of the service originally requested may be considered a reasonable basis for requesting a change in the audit engagement)

The report would not include reference to

- the ***original engagement***; or
- any ***procedures*** that may have been performed in the original engagement.

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.

The auditor should not agree to a change of engagement where there is no reasonable justification for doing so. (a change may not be considered reasonable if it appears that the 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.)

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:

- ➔ ***Withdraw*** from the audit engagement where possible under applicable law or regulation; and
- ➔ 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.

A request from the client for the auditor to change the engagement may result from-

- a change in ***circumstances*** affecting the need for the service,
- a ***misunderstanding*** as to the nature of an audit or related service originally requested.
- a ***restriction*** on the ***scope*** of the engagement, whether imposed by management or caused by circumstances.

Terms of Engagement in 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.

The auditor may decide ***not*** to send a new audit engagement letter or other written agreement each period. However, in the following situations it is 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.
- A change in ***legal*** or regulatory requirements.

- A change in the *financial reporting framework* adopted in the preparation of the financial statements.
- A change in *other* reporting requirements.

Quality of an Audit Engagement

Standard on Quality Control (SQC) 1

Quality Control for Firms that Perform

- *Audits* and
- *Reviews* of Historical Financial Information, and
- *Other Assurance* and *Related* Services Engagements.

The firm should establish a system of quality control designed to provide it with reasonable assurance

- that the firm and its personnel comply with
  - *professional standards* and
  - regulatory and *legal* requirements, and
- that *reports* issued by the firm or engagement partner(s) are *appropriate* in the circumstances.

Elements of a System of Quality Control

1. Leadership responsibilities for quality within the firm.
2. Ethical requirements.
3. Acceptance and continuance of client relationships and specific engagements.
4. Human resources.
5. Engagement performance.
6. Monitoring

SA 220 - Quality Control For An Audit Of Financial Statements

SA 220 applies to audit engagements only.

SQC 1- Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.

Leadership responsibilities for quality within the firm

- The firm' policies and procedures must be designed to *create* an *internal culture* which *promotes quality* as *essential* in performing engagements to *achieve* the following *objectives*
  - Perform work that complies with professional standards and regulatory and legal requirements; and
  - Issue reports that are appropriate in the circumstances.
- Such policies and procedures should require the firm's *chief executive officer* (or equivalent) or, if appropriate, the firm's *managing partners* (or equivalent), to *assume ultimate responsibility* for the firm's system of quality control.
- Any person or *persons assigned* operational responsibility for the firm's quality control system by the firm's chief executive officer or managing board of partners should have *sufficient* and appropriate *experience* and *ability*, and the necessary authority, to assume that responsibility.

Ethical requirements

- The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel *comply* with *relevant ethical requirements* contained in the Code of ethics issued by ICAI.
- The Code establishes the *fundamental principles* of professional ethics which include *i*ntegrity, *o*bjectivity, *p*rofessional competence and due care, *c*onfidentiality and *p*rofessional behaviour.

Such policies and procedures should *enable* the firm to:

a. *Communicate* its independence requirements to its personnel and (Independence Requirement)
b. *Identify* and evaluate circumstances and relationships that create threats to independence, (Identification and evaluation of threat)
c. *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.(Action to eliminate and reduce)

There should exist a mechanism in the firm by which engagement partners provide the firm with relevant information about client engagements and personnel of firm promptly notify firm of circumstances and relationships that create a threat to independence. All *breaches* of *independence* should be promptly notified to firm for *appropriate action*. Its objective is to ensure that independence requirements are satisfied.

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.

Acceptance and Continuance of Client Relationships and Specific Engagements

The firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide it with reasonable *assurance* that it will *undertake* or *continue* relationships and engagements *only where* it:

a. Has considered the *integrity* of the client and
   - ➢ does not have information that would lead it to conclude that the client lacks integrity;
b. Is
   - ➢ *competent* to perform the engagement and
   - ➢ has the *capabilities*, *time* and
   - ➢ *resources* to do so; and
c. Can comply with the *ethical requirements*.

Where *issues* have been *identified*, and the firm *decides* to accept or continue the client relationship or a specific engagement, it should *document how* the issues were *resolved*.

Matters to be considered with regard to integrity of the client

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.
- 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.
- The nature of the client's *operations*, including its business practices.
- 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*.
- The *reasons* for the proposed *appointment* of the firm and non-reappointment of the previous firm.

The extent of *knowledge* a firm will have regarding the integrity of a client will generally *grow* within the context of an ongoing relationship with that client.

If there is any conflict of interest between the firm and client, it should be properly resolved before accepting the engagement.

Information that would have caused it to decline an engagement

Where the firm obtains information that would have caused it to decline an engagement if that information had been obtainable earlier, policies and procedures on the continuance of the engagement and the client relationship should include consideration of:

- The professional and legal responsibilities that apply to the circumstances, including whether there is a requirement for the firm to report to the person or persons who made the appointment or, in some cases, to regulatory authorities; and
- The possibility of withdrawing from the engagement or from both the engagement and the client relationship.

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 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.
Such policies and procedures address the following personnel issues:

(a) Recruitment;
(b) Performance evaluation;
(c) Capabilities;
(d) Competence;
(e) Career development;
(f) Promotion;
(g) Compensation; and
(h) Estimation of personnel needs.

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.

Engagement Performance

The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances.

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.

Matters to be considered to ensure the achievement of objective of Engagement Performance

Matters addressed include the following-

- 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.

Following things are covered in Engagement Performance

- Supervision
- Review
- Consultation
- Difference of Opinion
- Engagement Quality control review
- Enagagement Documentation

Supervision

Supervision includes the following:

- *Tracking* the progress of the *engagement*
- *Considering* the *capabilities* and competence of individual members of the engagement team
- *Addressing* significant *issues* arising during the engagement
- *Identifying* matters for *consultation* or *consideration* by more experienced engagement team members during the engagement.

Review

Review responsibilities are determined on the basis that *more experienced* engagement team *members*, including the engagement partner, *review work* performed by *less experienced team members*. Reviewers consider whether

a. The work has been *performed* in accordance with professional standards and regulatory and legal requirements;
b. *Significant matters* have been *raised* for further consideration;
c. Appropriate *consultations* have taken place and the resulting conclusions have been documented and implemented;
d. There is a *need* to *revise* the nature, timing and extent of work performed;
e. The *work* performed supports the conclusions reached and is appropriately *documented*;
f. The *evidence* obtained is sufficient and appropriate to support the report; and
g. The *objectives* of the engagement procedures have been achieved.

Consultation

The firm should establish policies and procedures designed to provide it with reasonable assurance that:

a. Appropriate consultation *takes place* on difficult or contentious matters;
b. Sufficient *resources* are *available* to enable appropriate consultation to take place;
c. The nature and scope of such consultations are *documented*; and
d. Conclusions resulting from consultations are *documented* and *implemented*.

Differences of Opinion

The firm should establish policies and procedures for *dealing* with and *resolving* differences of opinion

- within the engagement *team*,
- with those *consulted* and, where applicable,
- between the engagement *partner* and the engagement quality control *reviewer*.

Conclusions reached should be documented and implemented.

Engagement Quality Control Review

The firm should establish policies and procedures requiring, an engagement quality control review that provides an *objective evaluation* of the significant *judgments* made by the engagement team and the *conclusions* reached in formulating the report. Such policies and procedures should:

- Require an engagement quality control review for *all* audits of financial statements of *listed entities*
- Set out *criteria* against which all other audits and reviews of historical financial information, and other assurance and related services engagements should be *evaluated* to *determine* whether an engagement quality control review should be *performed*.
- Require an engagement quality control review for all *engagements meeting* the *criteria* as set-out by the firm.

The firm's policies and procedures should require the *completion* of the engagement quality control *review before* the *report* is issued.

Engagement Documentation

- 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.
- The firm should establish policies and procedures designed to maintain the confidentiality, safe custody, integrity, accessibility and retrievability 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 7 years from the date of the auditor's report, or, if later, the date of the group auditor's report.
- Unless otherwise specified by law or regulation, engagement documentation is the property of the firm.
- The firm may, at its discretion, make portions of, or extracts from, engagement documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the firm or its personnel.

Monitoring

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.

The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

- Adherence to professional standards and regulatory and legal requirements;
- Whether the quality control system has been appropriately designed and effectively implemented;
- 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.

SA 220 - Quality Control For An Audit Of Financial Statements

Basics

This Standard on Auditing (SA) deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements.

It also addresses, where applicable, the responsibilities of the engagement quality control reviewer. This SA is to be read in conjunction with relevant ethical requirements

System of Quality Control and Role of Engagement Teams

- Quality control systems, policies and procedures are the responsibility of the audit firm.
- Under SQC 1, the firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance that
    - The firm and its personnel comply with professional standards and regulatory and legal requirements; and
    - The reports issued by the firm or engagement partners are appropriate in the circumstances

SA 220 is modelled on lines of SQC 1. It describes responsibilities of engagement partner in relation to following matters:

a. Leadership responsibilities for quality on audits
b. Relevant ethical requirements
c. Acceptance and continuance of client relationships and audit engagements
d. Assignment of engagement teams
e. Engagement performance
f. Monitoring

Leadership Responsibilities for Quality on Audits

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.

The actions of the engagement partner and his communication with the members of the engagement team should emphasis on

1. The importance of the following in audit quality
    a. Performing work that complies *regulatory* and *legal* requirements; with *professional standards* and
    b. Complying with the *firm's quality control policies* and *procedures* as applicable;
    c. Issuing auditor's *reports* that are *appropriate* in the *circumstances*; and
    d. The engagement team's ability to raise *concerns without fear* of reprisals; and
2. The fact that quality is *essential* in performing audit engagements

Relevant ethical requirements

The responsibilities of an engagement partner in relation to ethical requirements in an audit engagement are as under: -

- Identifying a *threat* to independence regarding the audit engagement that safeguards may not be able to eliminate or reduce to an acceptable level.
- *Reporting* by engagement partner to the relevant persons within the firm to determine appropriate action, which may include eliminating the activity or interest that creates the threat, or withdrawing from the audit engagement, where withdrawal is legally permitted.

Acceptance and Continuance of Client Relationships and Audit Engagements

SA 220 requires the *firm* to obtain *information before accepting* an engagement. Information such as the following *assists* the engagement *partner* in determining whether the *decisions* regarding the *acceptance* and continuance of audit engagements are appropriate

1. The *integrity* of the principal owners, key management and those charged with governance of the entity.
2. Whether the engagement team is *competent* to perform the audit engagement and has the necessary *capabilities*, including time and resources;
3. Whether the firm and the engagement team can *comply* with relevant *ethical requirements*; and
4. *Significant matters* that have arisen during the current or previous audit engagement, and their *implications* for continuing the relationship.

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*.

Assignment of Engagement Teams

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.

Engagement Performance

The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances.

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*. Matters addressed include the following

- 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*.

Engagement Quality Control Review

For audits of financial statements of *listed entities*, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall:

a. Determine that an engagement quality control reviewer has been *appointed*.
b. Discuss *significant matters* arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer.
c. *Not date* the auditor's report *until* the *completion* of the engagement quality control *review*.

Differences of Opinion

If differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the *firm's policies and procedures* for dealing with and resolving differences of opinion

Monitoring

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.

The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

- Adherence to *professional standards* and *regulatory* and *legal* requirements;
- Whether the quality control *system* has been appropriately *designed* and effectively *implemented*;
- 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.

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.

TDS Centralized Processing Cell | TRACES
TDS Reconciliation Analysis and Correction Enabling System

सत्यमेव जयते
Government of India
Income Tax Department

FORM NO. 16B

[See rule 31(1)(b)]

Certificate under Section 203 of the Income Tax Act, 1961 for Tax Deducted at Source

Certificate No.: HRHJCNA	Last Updated On: 18-Jan-2024
Name and Address of the Deductor (Transferee)	**Name and Address of the Deductee (Transferor)**
AAYUSH YOGESH DANI 301,TRAILOKYA PREMISES COOP S,16TH ROAD,KHAR WEST, MUMBAI - 400052 Maharashtra	ESTEEM CONSTRUCTIONS PRIVATE LTD 1,RAJKAMAL,OPP UNIVERSITY COMPUS,C S T ROAD KALINA, MUMBAI - 400098 Maharashtra

PAN of the Deductor (Transferee)	PAN of the Deductee (Transferor)	Assessment Year
HNQPD3593F	AAACE1497J	2024-25

Summary of Transaction(s)

Sr. No.	Unique Acknowledgement Number	Amount Paid / Credited (Rs.)	Date of Payment / Credit (dd-mmm-yyyy)
1	AK16894920-1	1655594.00	15-Jan-2024

I. DETAILS OF TAX DEDUCTED AND DEPOSITED WITH RESPECT TO THE DEDUCTEE
(Income Tax + Surcharge + Edu. Cess)

Sr. No.	Amount (Rs.)	Challan Identification Number (CIN)		
		BSR Code of the Bank Branch	Date on which Tax Deposited (dd-mmm-yyyy)	Challan Serial Number
1	16555.94	0510002	15-Jan-2024	08573

II. DETAILS OF TAX DEPOSITED IN THE CENTRAL GOVERNMENT ACCOUNT THROUGH CHALLAN
(Income Tax + Surcharge + Edu. Cess + Fee + Interest)

Sr. No.	Amount (Rs.)	Challan Identification Number (CIN)		
		BSR Code of the Bank Branch	Date on which Tax Deposited (dd-mmm-yyyy)	Challan Serial Number
1	16555.94	0510002	15-Jan-2024	08573

Verification

I, AAYUSH YOGESH DANI, son / daughter of YOGESH LAXMAN DANI in the capacity of Buyer of Immovable Property (Designation) do hereby certify that a sum of Rs. 16555.94 [Rs. Sixteen Thousand Five Hundred and Fifty Five Ninety Four paisa Only (in words)] has been deducted and deposited to the credit of the Central Government. I further certify that the information given above is true, complete and correct and is based on the books of account, documents, TDS statements, TDS deposited and other available records.

Place:	MUMBAI	Signature of Person Responsible for Deduction of Tax: Aayush Dani
Date:	19-Jan-2024	Full Name: AAYUSH YOGESH DANI