# CA INTERMEDIATE
# AUDITING AND ETHICS

Part 01

- ICAI Study Material Questions Covered
- RTP/MTP Questions Covered
- Previous Year Questions Covered

Ankit Mundra

# CA INTERMEDIATE

# AUDITING & ETHICS

**Ankit Mundra**

**EDITION: Third Edition**

**Published By: Physicswallah Private Limited**

# Physics Wallah Publication

**ISBN:** 978-93-6034-231-9

**Mobile App:** Physics Wallah (Available on Play Store)

**Website:** www.pw.live

**Youtube Channels:** CA Intermediate by PW (@CAintermediatebyPW)

CA Wallah by PW (@CAWallahbyPW)

Commerce Wallah by PW (@CommerceWallahPW)

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# PREFACE

A highly skilled professional team of CA Wallah works arduously to ensure that the students receive the best content for their CA-Intermediate exams.

A plethora of CA Study Material is available in the market but CA Wallah professionals at PW are continuously working to provide supreme quality study material for the CA-Intermediate students.

From the beginning, the content team comprising Subject Matter Experts, Content Creators, Reviewers, DTP operators, Proofreaders, and others is involved in shaping the material to their best knowledge and experience to produce powerful content for the students.

CA Wallah Faculties have adopted a novel style of presenting the content in easy-to-understand language and have provided the content team with expert guidance and supervision throughout the creation and curation of this book.

PW's CA Wallah strongly believes in conceptual and fun-based learning. CA Wallah provides highly exam-oriented content to bring quality and clarity to the students.

This book adopts a multi-faceted approach to mastering and understanding the concepts by having a rich diversity of questions asked in the CA-Intermediate examination and equipping the students with the knowledge for this highly competitive exam.

The main objective of this book is to provide an edge to your preparation with short & crisp yet high-quality content.

## BOOK FEATURES

This book, especially designed & amended for CA-Intermediate aspirants, contains:

- Syllabus coverage strictly as per ICAI Study Material
- All ICAI Study Material Questions
- Latest RTP & PYQ Questions
- Detailed Theory with Exam prototype and Concept Applications Questions
- Easy Clear Topic Wise Charts, Short Notes and Solve Miscellaneous Examples
- Topic wise, Learning Plus and Advanced Level Questions covered in the Book
- Elaborated Solutions

# ABOUT THE AUTHOR

Ankit Mundra, a faculty member at Physics Wallah, has a remarkable professional track record. With 12+ years of teaching experience, he excels as an educator and facilitates student learning and personal growth.

Beyond teaching, Ankit has ventured into diverse professional domains. As an entrepreneur, corporate lawyer, and GST practitioner, he brings a unique perspective to his work, contributing effectively in various areas.

Ankit Mundra's career highlights include forensic auditing for multinational corporations and esteemed positions as a professor. He has been recognized by prestigious institutions like ICAI and the Ministry of Corporate Affairs, where he has influenced policy development and implemented best practices.

As an educator, Ankit Sir is deeply committed to helping students learn. His innovative teaching methods, incorporating charts, stories, and real-life examples create an engaging learning environment, sparking enthusiasm and facilitating comprehension. His impact is far-reaching, having taught over 100,000 students offline and online. This achievement showcases his dedication to accessible education and his ability to inspire learners from diverse backgrounds. His unwavering commitment to teaching has transformed lives and elevated the overall learning experience.

Sir Ankit Mundra's journey is marked by remarkable achievements. His expertise in Auditing & Assurance, combined with his ventures as an entrepreneur, corporate lawyer, and GST practitioner, demonstrates his versatility. His innovative teaching methods and ability to inspire make him a respected educator. With his extensive reach, he empowers aspiring learners and contributes significantly to their education.

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## INTRODUCTION

**Business Environment→Complex**


→ Money Lender→Credit Worthiness


→ Share holders→Financial Position of Co.


→ Bank→Credit Worthy


→ Government → Taxes

Insurance Co.

→ InsuranceCo.→Settle Claims

RELIANCE ?
CONFIDENCE?

Financial Statements→True & Fair

## ORIGIN OF AUDITING

**Auditing→Ancient Times → Many Societies**

↓

**Kautilya's Arthshastra →4th Century BC**

↓

**Focus**
- **Fixed Accounting Year**
- **Procces of Closure of A/c.s**
- **Auditing**
- **Periodical Checking**
- **Verification**
- **Misstatement in F.S**
- **Abuse of Power**

Originof the word'Audit' → Latin→ Audire → To HEAR

I Auditor General of Indian → 1860

Accounting | Auditing

Presently → Constitutional Authority

↓

C & AG

ICAI → Statutory Body → Act of Parliament

What do such real-life situations highlight? Such instances underline importance of auditing in today's complex business environment. Be it investors desirous of investing their money in companies, shareholders anxious to know financial position of companies they have invested in, banks or financial institutions willing to lend funds to credit-worthy organizations, governments desirous of collecting taxes from trade and industry in accordance with applicable laws, trade unions negotiating with corporate managements for better wages or insurance companies wanting to settle property claims caused by fire or other disasters- range of diverse users in equally diverse fields rely upon audited financial statements.

Can you figure out reason behind such reliance? It is due to the fact that audited financial statements provide confidence to users of financial statements; audited financial statements provide assurance to users who may take their decisions on the basis of such audited financial statements.

Herein lies the importance of auditing. You can very well understand how significant is role of auditing profession and auditors in modern world involving multitude of economic activities being carried out in equally dynamic legal and regulatory environments.

Here, comes a vital question. What do we mean by auditing? What is its nature and scope? What it includes and What it does not? What are its limitations? We shall try to find out answers to these questions in succeeding paras.

Before we get to understand meaning and nature of auditing, let's travel back in time to know about origin of auditing. Auditing has existed even in ancient times in many societies of world including India. The reference to auditing is found in Kautilya's Arthshastra even in 4th century BC. It talks about fixed accounting year, a process for closure of accounts and audit for the same. Concepts of periodical checking and verification existed even in those times. Even there are references in his monumental work to misstatements in financial statements due to abuse of power. Wasn't he far ahead of his times? The word "audit" originates from Latin word "audire" meaning "to hear". In medieval times, auditors used to hear the accounts read out to them to check that employees were not careless and negligent. Industrial revolution in Europe led to astronomical expansion in volume of trade and consequently demand of auditors. Coming to more recent history, the first Auditor General of India was appointed in British India in 1860 having both accounting and auditing functions. Later on, office of Auditor General was given statutory recognition. Presently, Comptroller and Auditor General of India is an independent constitutional authority responsible for auditing government receipts and expenditures. The Institute of Chartered Accountants of India was established as a statutory body under an Act of Parliament in 1949 for regulating the profession of Chartered Accountancy in the country.

***Notes to Add***

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## MEANING AND NATURE OF AUDITING

**Audit → INDEPENDENT Examination → Financial Information**

**Any Entity → Profit Oriented → Or Not**

**Size** | **Legal Form**

**→ When such on Examination is conducted**

**With a view to express An Opinion there on**

**Auditor to Ensure**

**(1) F.S.**

- **→ Does not mislead**
- **→ As per → Books of A/c.**
- **→ Amount → Properly → Classified / Described / Disclosed — As per AS**
- **→ True + Fair**

(2) Entries

- → Supported by → Suff. + Appro. A.E.
- → Not omitted

(3) Information

- → Clear
- → Unambiguous

Auditing → Provides → Assurance → To user → F.S. — Credibility / Relied Upon

*Notes to Add*

"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". An incisive analysis of above meaning of auditing brings out following points clearly:

**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. The auditor should be independent of entity whose financial statements are subject to audit so that he can form an opinion without being affected by any influence.

Independence increases auditor's ability to act objectively without creeping in of any biases.

Consider, for example, a person who requests his brother, a Chartered Accountant, to audit accounts of his proprietary concern and issue a report.

Can CA audit accounts of concern in which his brother is sole proprietor? No, he cannot. It is due to the fact that there would be no independence in such a case due to relationship by birth between CA and his brother. He would be subject to influence from his brother.

Take another case where a CA has invested in shares of a company. Can he audit accounts of such a company in which he holds shares? The answer is resounding NO. It is due to the fact that by holding shares of the company, his own self-interest gets involved. His own money is invested in the company and he may not be able to form judgment independently on the financial statements of the company.

- The entity whose financial information is examined need not necessarily be profit oriented like in case of a business. It can be a non-profit organization like an NGO or a charitable trust. Audit can be undertaken in respect of any organization be it a small, medium or large. Further, it can be conducted for any entity irrespective of its legal structure i.e. such an entity may be a proprietary concern, a partnership firm, a LLP, a private company, a public company, a society or a trust.
- The purpose of audit is to express an opinion on the financial statements.

Understand that preparation and presentation of financial statements of an entity is responsibility of management of entity. The auditor expresses an opinion on financial statements by means of written audit report.

- In doing so, he has to see that financial statements would not mislead anybody by ensuring that:
  - The accounts have been drawn up with reference to entries in the books of account;
  - The entries in the books of account are adequately supported by sufficient and appropriate evidence;
  - None of the entries in the books of account has been omitted in the process of compilation;
  - The information conveyed by the statements is clear and unambiguous;
  - The financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; 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 financial statements. Such an assurance lends credibility to financial statements. Audited financial statements provide confidence to users that financial information reflected in financial statements can be relied upon.

## QUESTIONS

### Theory Questions

**1.** Explain clearly meaning of Auditing. How would you as an auditor perform the audit.

**Ans.** "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."

The person conducting this task should take care to ensure that financial statements would not mislead anybody. This he can do honestly by satisfying himself that:

(*i*) The accounts have been drawn up with reference to entries in the books of account;

(*ii*) The entries in the books of account are adequately supported by sufficient and appropriate evidence;

(*iii*) None of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements;

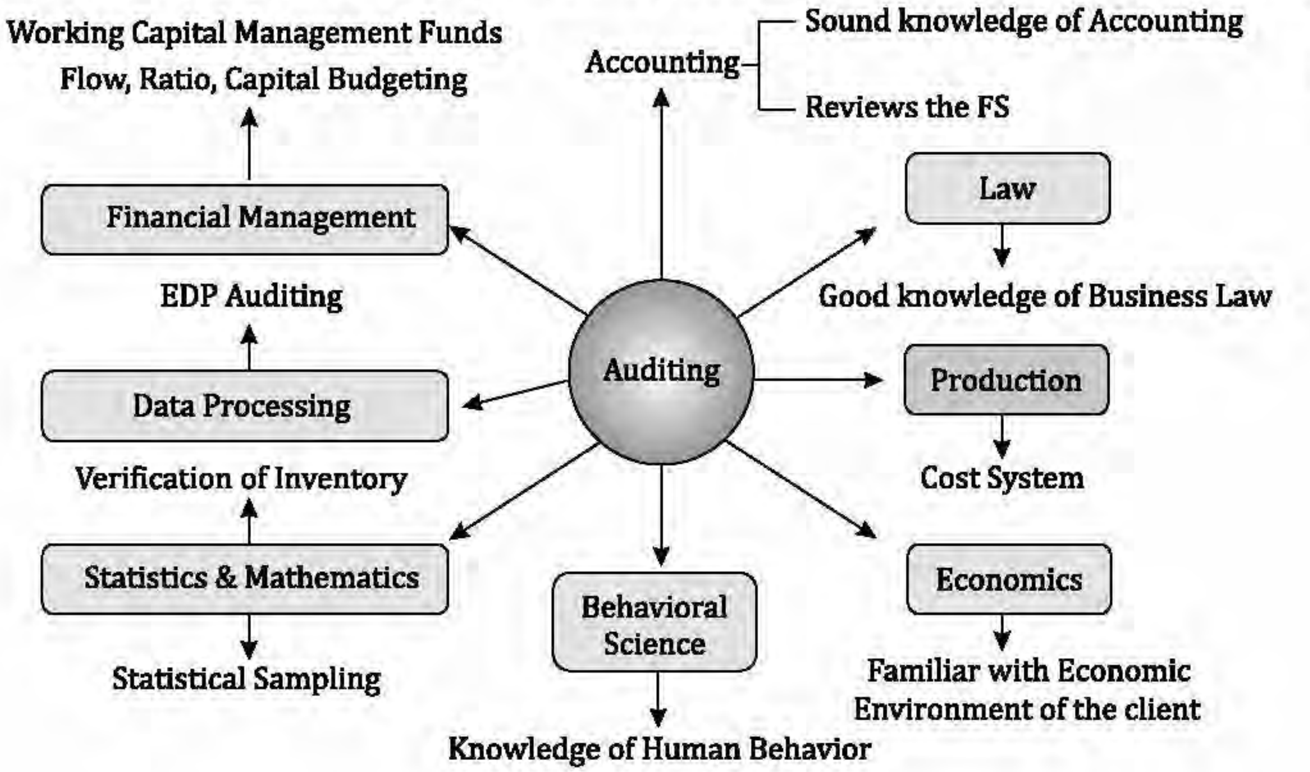
(*iv*) The information conveyed by the statements is clear and unambiguous;

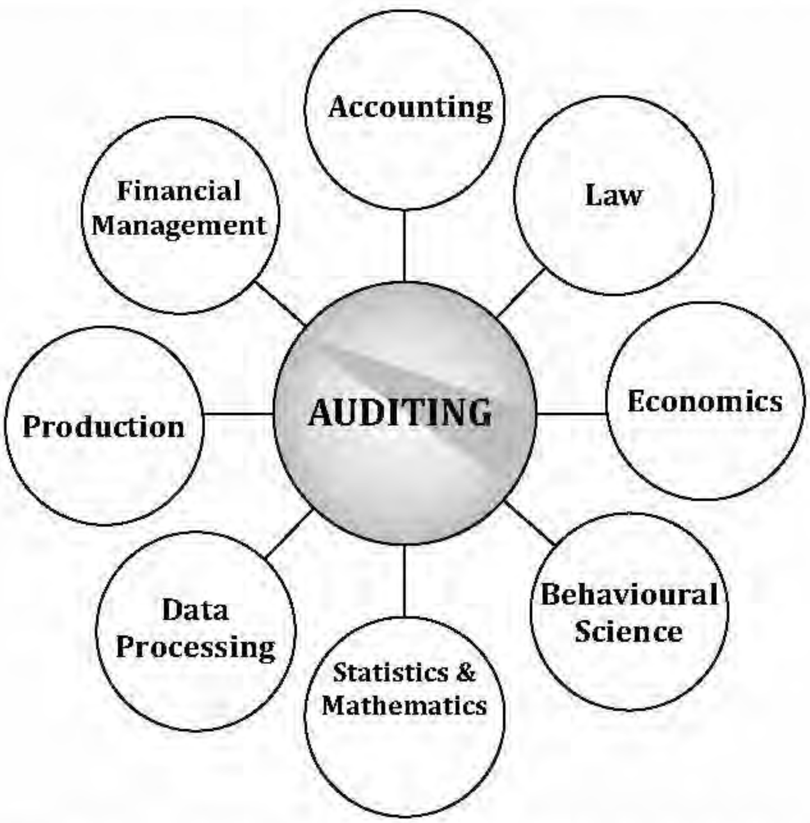
(*v*) The financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and

(*vi*) The statement of accounts present a true and fair picture of the operational results and of the assets and liabilities.

***Notes to Add***

## INTERDISCIPLINARY NATURE OF AUDITING-RELATIONSHIP WITH DIVERSE SUBJECTS



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

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

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

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

**Auditing and Law:** An auditor should have a good knowledge of business laws affecting the entity.

**Auditing and Economics:** Auditor is expected to be familiar with the overall economic environment of the client.

**Auditing and Behavioural Science:** Knowledge of human behaviour is essential for an auditor to effectively discharge his duties.

**Auditing and 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.

***Notes to Add***

## QUESTIONS

### Correct/Incorrect

**State with reasons (in short) whether the following statements are correct or incorrect:**

**2.** According to Mr. H, one of the team members of the auditor of Very Essential Limited was of the view that no relation exists between accounting and auditing from the point of view of a company.

**Ans. Incorrect:** The viewpoint of Mr. H is incorrect because there exists a proper relation between accounting and auditing from the point of view of a company. Audit is conducted for financial statements of a company and those financial statements are prepared with the help of books of accounts of that company. In order to properly conduct an audit of a company, an auditor is required to be aware of accounting principles and accounting policies of that company.

**3.** Mr. S, one of the new team members of the auditor of Extremely Effective Limited was of the view that for the purpose of conducting an audit, only knowledge of direct tax is required whereas no knowledge of indirect tax is required.

**Ans. Incorrect:** The viewpoint of Mr. S is incorrect because for the purpose of conducting an audit, proper knowledge of both direct tax as well as indirect tax is required.

### Theory Questions

**4.** "The independent audit of an entity's financial statements is a vital service to investors, trade payables, and other participants in economic exchange". Explain

**Ans.** Auditing along with other disciplines such as accounting and law, equips you with all the knowledge that is required to enter into auditing as a profession. No business or institution can effectively carry on its activities without the help of proper records and accounts, since transactions take place at different of time with numerous persons and entities. The effect of all transactions has to be recorded and suitably analysed to see the results as regards the business as a whole. Periodical statements of account are drawn up to measure the success of whole. Periodical statements of account are drawn up to measure the success or failure of the activities in achieving the objective of the organization. This would be impossible without a systematic record of transactions. Financial statements are often the basis for decision making by the management and for corrective action so as to even closing down the organization or a part of it. All this would be possible only if the statements are reliable; decisions based on wrong accounting statements may prove very harmful or even fatal to the business. For example, if the business has really earned a profit but because of wrong accounting, the annual accounts show a loss, the proprietor may take the decision to sell the business at a loss. Thus from the point of view of the management itself, authenticity of financial statements is essential. It is more essential for those who have invested their money in the business but cannot take part in its management, for example, shareholders in a company, such persons certainly need an assurance that the annual statements of accounts sent to them are fully reliable. It is auditing which ensures that the accounting statements are authentic. In today's economic environment, information and accountability have assumed a larger role than ever before. As a result, the independent audit of an entity's financial statements is a vital service to investors, trade payable, and other participants in economic exchange.

**5.** Mr. G, one of the team members of audit team of Different and Capable Limited was of the view that role of computers and data processing in auditing is increasing with each passing day. Explain how computers and data processing helps in conducting audit of a company.

**Ans.** The role of computers and data processing is important while conducting the audit of a particular company. Computers are able to save and process large volumes of data and at the same time provide that data whenever required. This way computers and data processing would be of huge help to the auditor in terms of saving time and efforts while conducting the audit of a company.

***Notes to Add***

## OBJECTIVES OF AUDIT

As per SA 200 → Overall OBJECTIVES of an Independent Auditor of the conduct of an Audit in accordance with SA

↓

Objective of Audit

↓

To obtain R.A. → That the F.S. as a whole
→ are Free from M.M.
→ Due to F/E

↓

Enabling the Auditor to Express an Option
→ F.S. are Prepared

↓

In accordance with App. F.R.F.

To Report on F.S
+
Communicate as required by SA

↓

In accordance with Auditor's Findings

Absolute Assurance = Guarantee

R.A. ≠ Not Guarantee

= High Level of Assurance

***Notes to Add***

In conducting audit of financial statements, 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 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

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

**An analysis of above brings out following points clearly:**

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

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

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

(*iii*) Obtaining reasonable assurance that financial statements as a whole are free from material misstatements enables 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.

(*iv*) The opinion is reported and communicated in accordance with audit findings through a written report as required by Standards on Auditing. (You would be studying about these in subsequent parts of this Chapter).

***Notes to Add***

## QUESTIONS

### Theory Questions

**State with reasons (in short) whether the following statements are correct or incorrect:**

**6.** The basic objective of audit does not change with reference to nature, size or form of an entity.

**Ans. (Correct)**

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. It is clear that the basic objective of auditing, i.e., expression of opinion on financial statements does not change with reference to nature, size or form of an entity.

**7.** The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements.

**Ans. (Correct)**

As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

**8.** State the objectives of Audit according to SA 200 (ICAI Study Material)

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

(*a*) To obtain reasonable assurance about whether the 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

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

**9.** CA N is the auditor of SR Ltd. The auditor expressed his opinion on the financial statements without ascertaining as to whether the financial statements as a whole were free from material misstatements or not. In your opinion, whether CA N has complied with objectives of audit considering the applicability of relevant SA? (May 2022)

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

(*i*) 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

(*ii*) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

In the given case of SR Ltd, CA N expressed his opinion on the financial statements of SR Ltd without obtaining reasonable assurance about whether the financial statements as a whole are free from material misstatement or not. Therefore, it can be concluded that CA N did not comply with the objective of audit as stated in SA 200.

*Notes to Add*

## SCOPE OF AUDIT-WHAT IS INCLUDED

- Scope = Range or Reach
- Purpose of Audit = Enhance the degree of Confidence of the intended user of FS.

Shareholders | Employees | Govt. | Regulatory Authorities | Bankers

- Scope of Audit

(1) Cover adequately all ASPECTS of an enterprise

(2) Financial Information — Reliable / Sufficient — Judgement

- Underlying A/C Records
- Other source of data

Judgement → Study + Assess (A/c. Sys., I.C.); Carryout (Test, Enquiries, Procedures)

(3) Information → Relevant ← Properly Disclosed

- Properly Summarized → Transactions, Events
- Consider ↓ Judgement Made by Mgt.
- Evaluate → Transactions, Applications — A/c. Policies

(4) Historical Financial Info.

- Financial Terms
- Relation to particular entity
- Derived from A/c. Sys.
- About Economic → Event, Conditions, Circumstonus → Past Pd.

*Notes to Add*

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

(Applicable financial reporting framework means a framework adopted in the preparation and presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.)

For example, in case of companies in India, financial reporting framework is provided under Schedule III of Companies Act, 2013.

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

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

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

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

(3) Proper disclosure of financial information

The auditor should also decide whether relevant information is properly disclosed in the financial statements. He should also keep in mind applicable statutory requirements in this regard.

It is done by ensuring that financial statements properly summarize transactions and events recorded therein and by considering the judgments made by management in preparation of financial statements.

The management responsible for preparation and presentation of financial statements makes many judgments in this process of preparing and presenting financial statements. For example, choosing of appropriate accounting policies in relation to various accounting issues like choosing method of charging depreciation on fixed assets or choosing appropriate method for valuation of inventories.

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

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

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

Since financial statements are prepared on the basis of historical financial information, it is logical that audit of financial statements is also based upon such historical financial information. Therefore, audit of financial statements is based upon historical financial information.

## SCOPE OF AUDIT-WHAT IS NOT INCLUDED

**Auditor is NOT EXPECTED to:**

(1) Perform duties

↓

which fall outside the domain of his competence

(2) Determine suitability + Life of civil structures (Bldg.)

(3) Authenticate Documentation → Not an Expert

(4) Audit Not official investigation → Alleged wrongdoing

(5) Auditor ≠ specific legal power

(6) Audit ≠ Investigation

Critical Examination of A/c.

With a special purpose

↓

Obtain R.A.

F.S. as a whole are free from MM Due to F/E

(7) Responsibility → Preparation FS

***Notes to Add***

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

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

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

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

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

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

***Notes to Add***

**Test Your Understanding**

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

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

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

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

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

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

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

***Notes to Add***

## INHERENT LIMITATIONS OF AUDIT

**Auditor**

➢ NOT EXPECTED to Reduce the Audit Risk to ZERO

➢ CANNOT obtain ABSOLUTE ASSURANCE

↓

That the FS. as a whole

↓

are FREE from MM

↓

Due to F/E

**Factor**

(1) Nature of Financial Reporting

Preparation of FS → Involves → Mgt. Judgement

(2) Nature of Audit Procedures

Practical + Legal Limitations

↓

Sampling Approach

Mgt. → Intentionally / Unintentionally → May not provide complete info

→ Fraud may involve → Sophesticated / Carefully Organised → Scheme

↓

Fabricated Documents

→ Related party transactions

(3) Not in Nature of Investigation

Not official Investigation

(4) Timeliness of Financial Reporting & Decrease in Relevance of Info. Over Time

Balance b/w. Reliability of Info ≅ cost of obtaining it

(5) Future Events

Entity' ability to continue as Going Concern

***Notes to Add***

The process of audit suffers from certain inbuilt limitations due to which an auditor cannot obtain an absolute assurance that financial statements are free from misstatement due to fraud or error. These fundamental limitations arise due to the following factors:

**(1) Nature of financial reporting**

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

One of the premises for conducting an audit is that management acknowledges its responsibility of preparation of financial statements in accordance with 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.

Consider, for example, that management of a company has devised a control that all purchase bills should reflect stamp and signatures of an authorised person in "Goods Receiving Section" of the company stating the date and time of receiving goods in premises. It is an example of internal control devised by the company to ensure that only those purchase bills are produced for payment for which goods have been actually received. Now, what happens if concerned accountant and authorised person in "Goods Receiving Section" collude. It is a case of overriding of internal controls devised by the company due to collusion between two persons. Such a probable collusion is one of limitations of internal controls itself.

**(2) Nature of Audit procedures**

The auditor carries out his work by obtaining audit evidence through performance of audit procedures. However, there are practical and legal limitations on ability of auditor to obtain audit evidence. For example, an auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence.

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 by auditor. In case he is not provided with required information, he can only report. It is an example of legal limitation on 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.

We have already discussed under section on scope of audit that 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 entity may have entered into some transactions with related parties. Such transactions may be only paper transactions and may not have actually occurred. The auditor may not be aware of such related party relationships or audit procedures may not be able to detect probable wrong doings in such transactions.

**(3) Not in nature of investigation**

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

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

The relevance of information decreases over time and auditor cannot verify each and every matter. Therefore, a balance has to be struck between reliability of information and cost of obtaining it Consider, for example, an auditor who is conducting audit of a company since last two years. During these two years, he has sought detailed information from management of company regarding various matters. During his third- year stint, he chooses to rely upon some information obtained as part of audit procedures of second year. However, it could be possible that something new has happened and that information is not relevant. So, the information being relied upon by auditor is not timely and may have lost its reliability.

**(5) Future events**

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

Therefore, it is in view of above factors, that an auditor cannot provide a guarantee that financial statements are free from material misstatements due to frauds or errors.

**Inherent Limitations of Audit** (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 because there are inherent limitations of an audit. The inherent limitations of an audit arise from:

**The Nature of Financial Reporting:** The preparation of financial statements involves judgment by management.

**The Nature of Audit Procedures:** There are practical and legal limitations on the auditor's ability to obtain audit evidence such as:

Possibility that management or others may not provide, intentionally or unintentionally, the complete information relevant for preparation and presentation of FS.

Fraud may involve sophisticated and carefully organised schemes.

**Not in the nature of Investigation:** An audit is not an official investigation into alleged wrongdoing.

**Timeliness of financial reporting and decrease in relevance of information over time:** Relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost.

**Future events:** Future events or conditions may affect an entity Adverse events may seriously affect ability of an entity to continue its Business.

***Notes to Add***

## QUESTIONS

### Multiple Choice Questions (MCQ)

**1.** Which of the following is not an advantage of audit?

(*a*) It provides high quality

(*b*) It acts as a moral check on employees

(*c*) It enhances risk of management bias

(*d*) It helps in safeguarding interests of shareholders

**Ans.** (*c*) It enhances risk of management bias

### Theory Questions

**10.** An audit does not provide absolute assurance. Discuss how nature of audit procedures itself is one of the reasons due to which audit cannot provide absolute assurance.

**Ans.** Nature of Audit procedures

The auditor carries out his work by obtaining audit evidence through performance of audit procedures. However, there are practical and legal limitations on ability of auditor to obtain audit evidence. For example, an auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence.

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 by auditor. In case he is not provided with required information, he can only report. It is an example of legal limitation on anditor's ability to obtain andit 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.

We have already discussed under section on scope of audit that 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 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.

**11.** MNO Ltd. requested the auditor CA P to provide for absolute assurance in respect of its ten branches scattered in Delhi and confirm that the financial statements are free from material misstatement due to fraud or error. Advise.

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

In view of the above, CA P cannot provide audit absolute assurance to MNO Ltd. in respect of its branches.

**12.** DEF & Co. Chartered Accountants successfully carried out the audit of Shree Garments for the f.y. 2019 - 2020. After the completion of the audit, there were found material misstatements due to fraud in the financial statements which were not noticed and reported by the auditor. Management alleges that it is failure on the part of auditor. Comment.

**Ans.** Because of the limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with SAs. Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit 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. Whether the auditor has performed an audit in accordance with SAs is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor's report based on an evaluation of that evidence in light of the overall objectives of the auditor.

**13.** In case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Explain such assertions or subject matters.

**Ans.** In the case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

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

**14.** An audit is distinct from investigation. However, it is quite possible that sometimes investigation results from the prima facie findings of the auditor. Discuss

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

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

Therefore, audit is never started with a pre-conceived notion about state of affairs; about wrong-doing; about some wrong having been committed. The auditor seeks to report what he finds in normal course of examination of accounts.

However, it is quite possible that sometimes investigation results from the prima facie findings of the auditor. It may happen that auditor has given some findings of serious concern. Such findings may prompt for calling an investigation.

***Notes to Add***

## WHAT IS AN ENGAGEMENT?

Arrangement to do something

→ Formal Agreement → b/w — Auditor / Client — Under Which

Auditor agrees to provide Auditing Service

Engagement Letter

## EXTERNAL AUDIT ENGAGEMENT / REASONABLE ASSURANCE ENGAGEMENT

Purpose → Enhance the degree of confidence
↓
of the intended user of F.S.

## BENEFITS OF AUDIT / WHY IS AUDIT NEEDED?

(1) Audited A/c. → provide → High Quality Info.
↓
Give confidence to user of FS

(2) Interest of shareholders → safeguarded

(3) Moral Check on employees

(4) Helpful for Govt. → determine Tax Liabilities

(5) Relied upon by Bankers / Lenders

(6) Detection of F/E

(7) Review — Existence / Operation — I.C.

***Notes to Add***

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

***Notes to Add***

## EXTERNAL AUDIT ENGAGEMENTS

The purpose of external audit engagements is to enhance the degree of confidence of intended users of financial statements. Such engagements are also reasonable assurance engagements. For example, in India, companies are required to get their annual accounts audited by an external auditor. Even non-corporate entities may choose to have their accounts audited by an external auditor because of benefits of such an audit.

**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 financial statements 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 financial statements are helpful to government authorities for determining tax liabilities.
- Audited financial statements can be relied upon by lenders, bankers for making their credit decisions i.e. whether to lend or not to lend to a particular entity.
- An audit may also detect fraud or error or both.
- An audit reviews existence and operations of various controls operating in any entity. Hence, it is useful at pointing out deficiencies.

***Notes to Add***

## AUDIT-MANDATORY OR VOLUNTARY?

Mandatory → Companies

→ Entities

↓

T/o > threshold limit as per Income Tax

→ Organization → Receiving Govt. Grants

## WHO APPOINTS AN AUDITOR?

| | | |
|---|---|---|
| Generally | → | Owners |
| Constitutional/Govt. Authorities | → | As per Law/Regulation |
| Companies (Non-Govt.) | → | Members (Shareholders) @ AGM |
| Companies (Govt.) | → | C & AG |
| Firms | → | Partners |

## TO WHOM REPORT IS SUBMITTED BY AN AUDITOR?

Report → Written

Submited → To the person → Making Appointment

***Notes to Add***

However, in case of government companies in India, auditor is appointed by Comptroller & Auditor General of India (CAG), an independent constitutional authority. Take case of a firm who engages an auditor to audit its accounts. In such a case, auditor is appointed by partners of firm.

There may be a situation in which auditor may be appointed by a government authority in accordance with some law or regulation. For example, an auditor may be appointed under tax laws by a government authority.

Generally, an auditor is appointed by owners or in some cases by constitutional or government authorities in accordance with applicable laws and regulations. For example, in case of companies, auditor is appointed by members (shareholders) in Annual General Meeting (AGM). Shareholders are owners of a company and auditor is appointed by them in AGM.

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

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

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

The outcome of an audit is written audit report in which auditor expresses an opinion. The report is In case of companies, these are shareholders- in case of a firm, to partners who have engaged him.

We shall now discuss understanding reached so far from a case study involving discussion among students regarding nature, scope, limitations, benefits of auditing and other related matters.

Rohit, Gurpreet, Ali and Goreti are friends since their school days based in Mumbai.

They have cleared CA foundation exams in the same attempt and now plan to appear for CA Intermediate exams. All of them are avid news listeners and regularly keep track of business news even on social media.

They are trying to understand new subjects including auditing. Rohit, Gurpreet and Ali have also started attending Live Coaching Classes (LCC) being conducted by Board of studies of ICAI. Goreti has not been able to join Live Coaching Classes yet as she was away on a holiday with her parents. However, she plans to catch it up with her friends very soon. Ali had also joined the classes but he had skipped some lectures.

During one informal get together, their discussions centred around new subject of auditing. They discussed many things regarding its nature, scope, benefits and other general practical issues. Goreti was regular in keeping track of audited results of companies being published in leading newspapers. Her view was that audited financial statements of companies give 100% guarantee to different stake holders. It is the main reason behind so much reliance upon auditing. But she could not understand why wrong doings in financial matters are being discovered after many years have gone by.

Ali also concurred with her view and added that when financial statements are audited, each and every transaction appearing in books of accounts is verified. However, he could not give clarity to Goreti.

Gurpreet was of the opinion that audit was conducted on the basis of sample checking. He was also of the view that audited financial statements are not a guarantee against probable wrong doings in financial matters of the companies. Not to be left behind, Rohit also jumped in the fray. He supported Gurpreet and also added something of his own.

## QUESTIONS

### Multiple Choice Questions (MCQ)

**2.** Gurpreet was of the view that audited financial statements are not a guarantee against probable wrong doings in financial matters of companies. What kind of assurance does audit of financial statements provide?

(*a*) It provides reasonable assurance meaning a moderate level of assurance.

(*b*) It provides reasonable assurance meaning a low level of assurance

(*c*) It provides reasonable assurance meaning a high level of assurance

(*d*) It provides reasonable assurance meaning an absolute level of assurance

**Ans.** (*c*) It provides reasonable assurance meaning a high level of assurance

**3.** Rohit added that auditor can force an employee of the company to provide him required information and documents. Can he do so?

(*a*) Yes, he can do so. It is necessary to obtain audit evidence

(*b*) Yes, he can do so. There are express rights given to him in this respect

(*c*) No, he cannot do so. He can only request for providing him with necessary information and documents. But it cannot be forced by him

(*d*) No, he cannot do so. He has no right of seeking information and documents. Therefore, question of forcing does not arise

**Ans.** (*c*) No, he cannot do so. He can only request for providing him with necessary information and documents. But it cannot be forced by him

**4.** Ali had listened in one of the classes that audit covers all aspects of an entity and concluded that each and every transaction of entity is verified by auditor. Goreti also seemed to be in agreement with him but she was of the view that besides this, it also meant that audit should be so organized to cover all areas of an entity. Which of following statements is appropriate in this regard?

(*a*) Only view of Ali is correct

(*b*) Only view of Goreti is correct

(*c*) Views of both Ali and Goreti are correct

(*d*) Views of both Ali and Goreti are incorrect

**Ans.** (*d*) Views of both Ali and Goreti are incorrect

**5.** All of them also discussed about benefits of auditing. Which of the following is not a likely benefit of auditing?

(*a*) Since auditing is connected to future events, audited information can be easily relied upon by users

(*b*) Errors or frauds may be discovered during audit

(*c*) Government authorities can make use of audited accounts for different purposes

(*d*) It can help in bringing out deficiencies in maintenance of financial records

**Ans.** (*a*) Since auditing is connected to future events, audited information can be easily relied upon by users

6. Goreti told her friends that she had read a news report about how a company had misled its auditors by producing some fabricated documents. Which of following statements seems to be appropriate in this regard?

   (*a*) It was wrong on the part of auditor to rely upon fabricated documents. He must have discovered it as the same falls within the scope of his duties.

   (*b*) Although it was wrong on the part of auditor to rely upon fabricated documents, he cannot do anything in the matter. He has to report on the basis of documents provided to him. He has no duty in this regard.

   (*c*) Auditor has to conduct audit by exercising professional skill. But he is not an expert in discovering genuineness of documents. Hence, management consisting of dishonest persons may have led him to rely upon fabricated documents deliberately.

   (*d*) Management cannot mislead auditor due to high level of knowledge and expertise possessed by him. The above is an outlier case-one of the rare odd cases.

**Ans.** (*c*) Auditor has to conduct audit by exercising professional skill. But he is not an expert in discovering genuineness of documents. Hence, management consisting of dishonest persons may have led him to rely upon fabricated documents deliberately.

**Test Your Understanding**

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

   However, later on, it was discovered that purchase manager responsible for procuring dresses from one location was also booking fake purchases of small values by colluding with unethical dealers. Payments to these dealers were also made in connivance with accountant through banking channel.

   The partners of firm blame auditors for futile audit exercise. Are partners of firm correct in their view point? Imagine any probable reason for such a situation. Audit is a type of assurance engagement under which auditor gives an opinion as to whether financial statements give a true and fair view of state of affairs of the concern. However, assurance engagements are not restricted to audit alone. We shall now discuss meaning of assurance engagement and different types of assurance engagements.

**Ans.** It is example of failure of internal controls of the firm. The internal control has not operated due to collusion between employees which is a limitation of internal control itself. The auditor has relied upon internal controls. It is very nature of financial reporting that management is responsible for devising suitable internal controls. This is an inherent limitation of audit.

## MEANING OF ASSURANCE ENGAGEMENT

- Practitioners expresses a conclusion → About the outcome of → Evaluation OR Measurement → Of a subject matters → Against Criteria

  ↓

  Designed to enhance the degree of confidence of the intended user (Other than the Responsible Party)

- Practitioner → Gives Opinion → About Specific info.

  ↓

  Due to which users make confident decisions

  ↓

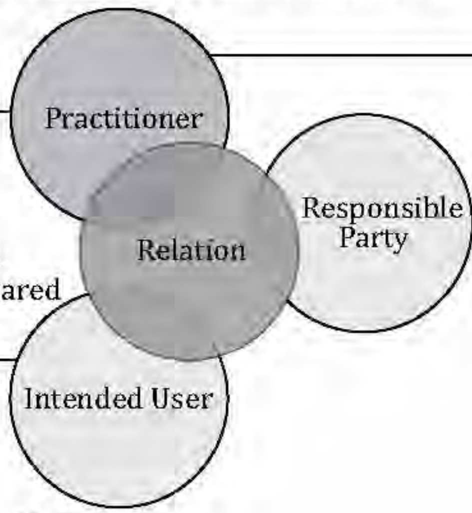
  Knowing well → Chance of Incorrect info.

  ↓

  DIMINISHED

## ELEMENTS OF AN ASSURANCE ENGAGEMENT

(1) Provides Assurance Broader than Auditor




Audit → Historical
Assurance → Historical or Present or Future

Person for whom an Assurance Report is prepared

Responsible for Preparation of Subject Matter

(2) Appropriate Subject Matter

Info. To be examined by the practitioner

(3) Suitable criteria → Benchmarks → Used to evaluate the subject matter

Standards | Guidance | Laws | Rules | Regulations

(4) Suff. + Appro. Evidence → Conclusion → Opinion

↓ Qty. ↓ Quality

(5) Written Assurance Report → in appropriate format

↓

Outcome of an Assurance Engagement

"Assurance engagement" means an engagement in which a practitioner expresses 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. It means that the practitioner gives an opinion about specific information due to which users of information are able to make confident decisions knowing wel lthat chance of information being incorrect is diminished.

***Notes to Add***

**Following elements comprise an assurance engagement:**

(1) A three party relationship involving a practitioner, a responsible party, and intended users An assurance engagement involves abovesaid three parties. A practitioner is a person who provides the 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.

(2) An appropriate subject matter It refers to the information to be examined by the practitioner. For example, financial information contained in financial statements while conducting audit of financial statements.

(3) Suitable criteria These refer to benchmarks used to evaluate the subject matter like standards, guidance, laws, rules and regulations.

(4) 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.

"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.

(5) A written assurance report in appropriate form

A written report is provided containing conclusion that conveys the assurance about the subject matter. A written assurance report is the outcome of an assurance engagement.

***Notes to Add***

## AUDIT VS. REVIEW

| Audit | vs. | Review |
|---|---|---|
| → R.A. Engagement | | → Limited Assurance Engagement |
| → Higher assurance | | → Lower level of assurance |
| → More Procedures | | → Fewer Procedures |
| → Scope of Conclusion is higher | | → Limited Conclusion |

→ Both are related to FS prepared on the basis of HISTORICAL FINANCIAL INFO.

***Notes to Add***

## R.A. ENGAGEMENT VS. L.A. ENGAGEMENT

| Basis | R.A.E | L.A.E. |
|---|---|---|
| Level | Higher | Lower |
| Audit Procedure | Elaborate & Extensive | Fewer Procedure as compared with RA |
| Conclusion | Reasonable | Limited |
| Example | Audit Engagement | Review Engagement |

***Notes to Add***

## QUESTIONS

### Multiple Choice Questions (MCQ)

**7.** Which of the following is NOT TRUE about an assurance engagement?

(*a*) It relates to providing assurance about historical financial information only
(*b*) The practitioner obtains sufficient appropriate evidence
(*c*) There is some information to be examined by practitioner
(*d*) A written assurance report in appropriate form is issued by practitioner

**Ans.** (*a*) It relates to providing assurance about historical financial information only

### Types of Assurance Engagements Reasonable assurance engagement vs. Limited assurance engagement

As already discussed, assurance engagements provide assurance to users. The difference is of degree. Reasonable assurance engagement like audit provides reasonable assurance which is a high level of assurance. Limited assurance engagement like review provides lower level of assurance than audit. It is only a moderate level of assurance.

| Reasonable assurance engagement | Limited assurance engagement |
|---|---|
| Reasonable assurance engagement provides high level of assurance. | Limited assurance engagement provides lower level of assurance than reasonable assurance engagement. |
| It performs elaborate and extensive procedures to obtain sufficient appropriate evidence. | It performs fewer procedures as compared to reasonable assurance engagement. |
| It draws reasonable conclusions on the basis of sufficient appropriate evidence. | It involves obtaining sufficient appropriate evidence to draw limited conclusions. |
| Example of reasonable assurance engagement is an audit engagement. | Example of limited assurance engagement is review engagement. |

***Notes to Add***

## QUESTIONS

### Correct/Incorrect

**State with reasons (in short) whether the following statements are correct or incorrect:**

**15.** A Chartered Accountant is specifically asked to check accounts whether fraud exists. State with reasons whether it is an example of reasonable assurance engagement.

**Ans.** It is not a reasonable assurance engagement. It is in nature of investigation.

### Correct/Incorrect

**16.** The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error.

**Ans. (Correct)**

As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, 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.

### Multiple Choice Questions (MCQ)

**8.** Consider following statements in relation to "Limited assurance engagement":-

Statement I - It involves obtaining sufficient appropriate evidence to draw reasonable conclusions.

Statement II - Review of interim financial information of a company is an example of limited assurance engagement.

(*a*) Statement I is correct. Statement II is incorrect
(*b*) Both Statements I and II are correct
(*c*) Both Statements I and II are incorrect
(*d*) Statement I is incorrect. Statement II is correct

**Ans.** (*d*) Statement I is incorrect. Statement II is correct

### *Notes to Add*

## AUDIT & REVIEW VS. PROSPECTIVE FINANCIAL INFO

Audit & Review → Historical Financial info.

Prospective Financial Info. → NOT Historical Financial Info.

- Generally on I.C. of an entity
- Based on Assumptions → About events
  ↓
  That may occur in the future
  \+
  Possible Actions by an Entity
- In the form of
  - Forecast
  - Projection
- Obtains Suff. + Appro. A.E. → about Mgt.'s Assumptions
  ↓
  NOT UNREASONABLE
- Financial Info. → Properly
  - Prepared
  - Presented
  - Disclosed
- Moderate level of Assurance
- Auditor → NOT in a position → to express an opinion
  ↓
  Results shown Will be achieved
- Report :- Nothing has come to practitioner's attention
  ↓
  To suggest that these assumptions
  Do not Provide a reasonable basis for the projection

**_Notes to Add_**

Besides reasonable assurance engagements and limited assurance engagements, there is another kind of assurance which is related to matters other than historical financial information. Such an assurance may relate to prospective financial information and not to historical financial information. It may relate to providing assurance on internal controls in an entity.

"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.

It is to be noted that in such type of assurance engagements, examination is not of historical financial information.

Here, it is important to note the difference between "Historical financial information" and "Prospective financial information." The former relates to information expressed in financial terms of an entity about economic events, conditions or circumstances occurring in past periods. The latter relates to financial information based on assumptions about occurrence of future events and possible actions by an entity.

Therefore, historical financial information is rooted in past events which have already occurred whereas prospective financial information is related to future events. 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.

Prospective financial information relates to future events. While 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.

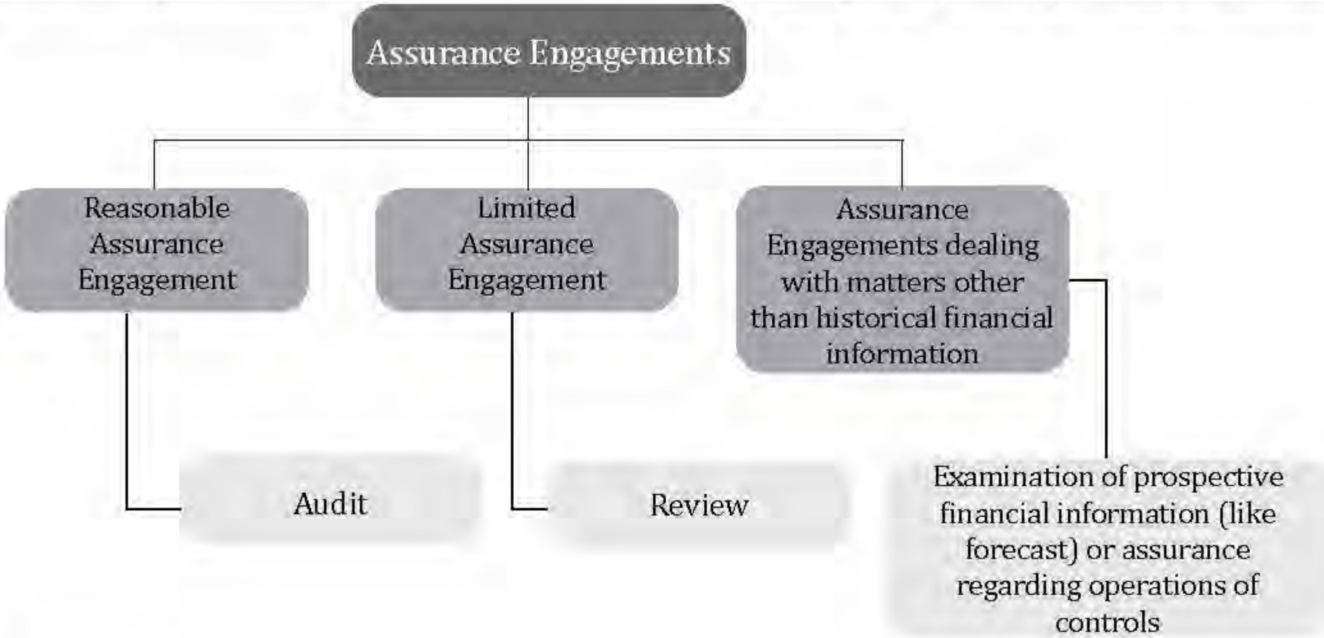
Therefore, in such assurance engagements, practitioner provides a report assuring that nothing has come to practitioner's attention to suggest that these assumptions do not provide a reasonable basis for the projection.

Hence, such type of assurance engagement provides only a "moderate" level of assurance.

***Notes to Add***

## ■ EXAMPLES OF ASSURANCE ENGAGEMENTS

| Checkbox | Example of engagement Assurance | Type of assurance engagement |
|---|---|---|
| ✓ | Audit of statements financial | Reasonable assurance engagement |
| ✓ | Review of statements Financial | Limited assurance engagement |
| ✓ | Examination of Prospective financial information | Provides |
| ✓ | Report on controls operating at an organization | Provides assurance regarding design and operation of controls |




***Notes to Add***

## QUESTIONS

### Theory Questions

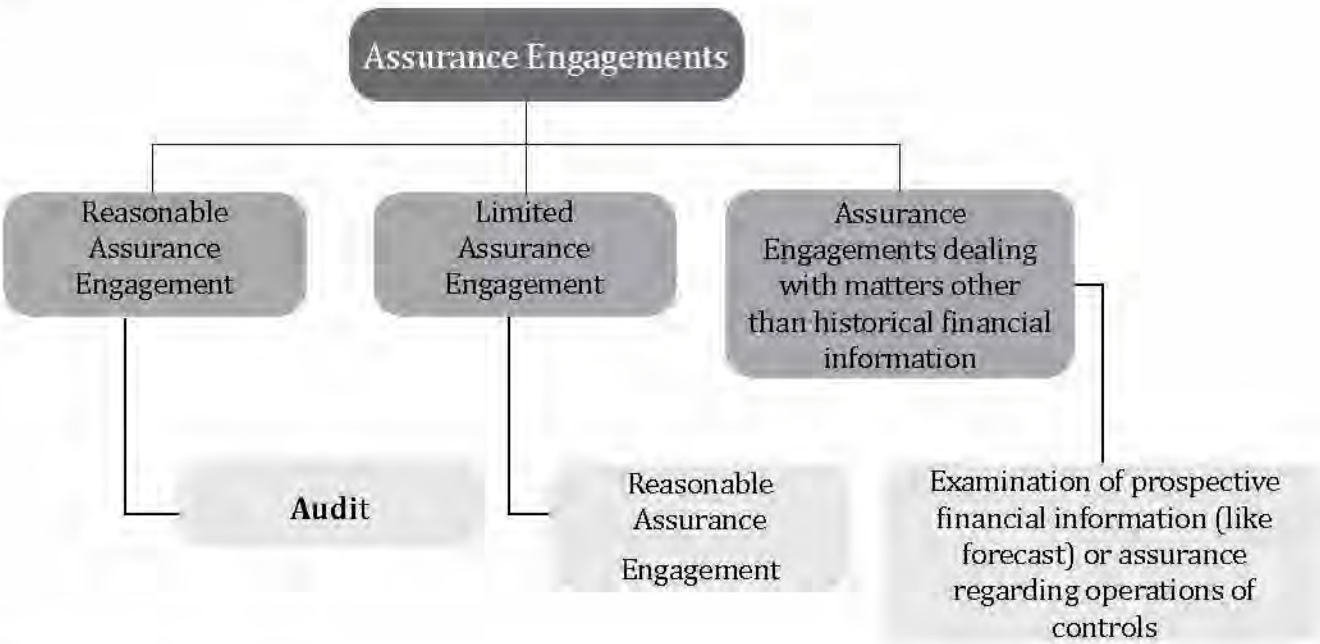
**17.** Assurance engagements are not restricted to audit of financial statements alone. Discuss.

**Ans.** Example of engagement Assurance

1. Audit of statements financial
2. Review of statements Financial
3. Examination of Prospective financial information
4. Report on controls operating at an organization

**18.** An assurance engagement involves a three party relationship. Discuss meaning of three parties in such an engagement.

**Ans.**




**Test Your Understanding**

**5.** The management of Exotic Tours and Travels Limited requests its auditor Raja & Co.to provide an assurance report on the financial information for first quarter of a year by skipping required detailed procedures.

Can Raja & Co. provide such a report? What would be nature of such a report? Would it be necessary for them to obtain sufficient appropriate evidence in such a case?

**Ans.** Such report would be in nature of "review". However, auditors would have to obtain sufficient appropriate evidence.

## QUALITIES OF AN AUDITOR

- Tact, Caution, Firmness, Good Temper, Integrity, Discretion, Industry Judgement, Patience, Clear Headedness & Reliability
- Qualities of Good Businessman = Qualities of on Auditor
- Shine of culture for attaining great height
- Highest Degree of Integrity + Independence
- Basic Human Qualities
- Exhaustive Knowledge of Accounting is sine qua non
- Thoroughly known → A/c. & Principles → Techniques

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

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

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

The auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education. He is called upon constantly to critically review financial statements and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert. An exhaustive knowledge of accounting in all its branches is the sine qua non of the practice of auditing. He must know thoroughly all accounting principles and techniques.

## QUESTIONS

### Theory Questions

**19.** Professional integrity and independence are considered essential characteristics of all the professions professions. There are two interlinked perspectives of independence independence of auditors, one, independence of mind and two, independence in appearance. Explain.

**Ans.** Professional integrity and independence are considered essential characteristics of all the professions but are more so in the case of accountancy profession. Indepence 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, one, independence of mind; and two, 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:

(*i*) **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

(*ii*) **Independence in appearance:** The avoidance of facts and circumstances that are so significant that a third party would reasonably conclude an auditor's integrity, objectivity or professional skepticism had been compromised." Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons.

**20.** The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats. Explain the guiding principles in the above context. (May 2023)

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

The following are the guiding principle in this regard:

1. 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 hte entities that they are auditing.
2. In the case of audit, the key fundamental principles are integrity, objective and professional skepticism, which necessarily require the auditor to be independent.
3. Before taking on an y work, an auditor must conscientiously consider whether it involves threats to his independence.
4. When such threats exists, the auditor should either desist from the task or pur in place safeguards that eliminate them.
5. If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

***Notes to Add***

## ENGAGEMENT AND QUALITY CONTROL STANDARDS

Engagement Standards → Issued under authority of → ICAI Council

- SQC → Quality control for all services → Only Firm
- SA → Audit of Historical Financial Info.
- SRE → Review of Historical Financial Info.
- SAE → Assurance Engagement → Other than Historical Financial Info.
- SRS → Procedures
  - Info.
  - Compilation
  - Related Services

***Notes to Add***

## WHY ARE STANDARDS NEEDED?

(1) Carrying Audit as per Global Practices & Benchmarks

(2) Improve → Quality of F.R

(3) Promote → Uniformity

(4) Equips → Professional — Knowledge / Skills

(5) Ensure → Audit Quality

***Notes to Add***

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 financial statement audits and in other types of assurance services.

***Notes to Add***

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## STANDARDS ON AUDITING

Standards on Auditing apply in the context of an audit of financial statements by an independent auditor. It is important to remember that Standards on Auditing apply in audit of historical information. These establish high quality benchmarks and are followed by auditors in conducting audit of financial statements.

Standards on Auditing have been issued on wide spectrum of issues in the field of auditing ranging from overall objectives of independent auditor, audit documentation, planning an audit of financial statements, identifying and assessing risk of material misstatement, audit sampling, audit evidence and forming an opinion and reporting on financial statements. These cover all significant aspects of audit of financial statements.

**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 Evidence46
- Revised SA 700 Forming an Opinion and Reporting on Financial Statements

## QUESTIONS

**Multiple Choice Questions (MCQ)**

**9.** Which of the following is TRUE about Standards on auditing?

(*a*) These deal mainly with voluntary responsibilities of auditors

(*b*) These deal mainly with mandatory responsibilities of auditors

(*c*) Their sole purpose is to help government authorities in augmenting revenues

(*d*) These deal mainly in carrying out audit according to legal provisions

**Ans.** (*b*) These deal mainly with mandatory responsibilities of auditors

## STANDARDS ON REVIEW ENGAGEMENTS

Standards on review engagements apply in the context of review of financial statements. We have already understood that 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 Financial Statements
- SRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity

## STANDARDS ON ASSURANCE ENGAGEMENTS

It is to be noted that both Standards on auditing and Standards on review engagements apply to engagements involving historical financial information.

There is another set of standards which apply in assurance engagements dealing with subject matters other than historical financial information. Such assurance engagements do not include "audit" or "review" of historical financial information. These standards are known as Standards on Assurance Engagements. For example, an assurance engagement relating to examination of prospective financial information.

It is to be noted that in such type of assurance engagements, examination is not of historical financial information or engagement may relate to providing assurance regarding non-financial matters like design and operation of internal control in an entity.

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

Lastly, there are standards on related services. These standards apply in engagements to perform agreed-upon procedures regarding financial information. For example, an engagement to perform agreed-upon procedures may require the auditor to perform certain procedures concerning individual items of financial data, say, accounts payable, accounts receivable, purchases from related parties and sales and profits of a segment of an entity, or a financial statement, say, a balance sheet or even a complete set of financial statements.

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. Such type of compilation engagements fall in the category of related services and practitioner issues a report clearly stating that it is not an assurance engagement and no opinion is being expressed.

These types of services are called related services and standards have been issued to deal with practitioner's responsibilities in this regard.

Examples of Standards on related services are:

- SRS 4400 Engagements to perform agreed-upon procedures regarding financial information
- SRS 4410 (Revised) Compilation engagements

It is to be clearly understood that all the above standards i.e., Standards on Auditing (SAs), Standards on Review Engagements (SREs), Standards on Assurance Engagements (SAEs) and Standards on related services (SRSs) are collectively known as the Engagement Standards.

Engagement Standards issued under the authority of Council of ICAI deal with responsibilities of auditor/practitioner.

## STANDARDS ON QUALITY CONTROL

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.

Its basic objective is that while rendering services, to which engagement standards apply, there should be a system of quality control with in firms to ensure complying with professional standards/legal requirements. System of quality control ensures issuing of appropriate reports in the circumstances. Further, it is also to be remembered that Standards on Quality Control (SQCs) are to be applied for all services covered by 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 financial statements is carried out following these Standards.
- Standards equip professional accountants with professional knowledge and skill.
- Standards ensure audit quality.

## 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. Also, reason for departure has also to be documented unless it is clear. Further, his report should draw attention to such departures. It is also to be noted that a mere disclosure in the report does not absolve a professional accountant from complying with applicable Standards.

## QUESTIONS

### Theory Questions

**21.** The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise the importance to audit qiality. Explain w.r.t. SA 220

**Ans.** As per SA 220 "Quality Control for an Audit of Financial Statement", 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 appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise:

(1) The importance to audit quality of:

(*i*) Performing work that complies with professional standards and regulatory and legal requirements;

(*ii*) Complying whith the firm's quality control policies and procedures as applicable;

(*iii*) Issuing auditor's reports that are appropriate in the circumstances; and

(*iv*) The engagement team's ability to raise concerns without fear of reprisals;

(2) The fact that quality is essential in performing audit engagements.

### Multiple Choice Questions (MCQ)

**10.** Which of the following is TRUE about Engagement Standards?

(*a*) Engagement standards ensure proper rights to practitioners in course of performance of their duties

(*b*) Engagement standards ensure preparation and presentation of financial statements in a standardized manner

(*c*) Engagement standards ensure uniformity by practitioners in course of performance of their duties

(*d*) Engagement standards ensure savings in resources of clients

**Ans.**(*c*) Engagement standards ensure uniformity by practitioners in course of performance of their duties

### Correct/Incorrect

**State with reasons (in short) whether the following statements are correct or incorrect:**

**22.** The term "Engagement Standards" refer to Standards on Auditing only. (Imp. ICAI Study Material)

**Ans. Incorrect:** Engagement Standards refer not only to Standards on auditing but also to Standards on review engagements, Standards on assurance engagements and Standards on related services.

**23.** Historical financial information relates to financial information based on assumptions about occurrence of future events and possible actions by an entity. (November 2022)

**Ans. Incorrect:** Historical financial information relates to information expressed in financial terms of an entity about economic events, conditions or circumstances occurring in past periods. Whereas financial information based on assumptions about occurrence of future events and possible actions by an entity relates 3to prospective financial information.

**Theory Questions**

24. "Choosing of appropriate accounting policies in relation to accounting issues is responsibility of management". Do you agree? Discuss duty of auditor, if any, in relation to accounting policies.

**Ans.** Choosing of appropriate accounting policies is responsibility of management. The role of auditor lies in evaluating selection and consistent application of accounting policies by management- Refer to scope of audit- what it includes.

**Test Your Understanding**

6. CA. P Babu is conducting audit of financial statements of Quick Buy Private Limited. He was not able to obtain external confirmations from certain debtors due to practical difficulties and peculiar circumstances. However, such a procedure is mandated under one of Standards on Auditing.

Unable to obtain external confirmations from these debtors, he relied upon sale details to these parties, e-invoices, e-way bills and also traced payments from these parties in bank accounts of the company. He was reasonably satisfied with audit evidence obtained. Is there any other reporting duty cast upon him relating to not following a mandated procedure in one of Standards on Auditing?

**Ans.** He is required to document how alternative procedures performed achieve the purpose of required procedure. Reason for departure has to be documented unless it is clear. His report should draw attention to such deDarture.

**CASE STUDY**

Me and You Private Limited has been newly incorporated. The plant of the company has recently started production with the help of funds provided by a bank for purchase and installation of machinery. Further, the company is also utilizing working capital credit facilities from the same bank for meeting its day to day working capital requirements like for purchase of raw materials, labour payment etc. However, just within six months of its operations, the management feels that working capital funds are inadequate and situation is creating liquidity issues in the company.

The management of the company has approached its bankers and requested for enhancement in working capital credit facilities. The bank manager is insisting upon financial statements of the company for half year along with report providing assurance in this respect duly signed by Chartered Accountant as audit is far away. It also requires projected financial statements for coming years along with a report from CA providing assurance regarding these projections to consider request of management.

The management approaches CA P, who has qualified recently and started practising. Reports providing assurance for half yearly results and projected financial statements are sought from CA P. The Management provides necessary information and records to him in this regard.

Assume, in above case, the company only provides trial balance, financial statements in draft/ preliminary form along with accompanying records for the relevant half year to CA P and requests him to provide duly signed financial statements with a report for mutually agreed professional fees.

## QUESTIONS

### Theory Questions

**Based on above, answer the following questions**

**25.** The management of company has engaged CA P to issue a duly signed report for half year. Which of the following standards, if any, issued by ICAI are relevant for CA P?

(*a*) Standards on Review Engagements

(*b*) Standards on Auditing

(*c*) Standards on Related Services

(*d*) There are no standards for issuing report in such situation

**Ans.** (*c*) Standards on Related Services

**26.** Which of the following statements is MOST APRROPRIATE in given case situation?

(*a*) CA P can assist management in preparation of financial statements of the company. However, issue of a report in such a case is outside the scope of work

(*b*) CA P can assist management in preparation of financial statements of the company and he can issue an audit report.

(*c*) CA P can assist management in preparation of financial statements of the company and he can issue a compilation report in this respect.

(*d*) The responsibility of preparation of financial statement is of company's management. CA P cannot assist management in preparation of financial statements of the company. However, he can issue a review report.

**Ans.** (*c*) CA P can assist management in preparation of financial statements of the company and he can issue a compilation report in this respect.

**27.** In the above said scenario for issuance of signed financial statements for half year by CA P, as discussed in last para of Case Study, identify the MOST APPROPRIATE statement: -

(*a*) Standard on Quality control (SQC 1) is not applicable as CA P cannot issue audit report.

(*b*) Standard on Quality Control (SQC 1) is not applicable as CA P cannot issue review report.

(*c*) Standard on Quality Control (SQC 1) is applicable in such type of engagement.

(*d*) Standard on Quality Control (SQC 1) is not applicable as CA P is barred from issuing any report in such type of engagement.

**Ans.** (*c*) Standard on Quality Control (SQC 1) is applicable in such type of engagement.

**28.** The banker of company has also requested for projected financial statements for coming years along with a report from CA regarding these projections to consider request of management. Which of the following standards issued by ICAI are relevant for CA P in such a situation, if any?

(*a*) Standards on Review Engagements

(*b*) There are no standards for issuing such type of reports.

(*c*) Standards on Related Services

(*d*) Standards on Assurance Engagements

**Ans.** (*d*) Standards on Assurance Engagements

**29.** Suppose CA P also accepts work of issuing projected financial statements with a report to be signed by him. The management has projected turnover of ₹100 core for the next year, 150 crore & 200 crore for following years respectively as compared to present turnover of 25 crore in current half year. Identify the MOST APPROPRIATE statement in this situation:

(*a*) CA P has to satisfy himself regarding arithmetical accuracy of projected data.

(*b*) CA P has to satisfy himself regarding reasonableness of assumptions underlying projected turnover and its consistency with actuals.

(*c*) CA P has to satisfy himself regarding arithmetical accuracy of data along with its proper presentation to banker.

(*d*) CA P has to satisfy himself regarding reasonableness of assumptions underlying projected turnover, its consistency with actuals, disclosure and presentation.

❑❑❑

# 2 CHAPTER

# Audit Strategy, Audit Planning and Audit Programme

| S. No. | Sub Topics | Easy | Moderate | Hard |
|---|---|---|---|---|
| 1. | Auditor's responsibility to plan an audit of financial statements | | | |
| 2. | Why Planning an audit is necessary? - Its Benefits | | | |
| 3. | Nature of Audit Planning- A Continuous and iterative process | | | |
| 4. | Planning Process- Elements of Planning | | | |
| 5. | Relationship Between Overall Audit Strategy and Audit Plan | | | |
| 6. | Overall audit strategy and the audit plan- The auditor's responsibility | | | |
| 7. | Changes to Planning decisions during the course of audit | | | |
| 8. | Planning supervision and review of work of engagement team members | | | |
| 9. | Documentation | | | |
| 10. | Audit Programme | | | |
| 11. | Evolving one audit programmes | | | |
| 12. | The Assistant to keep an open mind | | | |
| 13. | Periodic review of the audit programme | | | |
| 14. | Constructing an audit programme | | | |
| 15. | Audit Programme- Designed to provide audit evidence | | | |
| 16. | Advantages and disadvantages of an audit programme | | | |

***Notes to Add***

### *Notes to Add*

## AUDITOR'S RESPONSIBILITY TO PLAN AN AUDIT OF FINANCIAL STATEMENTS

SA 300 "Planning an Audit of FS"

Objective of the Auditor to plan an Audit

↓

So that it can be performed Effectively

↓

Timely Manner

***Notes to Add***

## BENEFITS

(1) Auditor Devotes→Appropriate Attention→Imp. Areas

(2) Auditor — Identify / Resolve — Potential problems→Timely Basis

(3) Auditor — Organise / Manage — Audit Engagement — **Effective** / Efficient

(4) **Assisting in Selecting→Engagement** Team **Members**

(5) Facilating — Direction / Supervision / Review

(6) Assisting →Coordination of work (Eg. Experts)

Planning ensures —
- Audit Risk is REDUCED ↓ To an Acceptable Level
- Reduces the Risk of INAPPROPRIATE OPINION

***Notes to Add***

SA 300 Planning an audit of financial statements deals with the auditor's responsibility to plan an audit of financial statements. It states that objective of the auditor is to plan the audit so that it will be performed in an effective manner.

## QUESTIONS

**Multiple Choice Questions (MCQ)**

**1.** Which of the following is not considered in planning an audit generally?

(*a*) Understanding of legal and regulatory framework of an entity

(*b*) Need to consider determination of materiality

(*c*) Evaluating audit evidence

(*d*) Need to consider involvement of expert

**Ans.** (*c*) Evaluating audit evidence

## WHY PLANNING AN AUDIT IS NECESSARY? ITS BENEFITS

Planning an audit is necessary to carry out it effectively in a timely manner. Besides ensuring compliance with professional standards, it helps in performing audit engagement effectively.

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.

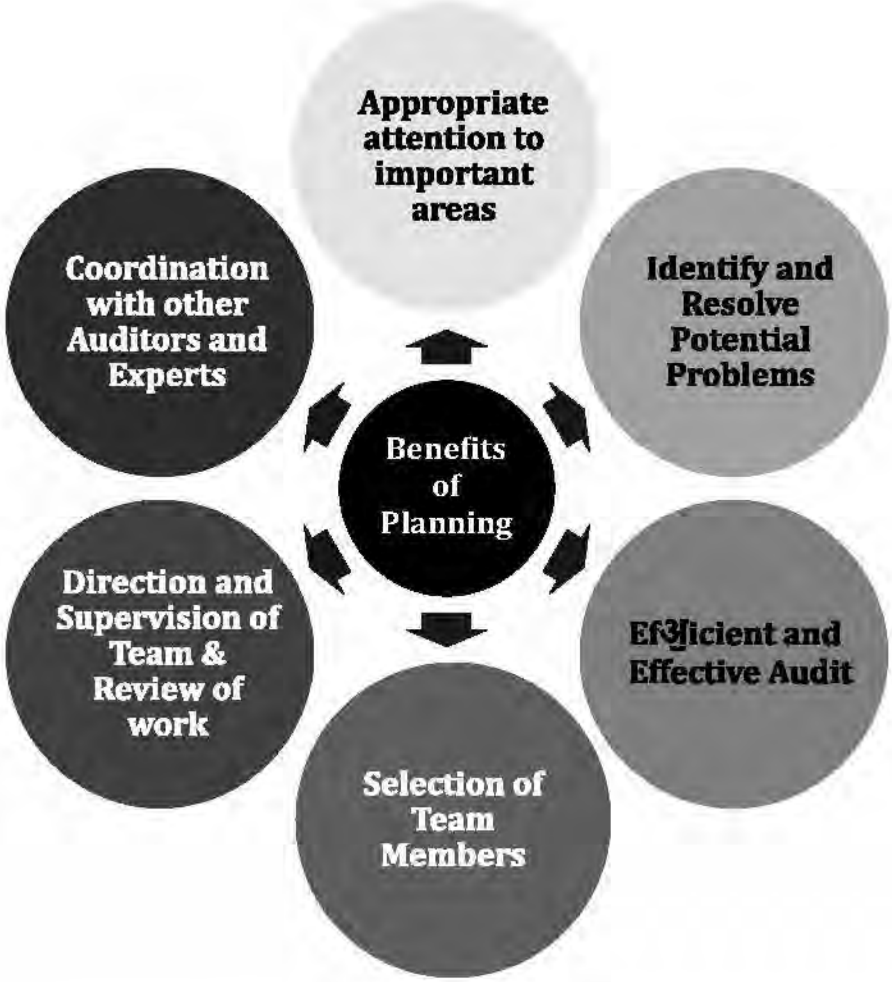
(4) Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.

(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 others such as experts.

Therefore, planning an audit ensures that audit risk is reduced to an acceptable low level. When audit work is adequately and properly planned, it reduces the risk of inappropriate opinion by the auditor.

***Notes to Add***


Appropriate attention to important areas
Identify and Resolve Potential Problems
Efficient and Effective Audit
Selection of Team Members
Direction and Supervision of Team & Review of work
Coordination with other Auditors and Experts
Benefits of Planning

***Notes to Add***

## QUESTIONS

### Correct/Incorrect

**State with reasons (in short) whether the following statements are correct or incorrect:**

1. Once the audit plan has been drafted and communicated, it is obligatory on the auditor to follow the same.

**Ans. Incorrect:** 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 overall audit strategy and audit plan and thereby the resulting 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.

***Notes to Add***

## NATURE OF AUDIT PLANNING

- **Continuous**
- Iterative

**NOT A DISCRETE PHASE**

**Begins** — [**Shortly after** / **In connection with**] — **PREVIOUS AUDIT**

→Continues →Until Completion → Current Audit

→EXTRA GYAAN →Audit Procedures
+
Stages of Audit

Risk Assessment Procedures (R.A.P)
↓
SA 315
"Identification & Assessment of RoMM through understanding the Entity & its Environment"

Further Audit Procedures (F.A.P)
↓
SA 330
"Auditor's Response to Assessed Risk"

Things to be done before R.A.P. → Consider

(1) Analytical Procedures → to be applied as → RAP
(2) General Understanding / Entity Complying — LEGAL + REGULATORY Framework
(3) Determination of Materiality
(4) Involvement of Experts → Taking A/c. of Complexity of Business
(5) Performance of other RAP

Planning Involves — [Engagement Partner / Other key Members] —
- Experience
- Insight
- Enhance Eff. & EFF.

DISCUSSION OF ELEMENTS OF PLANNING → with Mgt.
↓
Auditor May Discuss→To — [Facilitate / Conduct] — of Audit Engagement
↓
NOT TO COMPROMISE THE EFFECTIVENESS OF AUDIT

***Notes to Add***

## NATURE OF AUDIT PLANNING-A CONTINUOUS 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.

Risk assessment procedures are audit procedures 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, whether due to fraud or error at the financial statement and assertion levels.

Therefore, planning includes consideration of matters such as obtaining knowledge about legal framework in which entity is operating. Consider for example- Telecom companies and Banks. Such entities operate in different legal and regulatory frameworks. TRAI (Telecom Regulatory Authority of India) and RBI (Reserve Bank of India) are regulators for telecom and banking industry respectively.

Planning also includes need to consider determination of material or significant matters. It also involves considering whether experts need to be involved taking into account complexity of business. Further, it also involves considering need to perform risk assessment procedures for identifying and assessing risks of material misstatement.

Planning is not a separate or distinct phase of an audit. It is to be viewed as a continual and repetitive process. It is a continuous process that begins with completion of previous audit and continues till the completion of current audit engagement.

## INVOLVEMENT OF KEY ENGAGEMENT TEAM MEMBERS IN PLANNING AUDIT

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.

## PLANNING PROCESS ELEMENTS OF PLANNING

- **Preliminary Engagement Activities**
  - Procedure regarding continuance of Relationship ↓ 3rd Element of Sys. Of Q.C. + Communication with predecessor Auditor
  - Compliance with Ethical Requirements + Independence
    - (1) Consider→ Threat to Independence
    - (2) Evaluate→ Identified Breaches
    - (3) Take→Appropriate Action OR Withdraw
  - Understanding Terms of Engagement ↓ Send Audit Engagement Letter
- **Planning Activities**
  - Establishing O.A.S ↓ Sets
    - S T D (of Audit) + Guides Development of Audit Plan
  - Developing Audit Plan

OAS→Assist Auditor →To Determine→AFTER R.A.P

- Resources to DEPLOY (TYPE)
- Amount of Resources (QTY.)
- When to Deploy (TIME)
- How to DEPLOY (HOW)
  - D S R

* Factors to be considered →for establishing Audit Strategy

(1) Identify→Characteristic→of Engagement

- App. F.R.F.
- Nature of Business
- Reporting Requirement
- A.E. of L.Y.

(2) Ascertain in → Reporting Objectives→To Plan — Nature (N) / Timing (T)

- Entity's Timetable for Reporting
- Meetings to Discuss
  - N E T (of work)
- Mgt's Expectation
  - Type Timing (of Report)
  - Communication of Status of Audit
- Expected
  - N T (of communication among Audit team member)

3. Consider →Significant Factors→ in directing → Team's Efforts

- Volume of Transactions
- Industry Judgements
- Δ in FRF
- Δ in Environment

4. Consider→Result — Preliminary Engagement Activities / Relevant Knowledge of Engagement Partner

5. Ascertain→N.E.T. →of Resources Necessary

**The elements of planning can be categorized as under:**

(i) Preliminary engagement activities

(ii) Planning activities

**(1) Preliminary engagement activities**

The auditor considers whether relationship with client should be continued and whether ethical requirements including independence continue to be complied with. It includes:

(A) Performing procedures regarding the continuance of the client relationship

(B) Evaluating compliance with ethical requirements, including independence

(C) Establishing an understanding of terms of engagement

**Preliminary engagement activities include the following:**

(A) **Performing procedures regarding the Continuance of Client Relationships and Audit Engagements:** Acceptance and Continuance of Client Relationships and Audit Engagements It should be ensured that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed and that conclusions reached in this regard are appropriate.

The firm should obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.

Matters such as integrity of principal owners and key management, competence of engagement team to perform the audit engagement and implications of matters that have arisen during current and previous audit engagement may need to be considered. Besides, in case of initial engagements, communication with predecessor auditor should be made, where there has been a change of auditors.

(B) **Evaluating compliance with ethical requirements including independence:** The auditor shall continuously evaluate compliance with ethical requirements including independence. "Independence" means that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him.

Throughout the audit engagement, the engagement partner shall remain alert, through observation and making inquiries as necessary, for evidence of non- compliance with relevant ethical requirements by members of the engagement team. If matters come to the engagement partner's attention that indicate that members of the engagement team have not complied with relevant ethical requirements, the engagement partner, in consultation with others in the firm, shall determine the appropriate action.

The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall:

(*i*) Obtain relevant information from the firm to identify and evaluate circumstances and relationships that create threats to independence Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement and take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.

Besides, consideration for client continuance and compliance with ethical requirements, preliminary engagements activities also include establishing an understanding of terms of engagement.

(C) **Establishing an understanding of terms of engagement:** It is in the interests of both the entity and the auditor that the auditor sends an audit engagement letter before the commencement of the audit to help avoid misunderstandings with respect to the audit. It ensures that there is no confusion with the client regarding terms of the engagement.

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

**Planning activities**

**Planning activities involve:** Establishing the overall audit strategy Developing an audit plan

(A) Establishing the overall audit strategy- Assistance for the auditor Overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan.

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

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:

(*i*) 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

(*ii*) 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

(*iii*) When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates

(*iv*) 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

Factors to be taken into consideration by auditor for establishing audit strategy The auditor shall take following factors into consideration while establishing audit strategy:

(a) 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

(b) 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 nature of communications. Some of the instances are given under: -

- The entity's timetable for reporting
- Organization of meetings to discuss of nature, timing and extent of audit work with management
- Discussion with management regarding the expected type and
- timing of reports to be issued including the auditor's report
- Discussion with management regarding the expected communications on the status of audit work throughout the engagement.
- Expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.

(c) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts

The auditor needs to direct efforts of engagement team towards matters that in his professional judgment are significant. Preliminary identification of material classes of transactions, account balances and disclosures help auditor in establishing overall audit strategy. More energies need to be devoted to significant matters to obtain desired outcomes. Few examples are listed as under:

- Volume of transactions which may determine whether it is more efficient for the auditor to rely on internal control
- Significant industry developments such as changes in industry regulations and new reporting requirements.
- Significant changes in the financial reporting framework, such as changes in accounting standards.
- Other significant relevant developments, such as changes in the legal environment affecting the entity.

(d) 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.

(e) Ascertain the nature, timing and extent of resources necessary to perform the engagement.

Selection of engagement team and assignment of audit work to team members is a significant factor in establishing overall audit strategy. Experienced team members may be assigned in areas where there is higher risk of material misstatement. Similarly, engagement budgeting and devotion of more time to areas of higher risk of material misstatement are to be kept in mind.

**In establishing the overall audit strategy, the auditor shall:**

Identify the scope of the engagement → Ascertain the reporting objectives of the engagement → Consideration of signifficant factors in directing the engagement team's efforts → Consider the results of preliminary engagement activities → Ascertain the nature, timing and extent of resources required for the engagement .

***Notes to Add***

## QUESTIONS

**Correct/Incorrect**

**State with reasons (in short) whether the given statements are correct/incorrect:**

**2.** Establishing an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan is prerogative of the management.

**Ans. (Incorrect)**

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

**3.** Planning is a discrete phase of an audit.

**Ans. (Incorrect)**

Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begin 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.

**Theory Questions**

**4.** 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. Explain clearly those ways.

**Ans.** 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:

Helping the auditor to devote appropriate attention to important areas of the audit. Helping the auditor identify and resolve potential problems on a timely basis.

Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.

Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.

Facilitating the direction and supervision of engagement team members and the review of their work. Assisting, where applicable, in coordination of work done by auditors of components and experts.

**Illustration 1:** The auditor T of Hand Fab Ltd is worried as to management of key resources to be employed to conduct audit.

**Required**

How the audit strategy would be helpful to the auditor?

**Solution:** Refer-Establishing the overall audit strategy- Assistance for the auditor for solution.

Development of Audit plan

Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources.

Understanding client's business is one of the important principles in developing an audit plan. In fact, without adequate knowledge of client's business, a proper audit is not possible. Gaining knowledge of client's business is, therefore, one of the foremost requirements to develop audit plan.

SA-300 states that auditor shall develop an audit plan that shall include description of-

(i) The nature, timing and extent of planned risk assessment procedures

(ii) The nature, timing and extent of planned further audit procedures at assertion level

(iii) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

The auditor plans what type of audit procedures are to be performed, their timing and how much work should be done taking into account sample size etc.

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.

For example, 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. In addition, the auditor may begin the execution of further audit procedures for some classes of transactions, account balances and disclosures before planning all remaining further audit procedures.


**Test Your Understanding**

**1.** MG & Co, a firm of auditors, having a standing of 30 years is appointed as a statutory auditor of company engaged in manufacturing of defence equipment. Due to opening of defence sector by government to private players in recent times, many new companies have entered the fray to manufacture sophisticated defence equipment. Considering technical and complex nature of operations, the auditors recognize that involvement of experts in the audit is required. Does consideration for involvement of experts by auditors fall in the domain of planning audit?

**Ans.** Consideration for involvement of experts by auditors falls within domain of planning. While planning an audit, auditor would have to consider whether involvement of experts is necessary. In the stated case, company is involved in technical and complex operations. Therefore, while planning an audit, auditors would have to consider whether involvement of expert is necessary..

**Multiple Choice Questions (MCQ)**

2. Which of the following is true about audit plan?

Once an audit plan has been finalized for an engagement,

(*a*) changes cannot be made to it Audit plan includes scope, timing and direction of planned

(*b*) assessment procedures

(*c*) Changes in audit plan cannot lead to change in audit strategy

(*d*) Audit plan has to be documented by auditor

**Ans.** (*d*) Audit plan has to be documented by auditor

3. Which of the following is most important principle for formulating an audit plan?

(*a*) Gaining knowledge of client's workforce

(*b*) Gaining knowledge of client's business

(*c*) Gaining knowledge of client's vendors

(*d*) Gaining knowledge of tax laws applicable to client

**Ans.** (*b*) Gaining knowledge of client's business

**Theory Questions**

5. Discuss how performing preliminary engagement activities as part of planning an audit assists auditor.

**Ans.** Performing preliminary engagement activities assists the auditor in identifying and evaluating events or circumstances that may affect auditor's ability to plan and perform audit engagement.

6. Discuss how an engagement partner ensures that firm complies with relevant ethical requirements including independence in relation to client.

**Ans.** Refer to point on evaluating compliance with ethical requirements including independence.

***Notes to Add***

## RELATION BETWEEN AUDIT STRATEGY & AUDIT PLAN

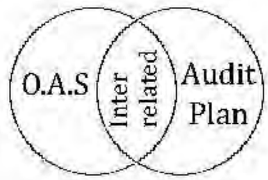
| Audit Strategy | Audit Plan |
|---|---|
| Sets Broad Overall Approach | ❑ Addresses Various Matters Identified in OAS |
| Determines S<br>T<br>D of Audit | ❑ Describes How Strategy is going to be implemented |
| Less Detailed than Audit plan | ❑ More Detailed than OAS<br>❑ Includes N.E.T of Audit Procedures |
| OAS is established First | ❑ Audit plan can be developed After OAS |

* Establishment of

OAS Audit Plan

Discrete Sequential

Not Necessarily ⟷




***Notes to Add***

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.

Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources.

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.

## QUESTIONS

### Correct/Incorrect

**State with reasons (in short) whether the following statements are correct or incorrect:**

**7.** 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.

**Ans. (Correct)**

Once the overall audit strategy has been established, an audit plan can be developed to achieve the audit objectives through the efficient use of the auditor's resources. 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.

**8.** The audit plan is more detailed than the overall audit strategy.

**Ans. (Correct)**

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.

### Theory Questions

**9.** "Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy". Explain.

**Ans.** Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources. 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.

## OVERALL AUDIT STRATEGY AND THE AUDIT PLAN-THE AUDITOR'S RESPONSIBILITY

Responsibility → Remains with Auditor

↓

May Discuss

↓

Elements of Planning

↓

Without Compromising Effectiveness of Audit

***Notes to Add***

## CHANGES TO PLANNING DECISION DURING THE COURSE OF AUDIT

- **Auditor — Update / Δ — OAS / Audit Plan + Planned — N / E / T — Of FAP**
  - **Δ: Unexpected Events | Δ in Conditions | A.E. Obtained**
- **This happens when → INFO — at the time of Planning / DIFFERS / In Auditor's attention**

## PLANNING SUPERVISION AND REVIEW OF WORK OF ENGAGEMENT TEAM MEMBERS

- Auditor shall Plan — N / E / T — of — D / S / R

  ↓

  Factors

  (1) Size, Complexity — of Entity

  (2) Area of Audit

  (3) Assessed RoMM

  (4) Capabilities, Competence — of the Engagement Team Members

***Notes to Add***

The overall audit strategy and the audit plan remain the auditor's responsibility. It is the auditor who is responsible for establishing overall audit strategy and developing audit plan. However, as discussed earlier, auditor may discuss elements of planning with entity's management without compromising effectiveness of audit.

**Illustration 2:** W, the auditor of SKM Ltd. asks its finance and audit head to prepare audit strategy for conducting audit of SKM Ltd. W also insists him to draw detailed audit procedures. On the request of auditor W completes audit strategy as well as audit procedures as prepared by finance head of the company. Subsequently, auditor realizes that effectiveness of the audit is compromised and it was his responsibility to prepare the overall audit strategy. Comment.

**Solution:** Refer - Overall audit strategy and the audit plan- The auditor's responsibility - Accordingly, approach of W was wrong and he should have prepared overall audit strategy and detailed audit procedures.

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 overall audit strategy and audit plan and thereby the resulting 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 on detailed checking may contradict the audit evidence obtained through testing internal controls.

The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including:

(1) The size and complexity of the entity.

(2) The area of the audit.

(3) The assessed risks of material misstatement

(4) The capabilities and competence of the individual team members performing the audit work.

***Notes to Add***

## QUESTIONS

### Theory Questions

**10.** SA 300 states that auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. Discuss few factors affecting such supervision and review of work of engagement team members.

**Ans.** Points on Planning supervision and review of work of engagement team members.

(1) The size and complexity of the entity.

(2) The area of the audit.

(3) The assessed risks of material misstatement

(4) The capabilities and competence of the individual team members performing the audit work.

***Notes to Add***

## DOCUMENTATION

- OAS
- Audit Plan
- Δ in
  - OAS
  - Audit Plan
- Reason for Δ

❑ Documentation = Record of : -

(i) RAP & FAP

(ii) Proper Planning of Audit Procedures

- Reviewed
- Approved

❑ Auditor May Use →STANDARD
- Audit Program
- Audit Completion Check List

→Tailored → as needed

***Notes to Add***

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.

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.

The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

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.

**Test Your Understanding**

**3.** CA Mary, while planning audit of a company, feels that she would inquire from inhouse legal counsel of the company status of pending litigation matters against the company to identify and assess risks of material misstatements. Considering above description, are you able to identify said procedures? Where these identified procedures are included in planning in accordance with SA-300?

**Ans.** These are planned risk assessment procedures to identify and assess risk of material misstatement. The objective of planned inquiry of inhouse legal counsel is to identify and assess risk of material misstatement. Such planned risk assessment procedures are included in audit plan in accordance with SA-300.

**4.** CA Shubhendu is statutory auditor of a social media company. Due to change in information technology regulations by government, it has become mandatory for such companies to constitute "grievance redressal mechanism" for users of social media platform of the company. Failure to comply with regulations can potentially lead to civil and criminal liabilities against the company. Is above factor to be considered by auditor while framing audit strategy?

**Ans.** Changes in laws and regulations affecting the company is a factor to be considered while establishing overall audit strategy. There has been change in information technology regulations applicable to the company. Non- compliance of the same can have implications in form of civil and criminal liabilities. Such an important matter concerning changes in laws and regulations is to be considered

***Notes to Add***

## QUESTIONS

### Theory Questions

**11.** Is it necessary to document the audit plan? If so, what all activities in the planning phase needs to be documented? State with Examples.

**Ans.** 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.

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.

**12.** An auditor of a company fails to document audit strategy and audit plan. Briefly outline consequences of such failure.

**Ans.** The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

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.

***Notes to Add***

## AUDIT PROGRAMME

↓

Desirable→Particularly→Bigger Audits

List of — Examination / Verification — Steps→to be — Applied / Set out — in a way

↓

Interrelationship

↓

of one step to another

Clearly Shown | Designed

Keeping in view the Assertions

OR

Detailed Plan —
- of applying→Audit procedures
- Instructions→Appropriate Techniques

↓

for accomplishing Audit Objectives

***Notes to Add***

.....

.....

.....

.....

.....

## EVOLVING ONE AUDIT PROGRAMME-NOT PRACTICABLE FOR ALL BUSINESSES

↓

NOT PRACTICABLE→or All Businesses

↓

Vary in

Nature | Size | Composition | I.C. | Work

It is desirable that in respect of each audit and more particularly for bigger audits, an audit programme should be drawn up. Audit programme is a list of examination and verification steps to be applied and set out in such a way that the interrelationship of one step to another is clearly shown and designed, keeping in view the assertions discernible in the statements of account produced for audit or on the basis of an appraisal of the accounting records of the client.

An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given entity for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on financial statements.

In other words, an audit programme is a detailed plan of applying the audit procedures in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives.

## QUESTIONS

### Multiple choice Questions (MCQ)

**4.** Which of the following is not included in an audit programme normally?

(*a*) Extent of checking

(*b*) Date of checking

(*c*) Nature or type of procedure

(*d*) Planning of risk assessment procedures

**Ans.** (*d*) Planning of risk assessment procedures

### Theory Questions

**13.** "Purported disadvantages of an audit programme can be overcome". Do you agree?

**Ans.** Purported disadvantages of audit programme may be eliminated by imaginative supervision of the work carried on by the assistants; the auditor must have a receptive attitude as regards the assistants; the assistants should be encouraged to observe matters objectively and bring significant matters to the notice of supervisor/principal.

Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. On account of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable. However, it becomes a necessity to specify in detail in the audit programme the nature of work to be done so that no time will be wasted on matters not pertinent to the engagement and any special matter or any specific situation can be taken care of.

## QUESTIONS

### Correct/Incorrect

**State with reasons (in short) whether the following statements are correct or incorrect:**

**14.** A detailed Audit Programme once prepared for a business can be used for all business under all circumstances.

**Ans. (Incorrect)**

Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. On account of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable.

***Notes to Add***

## ASSISTANTS TO KEEP AN OPEN MIND

- Auditor should frame →Audit Programme
  ↓ ↓
  Aim→Providing for →MINIMUM Essential Work
  Standard Audit Programme
- As in Programme →up on Gaining Experience
  ↓
  By actually carrying the work

Assistants — Note / Report — Significant Matters
↓
Open Mind

## PERIODIC REVIEW OF AUDIT PROGRAMME

- To Assess → Whether → Same continues to be ADEQUATE
  ↓
  for obtaining Requisite
  Knowledge
  Evidence
- Auditor → may have to face legal consequences
  ↓
  NEGLIGENTLY CONDUCTED AUDIT
  ↓
  On the basis of an OBSOLETE Audit Programme
- Audit Assistants → Unfailingly → Follow Instructions of Audit Programme
  ↓
  Untill changed by Principal

If periodic review is conducted → it removes RIGIDITY

***Notes to Add***

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.

***Notes to Add***

There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions. Unless this is done, any change in the business policy of the client may not be adequately known, and consequently, audit work may be carried on, on the basis of an obsolete programme and, for this negligence, the whole audit may be held as negligently conducted and the auditor may have to face legal consequences.

The utility of the audit programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed. However, as a basic feature, audit programme not only lists the tasks to be carried out but also contains a few relevant instructions, like the extent of checking, the sampling plan, etc. So long as the programme is not officially changed by the principal, every assistant deputed on the job should unfailingly carry out the detailed work according to the instructions governing the work. Many persons believe that this brings an element of rigidity in the audit programme. This is not true provided the periodic review is undertaken to keep the programme as up-to- date as possible and by encouraging the assistants on the job to observe all salient features of the various accounting functions of the client.

***Notes to Add***

## CONSTRUCTING AN AUDIT PROGRAMME

- Audit Planning
  Related Program — Commences → Conclusion → P.Y. Audit
  ↓
  Reconsidered → for Modification
  ↓
  Based on
  - Review of I.C.
  - Preliminary Evaluation
  - Result of
    - Compliance
    - Substantive
    
    Procedures

- While developing Audit Program → Auditor MAY

  (1)
  - Rely on I.C. ↓ Eff. & Eff. Way to conduct on Audit
  - Not to Rely on I.C. ↓ Other more eficient way to obtain Suff. + Appro A.E.

  (2) Consider
  - Timing of Procedure
  - Coordination with client
  - Availability of Assistants
  - Involvement of other
    - Auditor
    - Expert

  (3) When to Perform Audit Procedure
  - Generally Flexible
  - Some Cases→Not Flexible→Eg. Inventors Cash, etc.

- Construction of Audit Programme:

  (1) Stay within — Scope / Limitation — of the assignment

  (2) Prepare→Written Audit Programme

  (3) Identify→Best Evidence

  (4) Apply →Only useful steps

  (5) Include →Audit Objectives →of each area

  (6) Consider →Possibilities of Errors

  (7) Co-Ordinate →Proedures

The audit planning ideally commences at the conclusion of the previous year's audit, and along with the related programme, it should be reconsidered for modification as the audit progresses. Such consideration is based on the auditor's review of the internal control, his preliminary evaluation thereof, and the results of his compliance and substantive procedures.

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.

## QUESTIONS

### Correct/Incorrect

**State with reasons (in short) whether the following statements are correct or incorrect:**

**15.** A detailed Audit Programme once prepared for a business can be used for all business under all circumstances.

**Ans. Incorrect:** Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. On account of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable.

**16.** Materiality is not a matter of size.

**Ans. Incorrect:** Financial statements should disclose all 'material items', i.e., the items the knowledge of which might influence the decisions of the user of the financial statement. 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. In certain cases, quantitative limits of materiality are specified.

**Theory Questions**

**17.** "The utility of the audit programme can be retained and enhanced only by keeping the programme and also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed'. Discuss stating clearly the advantages of an audit programme.

**Ans.** The advantages of an audit programme are:

(*a*) It provides the assistant carrying out the audit with 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*) Without a written and pre-determined programme, work is necessarily to be carried out on the basis of some 'mental' plan. In such a situation there is always a danger of ignoring or overlooking certain books and records. Under a properly framed programme, such danger is significantly less and the audit can proceed systematically.

(*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 professional auditor.

**18.** M/s TP & Co., a firm of Chartered Accountants, is auditor of KSR Ltd. for many years. KSR Ltd. has diversified their business into newer areas during the last year. The senior member of the audit team handed over the standard audit programme of earlier years to the audit assistants and instructed them to follow the same. The assistants are conducting the audit accordingly. Whether the attitude of the audit assistants is justified or they are required to keep an open mind? Guide them.

**Ans.** The Assistant Engaged – Be Encouraged to Keep an Open Mind: 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. In the given case, the attitude of assistants of TP & Co. is not justified. They should keep an open mind and go beyond the programme to take care of newer areas of the business of KSR Ltd. into which the Company has diversified.

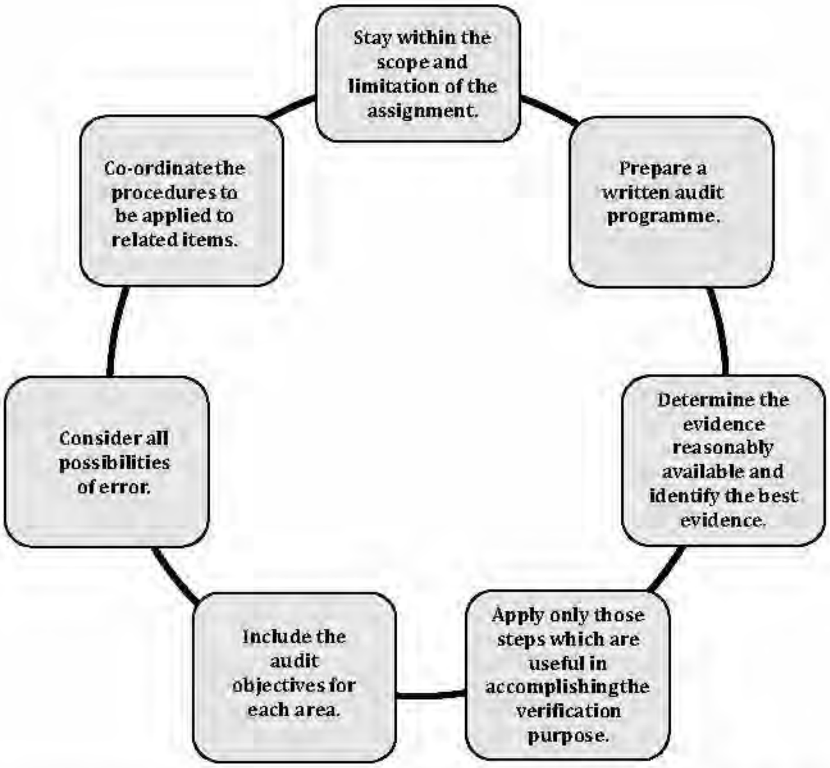
**19.** While developing an audit programme the auditor may conclude that relying on certain internal controls is an effective and efficient way to conduct his audit Explain stating clearly the points to be kept in mind while developing an audit programme.

**Ans.** 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

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

***Notes to Add***




## AUDIT PROGRAMME - DESIGNED TO PROVIDE AUDIT EVIDENCE

- A.E. = INFO→used by Auditor→in Arriving @ Conclusion
  - ↓ Includes ↓ Info. In
    - Other Info.
    - A/c. Records
  - ↓ On which Auditor's Opinion is based
- A.E.→basis for formulation→of opinion
  - ↓ Audit Programme
    - Procedures
    - Techniques
- Assertions→ Evidence is
  - Drawn
  - Considered
  - Weighted
  - ↓ to
    - Prove
    - Disprove

***Notes to Add***

Audit evidence may be defined as the 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.

Evidence is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and techniques. What is best evidence for testing the accuracy of any assertion is a matter of expert knowledge and experience. This is the primary task before the auditor when he draws up the audit programme. Transactions are varied in nature and impact; procedures to be prescribed depend on prior knowledge of what evidence is reasonably available in respect of each transaction. In most of the assertions much of the evidence be drawn and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion. In this process, an auditor would be in a position to identify the evidence that brings the highest satisfaction to him about the appropriateness or otherwise of the assertion.

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.

**Example:**

(1) For cash in hand, the best evidence is 'count'.

(2) For investment pledged with a bank, the banker's certificate.

(3) For verifying assertions about book debts, the client's ledger invoices, debit notes, credit notes, monthly accounts statement sent to the customers are all evidence: some of these are corroborative, other being complementary. In addition, balance confirmation procedure is often resorted to, to obtain greater satisfaction about the reliability of the assertion.

The auditor, however, has to place appropriate weight on each piece of evidence and accordingly should prescribe the priority of verification. It is true that in all cases one procedure may not bring the highest satisfaction and it may be dangerous for the auditor to ignore any evidence that is available. By the word "available", we do not mean that the evidence available with the client is the only available evidence. The auditor should know what normally should be available in the context of the transaction having regard to the circumstances and usage.

***Notes to Add***

## ADVANTAGES & DISADVANTAGES OF AUDIT PROGRAMME

**Advantages**

(1) Total + Clear →Set of Instructions
(2) Provide →Perspective →of work to be performed
(3) Selection of capable assistants
(4) Audit can proceed systematically
(5) Work may be tracked back to the assistant
(6) Principal can track progress
(7) Serves as a guide for future Auditors
(8) Serves as evidences

**Disadvantages**

**(1) Work → may become → mechanical**
**(2) Programme → tends to become — Rigid / Inflexible**
**(3) Inefficient assistants → may take shelter**
**(4) Hard & Fast Audit Programme → may kill initiative**

**Disadvantages may be overcome by**

- **Imaginitive Supervision**
- **Receptive Attitude**
- **Observe Matters Objectively**

***Notes to Add***

**The advantages of an audit programme are:**

(*a*) It provides the assistant carrying out the audit with 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*) Without a written and pre-determined programme, work is necessarily to be carried out on the basis of some 'mental' plan. In such a situation there is always a danger of ignoring or overlooking certain books and records. Under a properly framed programme, such danger is significantly less and the audit can proceed systematically.

(*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 professional auditor.

Some disadvantages are also there in the use of audit programmes but most of these can be removed by following some concrete steps.

**The disadvantages are:**

(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.

All these disadvantages may be eliminated by imaginative supervision of the work carried on by the assistants; the auditor must have a receptive attitude as regards the assistants; the assistants should be encouraged to observe matters objectively and bring significant matters to the notice of supervisor/principal.

***Notes to Add***

## QUESTIONS

### Multiple Choice Questions (MCQ)

**5.** Which of the following is not an advantage of an audit programme?

(*a*) It acts as a guide for audit of coming years.
(*b*) It fixes responsibility of assistants.
(*c*) It serves as a shelter for assistants.
(*d*) It serves a proof of work done by auditor.

**Ans.** (*c*) It serves as a shelter for assistants.

### Test Your Understanding

**5.** Rohit, undergoing practical training, is part of an engagement team conducting audit of a company engaged in manufacturing of paints. He has been provided with audit programme pertaining to sales. It lists out various items to be checked and verified by him including invoices, rate lists, posting in debtors accounts, correlation of invoices with e-way bills on sample basis etc. During verification, he notices that many e-way bills have been cancelled by the company within 24 hours of their generation in month of March. There is no specific instruction in audit programme in this regard. He keeps mum. Is attitude of Rohit proper?

**Ans.** Attitude of Rohit is not proper. The assistants should observe matters objectively and bring significant matters to the notice of supervisor/principal. Reasons for cancellation of many e-way bills in month of March need to be looked into. Matter should be informed to engagement partner.

Extract of Sample audit programme pertaining to sales of an entity

| | |
|---|---|
| Name of concern | Fine Industries |
| Financial year | 2021-22 |
| Prepared by | P (with date) |
| Reviewed by | Q (with date) |
| Approved by | R (with date) |

| Serial number | Nature of Procedure | Extent of Check | Basis of sample | Done by |
|---|---|---|---|---|
| (a) | Vouch few sales invoices from copies available in record of the concern. | | | |
| (b) | Trace theseinvoices into the account books of the concern. | | | |
| (c) | Verify few invoices with e-way bills generated on the e- way bill portal. | | | |
| (d) | Trace few sales invoices into the stock records to ensure that sold quantities have been reduced from stocks. | | | |
| (e) | Trace also few sales invoices into accounts of buyers | | | |

**CASE STUDY**

Kaur & Associates, a sole proprietor firm of Simran Kaur, is offered appointment as auditor of a company engaged in manufacturing of automobile components for the first time. She is fact checking about the integrity of promoters of the company and key managerial persons. Matters such as competence of staff to perform the engagement are also considered by her. The appointment is subsequently accepted by her.

She is also taking into account number and location of branches of the company, requirements of Schedule III of Companies Act, 2013 and expected time by which audit has to be completed keeping in view statutory requirements. Initially, she has thought it proper to inquire key employees of the company in procurement and marketing departments and planned for the same. She has also planned to visit three plants of the company. The purpose of planned inquiry and visit is to identify and assess risk of material misstatements.

A detailed set of instructions has been prepared by her office and it has been handed over to assistants in engagement team. These set of instructions include details of extent of checking and nature of audit procedures to be performed regarding purchases, sales, items of income, items of expenditure etc. During the course of execution of above set of instructions, it has been brought to her notice that company is also producing substantial quantities of scrap generated during manufacturing process. However, no instructions have been given to engagement team in this regard.

## QUESTIONS

### Multiple choice Questions (MCQ)

**Based on above, answer following questions**

**6.** Auditor is fact checking about promoters and key managerial persons. She is also considering competence of staff to perform engagement. What is she trying to do?

(*a*) She is establishing audit strategy
(*b*) She is conducting preliminary engagement activities
(*c*) She is designing audit plan
(*d*) She is checking her compliance of ethical requirements

**Ans.** (*b*) She is conducting preliminary engagement activities

**7.** Consideration of number and location of branches, requirements of financial reporting framework and expected time of completion are relevant factors primarily for which of the following -

(*a*) Developing audit plan
(*b*) Establishing overall audit strategy
(*c*) Designing audit programme
(*d*) Designing risk assessment procedures

**Ans.** (*b*) Establishing overall audit strategy

**8.** Taking into account description of planned inquiry and visit, which of the following statements is TRUE?

(*a*) Planned inquiry and visit fall in area of audit strategy
(*b*) Planned inquiry and visit are planned risk assessment procedures and fall in field of audit plan
(*c*) The said description is not related to audit planning
(*d*) Planned inquiry and visit fall in scope of audit programme

**Ans.** (*b*) Planned inquiry and visit are planned risk assessment procedures and fall in field of audit plan

**9.** What is detailed set of instructions given to assistants in engagement team known as?

(*a*) Audit guidelines
(*b*) Audit plan
(*c*) Audit Programme
(*d*) Audit Procedures

**Ans.** (*c*) Audit Programme

**10.** The issue of generation of scrap has been overlooked in detailed set of instructions given to engagement team. What should be proper course of action by CA Simran Kaur?

(*a*) She should ignore this information as audit has already begun
(*b*) She should modify earlier set of instructions
(*c*) She should leave the matter to wisdom of engagement team
(*d*) She should put the ball in court of management as she was not provided with complete information earlier

**Ans.** (*b*) She should modify earlier set of instructions

❑❑❑

# 3

CHAPTER

# Risk Assessment and Internal Control

| S. No. | Sub Topics | Easy | Moderate | Hard |
|---|---|---|---|---|
| 01. | Audit risk | | | |
| 02. | Risks of material misstatement | | | |
| 03. | Components of risk of material misstatement | | | |
| 04. | Detection risk | | | |
| 05. | Audit risk-What is not included? | | | |
| 06. | Assessment of risks- A matter of professional Judgment | | | |
| 07. | Identifying and assessing the risk of material misstatement | | | |
| 08. | Risk Assessment Procedures | | | |
| 09. | Information obtained by performing risk assessment procedures | | | |
| 10. | Materiality | | | |
| 11. | What is meant by materiality? | | | |
| 12. | Materiality in Planning and performing an audit | | | |
| 13. | Determination of materiality- a matter of professional judgment | | | |
| 14. | Performance Materiality | | | |
| 15. | Determining Materiality and Performance Materiality when Planning the Audit | | | |
| 16. | Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole | | | |
| 17. | Materiality Level or Levels for Particular Classes of Transactions, Account Balances or Disclosures | | | |
| 18. | Revision in Materiality level as the Audit Progresses | | | |
| 19. | Documenting the Materiality | | | |
| 20. | Materiality and audit risk | | | |
| 21. | Understanding the entity and its environment | | | |
| 22. | Why understanding the entity and its environment is significant? | | | |
| 23. | Understanding the entity-a continuous process | | | |

| | | | | |
|---|---|---|---|---|
| 24. | Internal Control | | | |
| 25. | Meaning of Internal Control | | | |
| 26. | Purpose of Internal Control | | | |
| 27. | Benefits of Internal Control | | | |
| 28. | Limitations of Internal Control | | | |
| 29. | Components of Internal Control | | | |
| 30. | Are all Controls Relevant to the audit? | | | |
| 31. | Controls over the completeness and accuracy of information | | | |
| 32. | Internal control over safeguarding of assets | | | |
| 33. | Controls relating to objectives that are not relevant to an audit | | | |
| 34. | Nature and Extent of the Understanding of Relevant Controls | | | |
| 35. | Risks that Require Special Audit Consideration | | | |
| 36. | Identifying Significant Risks | | | |
| 37. | Risks of Material Misstatement– Greater for Significant Non-Routine Transactions | | | |
| 38. | Risks of material misstatement– Greater for Significant Judgmental Matters | | | |
| 39. | Evaluation of Internal Control System | | | |
| 40. | Benefits of Evaluation of Internal Control to the Auditor | | | |
| 41. | Evaluation of Internal Control– Methods | | | |
| 42. | Testing of Internal Control | | | |
| 43. | What is an automated environment? | | | |
| 44. | Key features of an automated environment | | | |
| 45. | Understanding and documenting automated environment | | | |
| 46. | Risks arising from use of IT Systems | | | |
| 47. | Impact of IT related risks | | | |
| 48. | Types of Controls in an automated environment | | | |
| 49. | General IT Controls vs. Application Controls | | | |
| 50. | Testing methods in an automated environment | | | |
| 51. | Characteristics of manual and automated elements of internal control relevant to the auditor's risk assessment | | | |
| 52. | Manual elements vs automated elements in entity's internal control | | | |
| 53. | Audit approach in an automated environment | | | |
| 54. | Data analytics for audit | | | |
| 55. | Digital audit | | | |
| 56. | Internal financial controls as per regulatory requirements | | | |

| | | | | |
|---|---|---|---|---|
| 57. | Documenting the risks | | | |
| 58. | Assess and report audit findings | | | |
| 59. | The auditor's responses to assessed risks | | | |
| 60. | Nature and Extent of Test of Controls | | | |
| 61. | Timing of Test of Controls | | | |
| 62. | Using Audit Evidence Obtained in Previous Audits | | | |
| 63. | Evaluating the Operating Effectiveness of Controls | | | |
| 64. | Specific inquiries by auditor when deviations from controls are detected | | | |
| 65. | Tests of Details | | | |
| 66. | Substantive analytical procedures | | | |

***Notes to Add***

## AUDIT RISK

Auditor gives an INAPPROPRIATE OPINION

↓

when the FS ARE MM

Auditor expresses → unmodified Opinion → when the FS ARE MM

- Reputation Damage
- Regulatory Action
- Legal Action

Auditor — Plan / Perform — Audit → AUDIT RISK is

↓

REDUCED TO AN ACCEPTABLY LOW LEVEL

**Audit Risk = $f$(RoMM×Detection Risk)**

- **Inherent Risk**
- **Control Risk**

***Notes to Add***

Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated.

It means that an auditor expresses an unmodified opinion when financial statements are materially misstated. In such a case, not only reputation of auditor would be damaged, but he could also invite regulatory action from professional body and could face probable legal action by intended users.

To avoid such unpleasant consequences, the auditor will plan and perform the audit in such a way that audit risk is reduced to an acceptably low level. SA-200 states that the auditor shall obtain sufficient appropriate audit evidence 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.

Consider, for example, that profits of a company have been increased artificially by showing fake revenues of sizeable amounts in its financial statements. In such a case, financial statements are materially misstated. The probability, that auditor in such a case, expresses an inappropriate audit opinion is referred to as audit risk. It is the possibility that auditor expresses an unmodified opinion even when financial statements are materially misstated.

Audit risk is a function of the risks of material misstatement and detection risk.

## QUESTIONS

### Theory Questions

**1.** While conducting the audit of Smart TV Ltd, engagement team of HTR& Co, has considered materiality and audit risk throughout the audit. Discuss explaining the meaning of audit risk.

**Ans.** 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 are considered throughout the audit, in particular, when:

(*a*) Identifying and assessing the risks of material misstatement;

(*b*) Determining the nature, timing and extent of further audit procedures; and

(*c*) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

***Notes to Add***

## RISK OF MATERIAL MISSTATEMENT

FS are MM → PRIOR TO AUDIT

↓

Probability of — F / E — in FS ↔ Before Audit

* Misstatement = Amount, Classification, Presentation, Disclosure [Recorded F.S. - As per App.F.R.F.]

F E

* RoMM @ — Overall FS. Level → Relate Pervasively to F.S. as a whole + Potentially affect many assertions

— Assertion level → Assessed to determine

CoT A/c. Bal Disclosures

N E T of FAP

### *Notes to Add*

SA 200 states that risk of material statement is the risk that the financial statements are materially misstated prior to audit. It simply means that there is a probability of frauds or errors in financial statements before audit.

What is meant by misstatement?

Misstatement refers to a difference between the amount, 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.

**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
- Difference in accounting estimate of a financial statement item vis-à-vis its appropriateness in applicable financial reporting framework
- 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

**The risks of material misstatement may exist at two levels:**

- The overall financial statement level
- The assertion level for classes of transactions, account balances, & disclosures.

**Risks of material misstatement at the overall financial statement level** refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

**Risks of material misstatement at the assertion level** are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.

***Notes to Add***

## COMPONENTS OF RISK OF MATERIAL MISSTATEMENT (RoMM)

Inherent Risk | Control Risk

(1) Are Entity's Risk
(2) Exist independently of → Audit of F.S.
(3) Influenced by client
(4) Not Influenced by Auditor

## INHERENT RISK

**Susceptibility of an Assertion** → **CoT** / **A/c. Bal.** / **Disclosure**

↓

**To a MM → Before Consideration of any Related Control**
- **Individually**
- **Aggregate**

**→ May be Higher for some→Assertions**

↓

**Eg: Complex Calculations** → **CoT** / **A/c. Bal.** / **Disclosure**

→ External Factors→ May Influence→ Inherent Risk

↓

Eg.: (1) Mgt misunderstands AS → Still Preparing FS
(2) Industry has Business Failures

↓

∴ Entity may have MM

***Notes to Add***

The risk of material misstatement at assertion level comprises of two components i.e., inherent risk and control risk. Both inherent risk and control risk are the entity's risks and they exist independently of the audit of financial statements. Inherent risk and control risk are influenced by the client. These are entity's risks and are not influenced by the auditor.

***Notes to Add***

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## QUESTIONS

### Theory Questions

**2.** "Risk of material misstatement consists of two components" Explain clearly defining risk of material misstatement.

**Ans.** Refer to heading "Components of risk of material misstatement".

Inherent risk is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements before consideration of any related controls as described in SA-200.

There is always a risk that before considering any existence of internal control in an entity, a particular transaction, balance of an account or a disclosure required to be made in the financial statements of an entity have a chance of being misstated and such misstatement can be material. This risk is known as inherent risk.

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. Category of auditor's assessment lower or higher, each category covers a range of degrees of inherent risk. Auditor may assess the inherent risk of two different assertions as lower while recognizing that one assertion has less inherent risk than the other, although both have been assessed as lower.

It is important to consider the reason for each identified inherent risk even if the risk is lower, when auditor designs 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.

**Few examples of inherent risks could include:**

- An accounting standard provides guidance on some complex issue which might not be understood by the management. Therefore, recording of this issue in financial statements carries inherent risk of being misstated.
- There are large number of business failures in an industry. Therefore, assertions in financial statements of an entity operating in such an industry carry an inherent risk of being misstated.

## QUESTIONS

### Correct/Incorrect Questions

**State with reasons (in short) whether the following statements are correct or incorrect:**

3. Control risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

**Ans. (Incorrect)**

Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls. Control risk, on the other hand is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

In accordance with SA-200, control risk is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Control risk is a risk that internal control existing and operating in an entity would not be efficient enough to stop from happening, or find and then rectify in an appropriate time, any material misstatement relating to a transaction, balance of an account or disclosure required to be made in the financial statements of that entity. Therefore, in a way, it can be said that there exists an inverse relation between control risk and efficiency of internal control of an entity. When efficiency of internal control of an entity is high, the control risk is low and when efficiency of internal control of that entity is low, the control risk is high.

**Examples of control risk could include:**

A company has devised control that cash and cheque books should be kept in a locked safe and access is granted to authorized personnel only. There is risk that control is not being followed.

An entity has devised a control that fire extinguishers and smoke detectors are in place and are in working condition at all times to reduce the risk of damage to inventories caused by fire. There is a risk that fire extinguishers in place are expired and are not being refilled. Similarly, there is a possibility that smoke detectors are not working.

A company has devised a control relating to petty cash that items of expenditure of only less than ₹10000 should be routed through imprest system of petty cash. There is a risk that control is not being followed.

## QUESTIONS

### Theory Questions

4. When auditor identifies deficiencies and report on internal controls, he determines the significant financial statement assertions that are affected by the ineffective controls in order to evaluate the effect on control risk assessments and strategy for the audit of the financial statements. Explain

**Ans.** Control risk assessment when control deficiencies are identified: When auditor identifies deficiencies and report on internal controls, he determines the significant financial statement assertions that are affected by the ineffective controls in order to evaluate the effect on control risk assessments and strategy for the audit of the financial statements.

When control deficiencies are identified and auditor identifies and tests more than one control for each relevant assertion, he evaluates control risk considering all of the controls he has tested. If auditor determines that they support a 'rely on controls' risk assessment, or if compensating controls are identified, tested and evaluated to be effective, he may conclude that the 'rely on controls' is still appropriate. Otherwise we change our control risk assessment to 'not rely on controls.'

When a deficiency relates to an ineffective control that is the only control identified for an assertion, he revises risk assessment to 'not rely on controls' for associated assertions, as no other controls have been identified that mitigate the risk related to the assertion. If the deficiency relates to one WCGW (what can go wrong) out of several WCGW's, he can 'rely on controls' but performs additional substantive procedures to adequately address the risks related to the deficiency.

***Notes to Add***

## DETECTION RISK

Risk → Procedures performed by the Auditor

↓

To reduce the risk to an Acceptably Low level

↓

WILL NOT DETECT A MM → that exists

Individually | Aggregate

Detection Risk

**Sampling Risk**

↓

**Auditor's CONCLUSION → Different**

↓ ↓

**based on a SAMPLE** | **from the CONCLUSION**

↓

**If the population is subject to SAME AUDIT PROCEDURES**

↓

**Sample was NOT REPRESENTATIVE of the population**

**Non Sampling Rusk**

↓

**Auditor** reaches **an Erroneous Conclusion**

↓

**for any reason**

↓

**NOT RELATED TO Sampling Risk**

| Risk | Influenced by |
|---|---|
| Inherent Risk<br>Control Risk | Entity |
| Detection Risk | Auditor |

↓

**must REDUCE Detection Risk → To keep Low Audit Risk→ By**

**Increasing**

↓

**Area of Checking**

**Testing**

↓

**Larger Sample Size**

**Including**

↓

**Competent + Experienced**

↓

**Persons in team**

***Notes to Add***

SA 200 defines detection risk as the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

For example, auditor of a company uses certain audit procedures for the purpose of obtaining audit evidence and reducing audit risk, but still there will remain a risk that audit procedures used by the auditor may not be able to detect a misstatement which by nature is material, then that risk is known as detection Risk.

**Detection risk comprises sampling and non-sampling risk**

- Sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. It simply means that the sample was not representative of the population from which it was chosen.
- Non-sampling risk is the risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. Like an auditor may reach an erroneous conclusion due to application to some inappropriate audit procedure.

**Examples of detection risk could include**

- Sizeable work-in-progress inventories are expected in financial statements of a company. However, auditor of the company does not devote time to attending inventory count. Instead, he chooses to rely upon alternative audit procedures.
- The auditor of a company has audited revenue of a company by taking a sample. However, there is a risk that sample of revenue is not representative of overall revenue.
- The auditor can only influence detection risk. Inherent risk and control risk belong to the entity and are influenced by the entity. Therefore, auditor must reduce detection risk in order to keep audit risk at low level. Detection risk may be reduced by increasing area of checking, testing larger samples and by including competent and experienced persons in the engagement team.

***Notes to Add***

## AUDIT RISK-WHAT IS NOT INCLUDED?

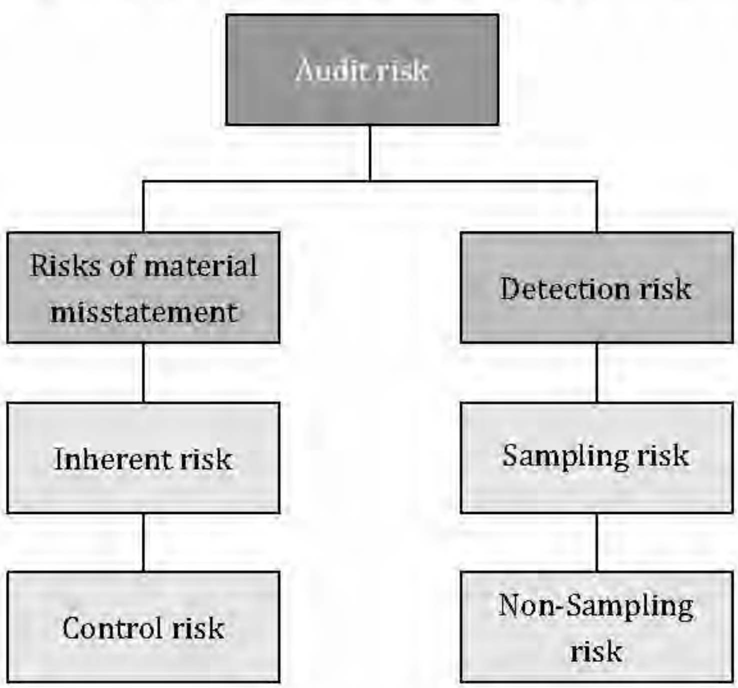
- Auditor's Business Risk
  - Loss from Litigation
  - Adverse Publicity
  - Other Events → connected with Audit
- Risk that the Auditor might express an opinion
  → That the FS. ARE MM
  → when they are NOT
  → This is ordinarily Insignificant

## ASSESSMENT OF RISK-MATTER OF PROF. JUDGEMENT

*** Audit Risk = *f*(RoMM × Detection Risk)**

**→ Assessment of Risk**

- **Matter of prof judgement**
  - **Training**
  - **Knowledge**
  - **Experience**
  - **Competencies**
- **Not a matter capable of Precise measurement**



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 financial statements.

For purposes of the SAs, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant.

***Notes to Add***

As discussed at the outset, audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement. The distinguishing feature of the professional judgment expected of an auditor is that it is exercised by an auditor whose training, knowledge and experience have assisted in developing the necessary competencies to achieve reasonable judgments.

***Notes to Add***

## COMBINED ASSESSMENT OF ROMM

Generally → $\underbrace{\text{Inherent Risk} \times \text{Control Risk}}_{\text{COMBINED}}$ = ROMM

But → Auditor may make
- Combined
- Separate

Assessment
- Quantitative
- Non Quantitative

Separate ↓ Depending on
- Preferred Audit Techniques
- Methodologies
- Practical Consideration

*Notes to Add*

### 1. Combined Assessment of the Risk of Material Misstatement

Standards on auditing do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or ombined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

It can be concluded from the above that:

Audit risk = Risks of material misstatement × 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 × Control risk × Detection risk

**Illustration 1:** XYZ Ltd is engaged in the business and running several stores dealing in variety of items such as ready made garments for all seasons, shoes, gift items, watches etc. There are security tags on each and every item. Moreover, inventory records are physically verified on monthly basis.

Discuss the types of inherent, control and detection risks as perceived by the auditor.

**Inherent Risk:** Because items may have been misappropriated by employees, therefore, risk to the auditor is that inventory records would be inaccurate.

**Control Risk:** There is a security tag on each item displayed. Moreover, inventory records are physically verified on monthly basis. Despite various controls being implemented at the stores, still collusion among employees may be there and risk to auditor would again be that inventory records would be inaccurate.

**Detection Risk:** Auditor checks the efficiency and effectiveness of various control systems in place. He would do that by making observation, inspection, enquiry, etc. In addition to these, the auditor would also employ sampling techniques to check few sales transactions from beginning to end. However, despite all these procedures, the auditor may not detect the items which have been stolen or misappropriated.

**Illustration 2:** A Partnership Firm of Chartered Accountants HT and Associates was appointed to audit the books of accounts of Wind and Ice Limited for the financial year 2020-21. There was a risk that HT and Associates would give an inappropriate audit opinion if the financial statements of Wind and Ice Limited are materially misstated. State the Risk mentioned in the question.

**Solution:** The risk mentioned in the question is known as Audit Risk, because risk that auditor of a company will give an inappropriate audit opinion if the financial statements of that company are materially misstated is known as Audit Risk.

**Test Your Understanding**

1. Wear & Tear Private Limited is a "start-up" engaged in providing holistic solutions to problem of paddy stubble burning mainly catering to needs of farmers of North western India. Due to importance given by governments to this issue, companies have entered in the market in past few years. Many of these companies have not been successful and have gone bust. As an auditor of the company, can you spot the component of risks of material misstatement involved in above?

**Ans.** It has been stated that many companies engaged in providing holistic solutions to problem of stubble burning have not been successful. It shows that line of activity is inherently risky. Therefore, there is a greater possibility of misstatements. The component of risks of material misstatement involved is "inherent risk."

**2.** A company has devised a control that its inventory of perishable goods is stored in appropriate conditions in a controlled environment to prevent any damages to inventory. Responsibility is fixed on two persons to monitor environment using sensors and to report on deviations. Identify the component of risks of material misstatement involved as an auditor of the company.

**Ans.** The company has devised a control that its inventory of perishable goods is stored in appropriate conditions and responsibility is fixed on two persons to monitor environment using sensors and to report on deviations. There is a possibility that persons given responsibility do not perform their work and report deviations. The component of risks of material misstatement is "control risk".

**3.** Shree Foods Private Limited is engaged in manufacturing of garlic bread. The auditors of company have planned audit procedures in respect of recognition of revenues of the company. Despite that, there is a possibility that misstatements in revenue recognition are not identified by planned audit procedures. Which risk is being alluded to?

**Ans.** There is a possibility that planned audit procedures may not achieve desired result and fail to detect misstatements in revenue recognition. The risk alluded to it is "detection risk".

## QUESTIONS

### Theory Questions

**5.** "The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement." Explain

**Ans.** The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

It can be concluded from the above that

**Risk of Material Misstatement = Inherent Risk × Control Risk (2) From (1) and (2), we arrive at Audit Risk = Inherent Risk × Control Risk × Detection Risk**

**SA 315 establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.**

***Notes to Add***

## IDENTIFYING & ASSESSING ROMM

* SA 315 → Identifying & Assessing RoMM → through

↓ Objectives

↓ understanding the → Entity / Environment

Identify + Assess → RoMM → due to → F / E

@ → F.S. Level / Assertion Level

Assertion → CoT / A/C Bal. / Disclosure

Through → Understanding → Entity, Environment, I. C. → Auditor Shall

RAP FAP

Providing → Basis for → Designing, Implementing → Responses → to the assessed RoMM

Auditor shall

(1) Identify Risk → throughout the process

(2) Assess + Evaluate Risk
- Relate pervasively to FS
- Potentially affect many assertions

(3) Relate Risks to → WCGW @ Assertion level
↓
Taking A/c of ToC

(4) Consider
- Likelihood of misstatement
- Possibility of multiple misstatement
- Misstatement could be material

### *Notes to Add*

As per SA 315 "Identifying and Assessing the Risks 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 financial statement 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.

The objective of the auditor as stated in SA 315 is to identify and assess the risks of material misstatement.

(i) The auditor shall identify and assess the risks of material misstatement at:
   (a) the financial statement level
   (b) the assertion level for classes of transactions, account balances, and disclosures.
   to provide a basis for designing and performing further audit procedures

(ii) For the purpose of identifying and assessing the risks 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.

## QUESTIONS

### Theory Questions

**6.** Risk of material misstatement consists of two components" Explain clearly defining risk of material misstatement.

**Ans.** As per SA 315 "Identifying and Assessing the Risks 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 financial statement 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.

The auditor shall identify and assess the risks of material misstatement at:

(*a*) the financial statement level

(*b*) the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures

## RISK ASSESSMENT PROCEDURES (R.A.P)

↓

Audit Procedures → to obtain understanding of
- Entity
- Env.
- I.C.

↓

To [Identify / Assess] RoMM → due to
- F
- E

↓

@

FS / Assertion

level

* RAP → by themselves → DO NOT PROVIDE → Suff· + Appro. A.E

↓

on which to base Audit Opinion

* RAP Includes
- (1) Inquiries — Mgt. / Others within
- (2) Analytical Procedures
- (3) Observation
- (4) Inspection

***Notes to Add***

You have already gained a little knowledge about risk assessment procedures in Chapter 2.

The audit procedures 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, whether due to fraud or error, at the financial statement and assertion level are defined as risk assessment procedures.

Risk assessment procedures are a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.

The risks to be assessed include both those due to error and those due to fraud.

**What is included in risk assessment procedures?**

**The risk assessment procedures shall include the following:**

(a) Inquiries of management and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error.

(b) Analytical procedures.

(c) Observation and inspection.

**(a) Inquiries of Management and Others Within the Entity:** Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority.

- Inquiries directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from those procedures.
- Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
- Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract
- Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.
- Inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
- Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system- related risks.

**(b) Analytical Procedures:** Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, relationship between sales and square footage of selling space or volume of goods sold.

Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, 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 misstatement due to fraud. However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

**(c) Observation and Inspection:** Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment. 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 financial statements) and those charged with governance (such as minutes of board of director's meetings)
- The entity's premises and plant facilities.

## QUESTIONS

### Theory Questions

**7.** Discuss how "analytical procedures" performed as "risk assessment procedures" can be useful to an auditor.

**Ans.** Refer to heading on "What is included in risk assessment procedures" and gather usefulness of analytical procedures performed as risk assessment procedures.

***Notes to Add***

## INFORMATION OBTAINED BY PERFORMING RISK ASSESSMENT PROCEDURES-USED AS AUDIT EVIDENCE

\+

Auditor may obtain A.E. — CoT / A/c. Bal. / Disclosure + Related Assertions + Operating Eff. of Controls

\+

Auditor may choose to perform — ToC / Substantive procedures — Simultaneously ↓ Efficient to do so

*Notes to Add*

**Information obtained by performing risk assessment procedures - Used as audit evidence**

Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures and related assertions and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or as tests of controls. 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.

**Test Your Understanding**

**4.** Jo Jo Limited is planning to list on Bombay Stock Exchange next year. As an auditor of Jo Jo Limited, identify any one reason of increased audit risk due to listing of the company next year.

**Ans.** Jo Jo Limited is planning to list on Bombay Stock Exchange next year. There is a greater chance of misstatements in the financial statements due to planned listing next year. There could be a possibility of intentional manipulation of financial statements so that good response is received to proposed issue. Therefore, there is increased audit risk i.e., risk of expressing inappropriate opinion by the auditor when financial statements are materially misstated.

On perusing financial statements of Jo Jo Limited put up for audit, it is observed by the auditor that current ratio has improved from 1.20:1 (in preceding year) to 1.75:1 (in current year). Identify what kind of risk assessment procedures are being performed by auditor? Has it any relation with listing of the company next year on Bombay Stock Exchange?

**5.** On perusing financial statements of Jo Jo Limited put up for audit, it is observed by the auditor that current ratio has improved from 1.20:1 (in preceding year) to 1.75:1 (in current year). Identify what kind of risk assessment procedures are being performed by auditor? Has it any relation with listing of the company next year on Bombay Stock Exchange?

**Ans.** It is noticed by the auditor that current ratio has improved from 1.20:1 (in preceding year) to 1.75:1 (in current year). The auditor is using "analytical procedures" as risk assessment procedures. Current ratio has improved from previous year. There could be a possibility of misstatement in current assets and current liabilities. It is possible that improvement in current ratio is artificial due to misstatements and has been done to secure good response to the proposed issue of company next year.

***Notes to Add***

## WHAT IS MEANT BY MATERIALITY?

SA320 "Materiality in Planning & Performing an Audit"

↓

States that

Misstatements Omissions

are considered to be

↓

MATERIAL — Individually / Aggregrate

↓

If they could reasonably be expected → to influence

↓

The Economic Decision of the user

* Objective of Auditor → to obtain R.A. → F.S. as a whole

↓

are free from MM → due to — F / E

↓

Thereby enabling an Auditor to Express an Opinion

↓

In ALL MATERIAL RESPECTS

↓

In accordance with App. F.R.F.

* Materiality → NOT Always → Matter of Size / Volume

***Notes to Add***

SA 320 Materiality in Planning and Performing an Audit states 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.

The objective of an independent auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, 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.

Herein, lies the significance of materiality. The auditor has to obtain reasonable assurance that financial statements as a whole are free from material misstatement whether due to fraud or error. As a result, an audit strives to identify significant risks of material misstatement and audit procedures are geared towards it.

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.

***Notes to Add***

## QUESTIONS

**Multiple Choice Questions (MCQ)**

**1.** Which of the following is true regarding materiality?

(*a*) It is unaffected by nature of an item.

(*b*) It is unaffected by requirements of law or regulations.

(*c*) It is not a matter of professional judgment.

(*d*) It is not always a matter of relative size.

**Ans.** (*d*)

***Notes to Add***

## MATERIALITY IN PLANNING AND PERFORMING AN AUDIT-AUDITOR'S RESPONSIBILITY

* Concept of Materiality → Applied by Auditor in

- Planning + Performing — Audit
- Evaluating the effect of — Identified / Uncorrected — Misstatement
- In Forming an Opinion on F.S.

→ **Judgements about materiality**
- **Concept discussed in App. F.R.F.**
- **If Not-based on:**
  - **(i) Surrounding circumstances** } or Both
  - **(ii) Size/Nature of misstatement** }
  - **(iii) Common Financial Info. needs of users → As a Group**
    - ↓ **Specific Individuals → Not Considered**
- **Provide basis**
  - **NET** — **RAP** / **FAP**
  - **Identifying + Assessing** — **RoMM**

→ Circumstances → may cause the Auditor → to Evaluate → Amount < Materiality

→ Auditor Considers — Nature / Size / Occurance — uncorrected misstatements
↓
When evaluating their effect on FS.
+
Apply → Prof. Judgement in
- Determining Materiality
- Choosing Appro. Benchmark
- Determining level of Benchmark

→ Materiality → forms Basis
- Determination of Audit Scope
- Level of testing the transaction

→ If → Statutory Requirement → ALWAYS MATERIAL

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. SA 320 deals with 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. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
- 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. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

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 to above provide the auditor with such a frame of reference.

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

(a) Determining the nature, timing and extent of risk assessment procedures;

(b) Identifying and assessing the risks of material misstatement; and

(c) Determining the nature, timing and extent of further audit procedures.

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. Although, it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements.

The auditor has to apply his professional judgement in determining materiality, choosing appropriate benchmark and determining level of benchmark. Materiality forms the basis for determination of audit scope and the levels of testing the transactions.

While judging materiality, the significance of an item has to be viewed from different perspectives. Materiality of an item may be judged by considering the impact on the profit and loss, or on the balance sheet, or in the total of the category of expenditure or income to which it pertains, and on its comparison with the corresponding figure for the previous year.

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 one percent 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 per cent shares specifying the number of shares held as per requirements of Division I of Schedule III of Companies Act,2013.

## QUESTIONS

### Correct/Incorrect

**State with reasons (in short) whether the following statements are correct or incorrect:**

**8.** There is direct relationship between materiality and the degree of audit risk.

**Ans. (Incorrect)**

There is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low but the risk that it could be misstated by an extremely small amount might be very high.

***Notes to Add***

## DETERMINATION OF MATERIALITY- A MATTER OF PROFESSIONAL JUDGMENT

+

Affected by Auditor's perception of

↓

Financial Info NEEDS of user of F.S.

* Auditor Assumes: user of F.S. has

- Reasonable knowledge
  - Business Activities
  - Economic Activities
  - Accounting
  - Willingness
  - Diligence
- Understanding → F.S.
  - Prepared
  - Presented
  - Audited
  - to levels of materiality
- Recognised uncertainties ↓ in measurement of amount ↓ Base on
  - Estimates
  - Judgements
  - Future Events Consideration
- Made Reasonable Economic decisions ↓ on the basis of Info. in F.S.

## PERFORMANCE MATERIALITY (PM)

→ Amount (s) → set by the Auditor

↓

At LESS than materiality for F.S. as a whole OR
- CoT
- A/c. Bal.
- Disclosure

↓

To reduce to an appropriately LOW LEVEL

↓

Probability that the aggregate of

- Uncorrected
- Undetected

misstatements

↓

EXCEEDS materiality for F.S. as a whole

* PM < OM

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.

***Notes to Add***

Practically, it is difficult for auditors to design tests to identify individual misstatements. It is likely that misstatements are material in aggregate. It takes us to the concept of "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 uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

Performance materiality is set at a value lower than overall materiality. It lowers the risk that auditor will not be able to identify misstatements that are material when added together.

***Notes to Add***

## DETERMINING MATERIALITY (DM) & PM

When establishing O.A.S

↓

Auditor DM → F.S. as a whole OR Particular
- CoT
- A/c. Bal.
- Disclosure

## USE OF BENCHMARKS IN DETERMINING MATERIALITY FOR THE FINANCIAL STATEMENTS AS A WHOLE

Involves → Exercise of Prof. Judgement

↓

A % age is often applied to a chosen benchmark

↓

As a STARTING POINT

* Factors → that may affect → Identification of Appro. Benchmark

(i) Elements of F.S.

(ii) Items in F.S. ← users tend to Focus

(iii) Nature of Entity + position at its Life Cycle + Industry & Economic Environment + Ownership structure

(iv) Volatility of Benchmark

| Best Benchmark | Operations | Orientation |
|---|---|---|
| PBT | Continuing | Profit |
| GP or Sales | Volatile | NPO |

## CHOSEN BENCHMARK-RELEVANT FINANCIAL DATA

- Prior pd. Financial
  - Result
  - Position
- Current Pd. financial
  - Result
  - Position
- Budget/ Forecast C.Y.
- **Significant** Δs in circumstances

When establishing the overall audit strategy, the auditor shall determine 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 materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.

Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

The elements of the financial statements like assets, liabilities, equity, revenue, expenses

- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused. For example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets.
- The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates, the entity's ownership structure and the way it is financed. For example, If an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings;
- The relative volatility of the benchmark.

Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

In relation to the 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.

Consider, for example, when, as a starting point, the materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that the materiality for the financial statements as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.

## DETERMINING A PERCENTAGE TO BE APPLIED TO A CHOSEN BENCHMARK INVOLVES THE EXERCISE OF PROFESSIONAL JUDGMENT

| Best Benchmark | Operations | Orientation |
|---|---|---|
| PBT (Higher) | Continuing | Profit |
| GP or Sales (Lower) | Volatile | NPO |

## MATERIALITY LEVEL OR LEVELS FOR PARTICULAR CLASSES OF TRANSACTIONS, ACCOUNT BALANCES OR DISCLOSURES

Factors that may → indicate → Misstatements

↓

Amount < Materiality

↓

could influence the economic decision of users.

(1) Law
Regulations
App. F.R.F.
Disclosures
- Related Party Transactions
- Remuneration
  - Mgt.
  - TCWG

(2) Key Disclosures

(3) Particular aspects → separately disclosed

## REVISION IN MATERIALITY LEVEL (S) AS THE AUDIT PROGRESSES

Materiality
- F.S. as a whole.
- particular
  - CoT
  - A/c. Bal.
  - Disclosure

↓

May need to be REVISED

↓

as a Result of

- **Δ** in Circumstances
- New Info.
- **Δ** in Auditor's understanding
  - Entity
  - its Operations
- Difference in
  - Actual
  - Anticipated

  Results
- **Δ** in Materiality ↓ More Appro.

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.

Consider, for example, that 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.

Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than 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 include the following:

- Whether law, regulations or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items like in case of related party transactions, and the remuneration of management and those charged with governance.
- The key disclosures in relation to the industry in which the entity operates. For example, research and development costs for a pharmaceutical company.
- Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements like in case of newly acquired business.

***Notes to Add***

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.

If during the audit it appears as though 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 the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

***Notes to Add***

## DOCUMENTING THE MATERIALITY

- Materiality ( ΔM)
  - F.S. as a whole
  - Particular
    - CoT
    - A/c. Bal.
    - Disclosure
- Performance Materiality (PM)
- Δ in DM/PM

***Notes to Add***

## MATERIALITY & AUDIT RISK

Concept is Applied — Planning / Performing / Evaluating — Stage + Forming the Opinion

- Identified MM
- Uncorrected misstatement

* Materiality & Audit Risk → considered → Throughout the Audit

- Identifying + Assessing (RAP) — RoMM
- Determining ↓ NET ↓ FAP
- Evaluating effect ↓ UNCORRECTED MISSTATEMENT
  - F.S.
  - Opinion

***Notes to Add***

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

## QUESTIONS

### Theory Questions

**9.** Is materiality required to be documented by the auditor? What factors have to be considered this regard?

**Ans.** Refer to heading on "documenting the 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. 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 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 are considered throughout the audit, in particular, when:

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

**Illustration 3:** One of the team members of auditors of Highly Capable Limited was of the view that Materiality and Audit Risk are only considered at planning stage of an audit. Comment as an auditor.

**Solution:** 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.

### Test Your Understanding

**6.** CA A. Raja is auditor of Build Well Forgings Private Limited having a revenue of ₹ 25 crore. The company has been sanctioned a term loan of ₹ 50 lacs from a bank. However, as at end of the year, only ₹ 1 lac was availed due to delay in procurement of asset. The financial statements of the company do not disclose nature of security against which loan has been taken. Schedule III of Companies Act, 2013 requires disclosure in this respect. Discuss, whether, non-disclosure of nature of security is material for auditor.

**Ans.** If there is any statutory requirement of disclosure, it is to be considered material. Schedule III mandates disclosure of nature of security in relation to loan. The amount involved is irrelevant.

## UNDERSTANDING THE ENTITY & ITS ENVIRONMENT

**As per SA315 → Auditor shall obtain understanding:**

**(i) Relevant — Industry / Regulatory / External — Factors + App. F.R.F.**

**(ii) Nature**
Operation
**Ownership**
**Governance**
**Financial Structure** — **of the entity**

(iii) Entity's — Selection / Application / Reason for Δ — Accounting Policies

(iv) Entity's — Objectives / Strategies / Business Risk

(v) Measurement / Review — Financial Performance

***Notes to Add***

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:

(a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework

Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments.

Examples of matters the auditor may consider include market and competition, whether entity is engaged in seasonal activities, product technology relating to the entity's products. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation.

Relevant regulatory factors include the regulatory environment. The regulatory environment includes, among other matters, the applicable financial reporting framework and the legal and political environment.

Examples of matters the auditor may consider include accounting principles and industry specific practices, regulatory framework for a regulated industry, legislation and regulation that significantly affect the entity's operations, including direct supervisory activities, taxation, government policies currently affecting the conduct of the entity's business, environmental requirements affecting the industry and the entity's business.

Examples of other external factors affecting the entity that the auditor may consider include the general economic conditions, interest rates and availability of financing, and inflation etc.

(b) The nature of the entity, including:

(i) its operations;

(ii) its ownership and governance structures;

(iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and

(iv) 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 financial statements.

An understanding of nature of entity enables the auditor to understand whether entity has a complex structure for example, whether it has subsidiaries. Complex structures often introduce issues that may give rise to risks of material misstatement. It also helps in understanding matters relating to the ownership, and relations between owners and other people or entities. This understanding assists in determining whether related party transactions have been identified and accounted for appropriately.

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

- Business operations such as nature of revenue sources, products or services, conduct of operations, location of production facilities, key customers and suppliers of goods and services
- Investment and investment activities such as capital investment activities and planned or recently executed acquisitions
- Financing and financing activities such as major subsidiaries, debt structure etc.
- Financial reporting such as accounting principles and revenue recognition practices

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

The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

(d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.

The entity conducts its business in the context of industry, regulatory and other internal and external factors. To respond to these factors, the entity's management define objectives, which are the overall plans for the entity. Strategies are the approaches by which management intends to achieve its objectives. The entity's objectives and strategies may change over time. Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk may arise from change or complexity.

An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, the auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement.

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 financial statements include:

- Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
- New products and services (a potential related business risk might be, for example, that there is increased product liability).
- Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).

(e) The measurement and review of the entity's financial performance

Management and others will measure and review those things they regard as important. Performance measures, whether external or internal, create pressures on the entity. These pressures, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Accordingly, an understanding of the entity's performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud.

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

- Key performance indicators (financial and non-financial) and key ratios, trends and operating statistics.
- Period-on-period financial performance analyses.
- Budgets, forecasts, variance analyses, and departmental or other level performance reports.
- Credit rating agency reports

### *Notes to Add*

## SIGNIFICANCE OF UNDERSTANDING

Helps Auditor in:

(*i*) Planning the Audit

(*ii*) Identify Areas → Special Attention

(*iii*) Gaining knowledge → Client's Business → Imp. principles

(*iv*) Without Knowledge → Proper Audit → NOT POSSIBLE

## UNDERSTANDING ENTITY - CONTINUOUS PROCESS

Dynamic process — [Gathering / Updating / Analysing] — Info. → Throughout the Audit

***Notes to Add***

Understanding the entity and the environment in which it operates is very 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.

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 risks of material misstatement of the financial statements
- 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.

**Illustration 4:** The auditor of ABC Textiles Ltd chalks out an audit plan without understanding the entity's business. Since he has carried out many audits of textile companies, there is no need to understand the nature of business of ABC Ltd. Advise the auditor how he should proceed.

**Solution:** 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 auditor should proceed accordingly.

**Illustration 5:** While auditing the books of accounts of Heavy Material Limited for the financial year 2022-23, a team member of the auditor of Heavy Material Limited showed no inclination towards understanding the business and the business environment of the above mentioned company. Is the approach of team member of the auditor of Heavy Material Limited correct or incorrect? Also give reason for your answer.

**Solution:** The approach of team member of the auditor of Heavy Material Limited is incorrect because understanding the business and the business environment of company whose audit is to be conducted is very important, as it helps in planning the audit and identifying areas requiring special attention during the course of audit of that company.

**Illustration 6:** Prince Blankets is engaged in business of blankets. Its major portion of sales is taking place through internet. Advise the auditor how he would proceed in this regard as to understanding the entity and its environment.

**Solution:** While understanding entity and its environment, internet sales is being perceived as risky area by the auditor and thereby would be spending substantial time and extensive audit procedures on this particular area.

## INTERNAL CONTROL

**Meaning of internal Control**

**Internal Control (I.C.)**

As per SA-315 → The process — [Designed / Implemented / Maintained] — by — [Mgt. / TCWG / Other Personnel]

↓

To provide R.A. about

↓

achievement of Entity's objectives

- Reliability of financial Reporting
- Eff. & Eff. Of operations
- Safeguarding of Assets
- Compliance with laws & Regulations

## PURPOSE OF INTERNAL CONTROL

I.C. — [D / I / M] — to Address → Identified → Identified Business Risk

↓

that threaten the achievement of

↓

ENTITY'S OBJECTIVES

- Reliability of Financial Reporting
- Eff. & Eff. Of Operations
- Safeguarding of Assets
- Compliance with Laws & Regulations

## BENEFITS OF UNDERSTANDING OF INTERNAL CONTROL

- Identifying types of ↓ Potential Misstatements
- Identifying factors ↓ That affect RoMM
- Designing N.E.T. ↓ If further Audit procedures

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 designed, implemented and maintained by those charged with governance, management and other personnel 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."

***Notes to Add***

**As derived from above definition, the purpose of Internal Control is as under**

Internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern:

- The reliability of the entity's financial reporting;
- The effectiveness and efficiency of its operations;
- Its compliance with applicable laws and regulations; and Safeguarding of assets.

The way in which internal control is designed, implemented and maintained varies with an entity's size and complexity.

***Notes to Add***

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.

***Notes to Add***

## LIMITATIONS OF INTERNAL CONTROL

| | |
|---|---|
| (*i*) Only R.A. | (*ii*) Human Judgement in Decision Making |
| (*iii*) Lock of understanding of purpose | (*iv*) Collusion among people |
| (*v*) Judgement by Mgt. | (*vi*) Limitations in case of small Entities |

(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 judgment in decision-making:** Realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error. For example, there may be an error in the design of, or in the change to, a control.

(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.

**Illustration 7:** Auditor GR and Associates, appointed for audit of PNG Ltd, a manufacturing company engaged in manufacturing of various food items. While planning an audit, the auditor does not think that it would be necessary to understand internal controls. Advise the auditor in this regard.

**Solution:** The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

**Illustration 8:** The team member of the auditor of Simple and Easy Limited was of the view that understanding the internal control of the company would not help them in any manner in relation to audit procedures to be applied while conducting the audit.

**Solution:** The view of the team member of the auditor is incorrect because understanding the internal control of the company would help the auditor and his team members in designing the nature, timing and extent of audit procedures to be applied while conducting the audit of the company.

## *Notes to Add*

## COMPONENTS OF IC

**Components of Internal control**

- Control environment Ⓐ
- Entity's risk assessment process Ⓑ
- Information system and communication Ⓒ
- Control activities Ⓓ
- Monitoring of controls Ⓔ

**(A) Control Environment → Auditor to Evaluates**

- Mgt. has created culture of
  - Honesty
  - Ethical Behavior
- Strength of Control Environment

**Component of internal control**

- Control environment
- Entity's risk assessment process
- Information system and communication
- Control activities
- Monitoring of controls

**The control Environment**

- Governance & Management function
- Attitude, Awareness & Actions of Mgt. /TCWG
- Sets the tone of originations → Influencing control consciousness of people

***Notes to Add***

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:

(a) The control environment

(b) The entity's risk assessment process

(c) The information system, including the related business processes, relevant to financial reporting, and communication

(d) Control activities

(e) Monitoring of controls

***Notes to Add***

## CONTROL ENVIRONMENT

The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

(*i*) Management has created and maintained a culture of honesty and ethical behaviour and

(*ii*) 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:

(*i*) the governance and management functions and

(*ii*) the attitudes, awareness, and actions of those charged with governance and management.

(*iii*) the control environment sets the tone of an organization, influencing the control consciousness of its people.

***Notes to Add***

## ELEMENTS OF CONTROL ENVIRONMENT

(i) Communication + Enforcement
  Integrity & Ethical Values

(ii) Commitment → to Competence

(iii) Participation → by TCWG

(iv) Mgt's — Philosophy
  — Operating style.

(v) Organisational Structure

(vi) Assessment of — Authority
  — Responsibility

(vii) H.R — Policies
  — Practice

→ Existence of Satisfactory Control Environment

↓

NOT AN ABSOLUTE DETERRENT TO FRAUD

↓

Can be a POSITIVE FACTOR → when Auditor assess → RoMM

→ Control Environment influence → Auditor's Evaluation → of Eff. Of Controls

↓

Does Not

P D C

MM

B. **Entity's R.A.P.**

- **Identifying Business Risk relevant to financial reporting objectives**
- **Estimating significance of Risk**
- **Assessing the likelihood of their occurrence**
- **Deciding about actions to address those risks**

C. **The Info. System → obtain understanding of**

- **CoT**
- **Procedures of I.R.P.R.**
- **Supporting**
  - **A/c.**
  - **Info.**
- **Financial Reporting process**

**I → Initiated** **R → Recorded** **P → Processed** **R → Reported**

D. Control Activities → Relevant to → Significant Risk → As per Auditor → Identified by R.A.P.

E. Monitoring → helps in assessing → effectiveness of control → on timely basis

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:** The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behaviour are the product of the entity's ethical and behavioural standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on integrity and ethical values may include the communication of behavioural standards to personnel through policy statements and codes of conduct and by example.

(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:** It includes attributes of those charged with governance such as their independence from management, their experience and stature, the extent of their involvement and the information they receive and the scrutiny of activities.

(d) **Management's philosophy and operating style:** Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions towards financial reporting- what approach is taken by management in selecting accounting policies, approach in developing accounting estimates etc. Matters such as approach of management to taking and managing business risks, management's attitude towards information processing and accounting function and personnel reflects upon management's philosophy and operating style.

(e) **Organisational structure:** The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed. Establishing a relevant organisational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The appropriateness of an entity's organisational structure depends, in part, on its size and the nature of its activities.

(f) **Assignment of authority and responsibility:** 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, counselling, promotion, compensation, and remedial actions. Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity.

For example, standards for recruiting the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behaviour – demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars illustrate expected levels of performance and behaviour. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

### Existence of a 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 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

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

(d) Deciding about actions to address those risks

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. Risks can arise or change due to factor such as new technology, new business models, products or activities, changes in operating environment etc. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

## THE INFORMATION SYSTEM, INCLUDING THE RELATED BUSINESS PROCESSES, RELEVANT TO FINANCIAL REPORTING AND COMMUNICATION

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

(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.

An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT). Information system should provide qualitative financial information. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.

The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities. It may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

## CONTROL ACTIVITIES

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 relevant to audit generally include policies and procedures relating to performance reviews (reviews of actual performance with budgets), information processing (for example controls over checking arithmetical accuracy of records, program change controls etc), physical controls (like controls over physical security of assets) and segregation of duties (controls over ensuring that different people are assigned the responsibilities of authorising transactions, recording transactions and maintaining custody of assets)

## MONITORING OF CONTROLS

The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It 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. It includes considering whether controls are operating as intended and that they are modified as appropriate for change in conditions.

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.

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.

**Test Your Understanding**

**7.** CA Smriti is auditor of a company. As part of audit, she is going through company policies and practices regarding employee recruitment, training, orientation and related matters. She seems to be very much interested in finding out whether company hires best candidates from applicant pool. Identify what she is trying to do? How gaining knowledge about this aspect is useful to her as an auditor?

**Ans.** The study of company policies and practices regarding employee recruitment, training, orientation and related matters including hiring of best candidates is part of understanding HR function of the company. It, in turn, helps in understanding control environment of the company. By gaining such a knowledge, she can better understand internal control of the company.

**8.** During the audit of same company, CA Smriti is keen to find out whether there exists a proper system of segregation of duties in the company. She wants to be sure that a person responsible for recording a transaction is different from the person authorising it. Discuss what she is trying to do and how its understanding is significant to her as an auditor.

**Ans.** She is keen to find out whether there exists a proper system of segregation of duties in the company. She is gaining an understanding of internal control of the company. In particular, she is understanding "control activities". When a person recording a transaction is different from one authorizing it, she gains confidence that there exists a system for preventing misstatements. It helps her in gaining insight into the internal control system of the company.

## ARE ALL CONTROLS RELEVANT TO THE AUDIT?

## CONTROLS RELEVANT TO AUDIT

- Direct Relationship → b/w
  - Entity's objectives
  - Control it implements
- Relevant Factors
  - Materiality
  - Significance of → related risk
  - Size of the entity
  - Nature of the entity's business
  - Organisation + Ownership characteristics
  - Diversity + Complexity of operations
  - Applicable legal + regulatory requirements
  - Circumstances + applicable component of IC
  - Nature + Complexity of the systems
  - Whether → control → prevents, or detects and corrects → material misstatement

## CONTROLS OVER THE COMPLETENESS AND ACCURACY OF INFORMATION

May be relevant to Audit

↓

If Auditor intends to make use of Info.

↓

In

Designing | Performing

FAP

## INTERNAL CONTROL OVER SAFEGUARDING OF ASSETS

Against → Unauthorised
- Acquisition
- Use
- Disposition

↓

May include controls relating to

Financial Reporting | Operations

There is a direct relationship between an entity's objectives and the control it implements to provide reasonable assurance about their achievement. The entity's objectives, and therefore controls, relate to financial reporting, operations and compliance; 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.

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.

***Notes to Add***

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 of such controls 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 financial statement 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 financial statement audit.

***Notes to Add***

**Controls relating to Objectives-Not relating to Audit**

NEED NOT BE CONSIDERED

→ If [Statute / Regulation] Require → Auditor's review of IC

↓

More

Broader | Detailed

## NATURE AND EXTENT OF THE UNDERSTANDING OF RELEVANT CONTROLS

**(i) Evaluating Design of Control = Considering whether control** → Capable of

↑

Considered First

P D C

MM

(ii) Implementation of control = control EXISTS + Entity USING it

→ R,A.P. to obtain → A.E. [Design / Implementation] of IC

- Inquiring ↓ Entity's Personnel ↓ Alone NOT SUFFICIENT
- Observing ↓ Application of Specific Control
- Inspecting ↓ Documents + Reports
- Tracing ↓ Transactions

→ Understanding I.C. → NOT SUFFICIENT

↓

Unless their is SOME AUTOMATION

↓

provides for Consistent operation of control

***Notes to Add***

## 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.

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.

Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first.

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.

Obtaining an understanding of an entity's controls is not sufficient to test their operating effectiveness, unless there is some automation that provides for the consistent operation of the controls. For example, obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit.

However, because of the inherent consistency of IT processing, performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on the auditor's assessment and testing.

***Notes to Add***

## RISK THAT REQUIRE SPECIAL CONSIDERATION

→ In R.A.P. Auditor shall determine → Any Risk ⇒ SIGNIFICANT RISK

↓

Consider

- Risk is a Risk of Fraud
- Risk relate to SIGNIFICANT
  - Economic
  - Accounting
  - Δin Regulatory Environment
- Complexity of transaction
- Risk involves Related Party Transactions
- Degree of subjectivity
- Transactions outside normal Course of Business

## IDENTIFYING SIGNIFICANT RISK

Identifying **Signifi**cant Risk

↓

Higher likelihood of OCCURANCE

\+

Higher magnitude of POTENTIAL MISSTATEMENT

often relate to SIGNIFICANT

- Non-Routine Transactions
  ↓
  Transactions that are
  - Unusual
  - Occur infrequently
- Judgements
  ↓
  Development of Accounting Estimates
  ↓
  for which there is SIGNIFICANT MEASUREMENT UNCERTAINITY

***Notes to Add***

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.

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

***Notes to Add***

## 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 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 interpretation.
- Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

## QUESTIONS

### Multiple Choice Questions (MCQ)

**2.** Which of the following is not a risk to a company's internal control due to its IT environment?

(*a*) Potential loss of data

(*b*) Inability to access data when required

(*c*) Unauthorized access to data

(*d*) Processing of large volumes of data

**Ans.** (*d*)

### Theory Questions

**10.** What is understood by "non-routine" transactions? Briefly outline why risks of material misstatement is greater for such transactions.

**Ans.** Refer to heading on "identifying significant risks".

***Notes to Add***

## EVALUATION OF INTERNAL CONTROL SYSTEM

↓

Indispensable part of overall Audit Program

## BENEFITS OF EVALUATION OF INTERNAL CONTROL TO THE AUDITOR

(i) F / E — likely to be located → ordinary course of business

(ii) Adequate IC — in use / operating as planned

(iii) Effective→Internal Auditing Dept.

(iv) Administrative Control→has a bearing on Auditor's work

(v) Controls→Adequately safeguards assets

(vi) How Mgt. is→Discharging its functions

(vii) Reliability of — Report / Record / Certificates

(viii) Areas→where→controls are weak

***Notes to Add***

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.

The review of internal controls will enable the auditor to know:

(*i*) whether errors and frauds are likely to be located in the ordinary course of operations of the business

(*ii*) whether an adequate internal control system is in use and operating as planned by the management

(*iii*) whether an effective internal auditing department is operating

(*iv*) whether any administrative control has a bearing on his work (for example, if the control over worker recruitment and enrolment is weak, there is a likelihood of dummy names being included in the wages sheet and this is relevant for the auditor)

(*v*) whether the controls adequately safeguard the assets

(*vi*) how far and how adequately the management is discharging its function in so far as correct recording of transactions is concerned

(*vii*) how reliable the reports, records and the certificates to the management can be

(*viii*) the extent and the depth of the examination that he needs to carry out in the different areas of accounting

(*ix*) what would be appropriate audit technique and the audit procedure in the given circumstances

(*x*) what are the areas where control is weak and where it is excessive and

(*xi*) whether some worthwhile suggestions can be given to improve the control system.

**Illustration 9:** Mr. Y, one of the team member of the auditors of What and Where Limited was very keen in knowing whether the internal control of the company would safeguard the company's assets. Advise Mr. Y.

**Solution:** The review of internal controls will enable the auditors to know whether the controls adequately safeguard the assets.

**Illustration 10:** Mr. H, a team member of the auditor of There and Here Limited was of the view that evaluation of internal control of the company would help in identifying the areas where internal control is weak. Advise

**Solution:** The review of internal controls will enable the auditor to know what are the areas where control is weak and where it is excessive.

**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. If he does not care to study this aspect, it is very likely that his audit programme may become unwieldy and unnecessarily heavy and the object of the audit may be altogether lost in the mass of entries and vouchers. It is also important for him to know whether the system is actually in operation. Often, after installation of a system, no proper follow up is there by the management to ensure compliance.

The auditor, in such circumstances, may be led to believe that a system is in operation which in reality may not be altogether in operation or may at best operate only partially. This state of affairs is probably the worst that an auditor may come across and he would be in the midst of confusion, if he does not take care.

It would be better if the auditor can undertake the review of the internal control system of client. This will give him enough time to assimilate the controls and implications and will enable him to be more objective in the framing of the audit programme. 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.

From the foregoing, it can be concluded that the extent and the nature of the audit programme is substantially influenced by the internal control system in operation. In deciding upon a plan of test checking, the existence and operation of internal control system is of great significance. 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.

In a situation where the internal controls are considered weak in some areas, the auditor might choose an auditing procedure or test that otherwise might not be required; he might extend certain tests to cover a large number of transactions or other items than he otherwise would examine and at times he may perform additional tests to bring him the necessary satisfaction.

For example, normally the distribution of wages is not observed by the auditor. But if the internal control over wages is so weak that there exists a possibility of dummy workers being paid, the auditor might include observation of wages distribution in his programme in order to find out the workers who do not turn up for receipt of wages.

On the other hand, if he is satisfied with the internal control on sales and trade receivables, the auditor can get trade receivables' balances confirmed at almost any time reasonably close to the balance sheet date. But if the control is weak, he may feel that he should get the confirmation exactly on the date of the year closing so that he may eliminate the risk of errors and frauds occurring between the intervening period. Also, he may in that situation, decide to have a large coverage of trade receivables by the confirmation procedure.

***Notes to Add***

## EVALUATION OF INTERNAL CONTROL– METHODS

Method of Evaluation of I.C.

- Narrative Record → Complete & Exhaustive description of System → As found in operation by Auditor
- Check List → Series of Instruction & / or questions → Auditing staff must follow
- Questionnaire → Comprehensive series of questions → Concerning I.C.
- Flow Chart → A graphic presentation of each part of Co's System of I.C.

**Disadvantages** (of Narrative Record)

(i) Difficult to Comprehend → System in operation

(ii) Identify – Weakness / Gap – in system

(iii) Incorporate Δs → arising out of → Reshuffeling of Manpower

**Methods of evaluation of internal control**

- Narrative record
- Check list
- Internal Control questionnaire
- Flow Chart

***Notes to Add***

A review of the internal control can be done by a process of study, examination and evaluation of the control system installed by the management. The first step involves determination of the control and procedures laid down by the management. By reading company manuals, studying organisation charts and flow charts and by making suitable enquiries from the officers and employees, the auditor may ascertain the character, scope and efficacy of the control system.

***Notes to Add***

The auditor must ask the right people the right questions if he is to get the information he wants. It would be better if he makes written notes of the relevant information and procedures contained in the manual or ascertained on enquiry. To facilitate the accumulation of the information necessary for the proper review and evaluation of internal controls, the auditor can use one of the following to help him to know and assimilate the system and evaluate the same:

(a) Narrative record
(b) Check List
(c) Internal Control questionnaire and
(d) Flow chart

***Notes to Add***

## NARRATIVE RECORD

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:

(i) To comprehend the system in operation is quite difficult.
(ii) To identify weaknesses or gaps in the system.
(iii) 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 initials the space against the instruction. Answers to the check list 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 check list 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 check list 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. This is the most widely used form for collecting information about the existence, operation and efficiency of internal control in an organisation. 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. The questionnaire form also provides an orderly means of disclosing control defects. It is the general practice to review the internal control system annually and record the review in detail. 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 questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees. If on a perusal of the answers, inconsistencies or apparent incongruities are noticed, the matter is further discussed by auditor's staff with the client's employees for a clear picture. The concerned auditor then prepares a report of deficiencies and recommendations for improvement.

Few illustrative examples of Internal Control Questionnaire in different areas of an entity are given as under:

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

**(A) Purchases**

(1) Are purchases centralised in the Purchase Department?

(2) (a) Are purchases made only from approved suppliers?

(b) Is a list of approved suppliers maintained for this purpose?

(c) Does the master list contain more than one source of supply for all important materials?

(*i*) Are the purchase orders based on valid purchase requisitions duly signed by authorised persons in this behalf?

(*ii*) Are purchases based on competitive quotations from two or more suppliers?

(*iii*) Are purchase orders pre-numbered?

(*iv*) Are purchase orders signed only by employees authorized in this behalf?

(*v*) Are all materials received only in the Receiving Department?

(*vi*) Are persons connected with receipt of materials and the keeping of receiving records denied authority to issue purchase orders or to approve invoices?

(*vii*) Are materials inspected and counted, weighed or measured in the Receiving Department?

(*viii*) Are receipt of materials evidenced by pre-numbered Goods Received Note?

**(B) Creditors**

(1)

(a) Are suppliers' invoices routed direct to the Accounts Department?

(b) Are they entered in a Bill register before submitting them to other departments for check and/or approval?

(c) Are advance and partial payments entered on the invoices before they are submitted to other departments?

(2) Does the system ensure that all invoices are duly processed?

(3) 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?

(4) Does the Accounts Department match the invoices of supplies with Goods Received Notes and purchase orders?

(5) Do all invoices bear evidence of being checked for prices, freight, terms etc.?

(6) Are all advance payments duly authorized by persons competent to authorize such payments?

(7) Are duplicate invoices marked immediately on receipt to avoid payment against them?

(8) Are all supplier's statements compared with ledger accounts?

(9) Is there any follow-up action to investigate difference, if any, between the suppliers' statements and the ledger accounts?

(10) Is a list of unpaid creditors prepared and reconciled periodically?

**(C) 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?

**(D) 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?

**Note:** The Internal Control questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees by giving replies as Yes/No/Not applicable along with explanatory notes, if any.

## FLOW CHART

It is a graphic presentation of each part of the company's system of internal control. A flow chart is considered to be the most concise way of recording the auditor's review of the system. It minimises the amount of narrative explanation and thereby achieves a consideration or presentation not possible in any other form.

It gives bird's eye view of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested. It is also necessary for the auditor to study the significant features of the business carried on by the concern, the nature of its activities and various channels of goods and materials as well as cash, both inward and outward and also a comprehensive study of the entire process of manufacturing, trading and administration. This will help him to understand and evaluate the internal controls in the correct perspective.

**Illustration 11:** In order to evaluate the Internal Control of Your and My Limited, a team member of the auditors used a method according to which, number of questions relating to internal control of the company were required to be answered by the employees of the company. After obtaining the answers there was a discussion relating to those answers between team member of the auditor and employees of the company for a clear picture. State the method of evaluation of internal control as discussed above.

**Solution:** The method of evaluation of internal control used in the above question is known as Internal Control Questionnaire because in questionnaire method, a number of questions relating to internal control of a company are required to be answered by employees of that company and when answers to the questions are obtained, there is a discussion relating to those answers between team members of the auditors and employees of that company for a clear picture.

**Illustration 12:** Healthy and Useful Limited is into small manufacturing as well as trading business. For the purpose of evaluating the internal control of Healthy and Useful Limited, a team member of the auditors of the company used a method according to which the whole description of internal control that was operating in the said company was to be recorded. Identify the method of evaluation of internal control as mentioned above.

**Solution:** The method of evaluation of internal control referred above is known as Narrative Record because in Narrative Record method, a whole description of internal control operating in an entity is recorded. Narrative Record method is also appropriate for small manufacturing as well as trading business as is mentioned in the question above case.

***Notes to Add***

## TESTING OF IC

Testing of I.C. → How far I.C. is actually in operation?

On selective basis

→ ToC are performed → to obtain A.E. → about effectiveness of → operation of I.C. → through the audit

↓

Design of A/c. & I.C. System

↓

i.e. whether they are suitably designed to

P D C

MM

### *Notes to Add*

## TEST OF CONTROLS MAY INCLUDE

(1) Inspection → of Document supporting transactions & other events to gain A.E. → that I.C. has operated properly.

(2) Inquiries + observation → about I.C. → which leaves → No Audit trail

(3) Reperformance → involves the Auditor's Independent execution of

Procedures Controls

That were originally framed

(4) Testing → of I.C. → operating on specified computerized application

OR

over the overall Infor. Technology function

After assimilating the internal control system, the auditor needs to examine whether and how far the same is actually in operation. For this, he resorts to actual testing of the system in operation. This he does on a selective basis: he can plan this testing in such a manner that all the important areas are covered in a period of, say, three years.

Test of controls are performed to obtain audit evidence about the effectiveness of the:

(i) Design of the accounting and internal control system

(ii) Operation of the internal control throughout the period

Test of controls include tests of elements of the control environment where strengths in the control environment are used by auditors to reduce control risk. Some of the procedures performed to obtain the understanding of the accounting and internal control systems may not have been specifically planned as tests of control but may provide audit evidence about the effectiveness of the design and operation of internal controls relevant to certain assertions and, consequently, serve as tests of control. For example, in obtaining the understanding of the accounting and internal control systems pertaining to cash, the auditor may have obtained audit evidence about the effectiveness of the bank reconciliation process through inquiry and observation. When the auditor concludes that procedures performed to obtain the understanding of the accounting and internal control systems also provide audit evidence about the suitability of design and operating effectiveness of policies and procedures relevant to a particular financial statement assertion, the auditor may use that audit evidence, provided it is sufficient to support a control risk assessment at less than a high level.

***Notes to Add***

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- Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised.
- Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.
- Re-performance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.
- Testing of internal control operating on specific computerised applications or over the overall information technology function, for example, access or program change controls.

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.

## QUESTIONS

### Multiple Choice Questions (MCQ)

**3.** Who is responsible for maintaining effective internal financial controls?

(*a*) Statutory auditor (*b*) Audit Committee

(*c*) Management (*d*) Shareholders

**Ans.** (*c*)

### Correct/Incorrect

**State with reasons (in short) whether the following statements are correct or incorrect:**

**11.** Tests of control are performed to obtain audit evidence about the effectiveness of Internal Controls Systems.

**Ans. (Correct)**

Tests of Control are performed to obtain audit evidence about the effectiveness of:

(*a*) the design of the accounting and internal control systems that is whether, they are suitably designed to prevent or detect or correct material misstatements and

(*b*) the operation of the internal controls throughout the period.

**12.** Maintenance of Internal Control System is the responsibility of the Statutory Auditor.

**Ans. (Incorrect)**

The management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of the business. Maintenance of Internal Control System is responsibility of management because the internal control is the process designed, implemented and maintained by those charged with governance/ management to provide reasonable assurance about the achievement of entity's objectives.

**13.** Mr. W, one of the team members of auditor of Different Limited was of the view that understanding the Internal Control of Different Limited will not help in developing an Audit Programme.

**Ans. Incorrect:** Understanding the Internal Control of Different Limited will help in developing an Audit Programme because it will assist the auditor and his team to understand as to how much they can rely on internal control of the company and what audit procedures would be appropriate to be used during the course of audit.

There is direct relationship between materiality and the degree of audit risk.

**14.** Internal control cannot eliminate risk of material misstatements in the financial statements.

**Ans. Correct:** Control risk is a function of the effectiveness of the design, implementation and maintenance of internal control by management. However, internal control can only reduce but not eliminate risks of material misstatement in the financial statements. This is because of the inherent limitations of internal control.

There is possibility of human errors or mistakes, or of controls being circumvented by collusion. Accordingly, some control risk will always exist.

### Theory Questions

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

**Ans.** 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.

**16.** Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. Analyse and explain giving examples.

**Ans.** Obtaining an understanding of the entity and its environment, including the entity's internal control, 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 risks of material misstatement of the financial statements;

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.

**17.** It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Explain with the help of example in respect of the procedure for sales

**Ans.** It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Procedural tests simply mean testing of the compliance with the procedures laid down by the management in respect of initiation, authorisation, recording and documentation of transaction at each stage through which it flows. For example, the procedure for sales requires the following:

1. Before acceptance of any order the position of inventory of the relevant article should be known to ascertain whether the order can be executed in time.
2. An advice under the authorisation of the sales manager should be sent to the party placing the order, internal reference number, and the acceptance of the order. This advice should be prepared on a standardised form and copy thereof should be forwarded to inventory section to enable it to prepare for the execution of the order in time.
3. The credit period allowed to the party should be the normal credit period. For any special credit period a special authorisation of the sales manager would be necessary.
4. The rate at which the order has been accepted and other terms about transport, insurance, etc., should be clearly specified.
5. Before deciding upon the credit period, a reference should be made to the credit section to know the creditworthiness of the party and particularly whether the party has honoured its commitments in the past.

**18.** Briefly discuss the limitations of Internal Control.

**Ans.** (b) 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 judgment in decision-making: Realities that human judgment 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.

**19.** The division of internal control into five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit. Mention those components of internal control.

**Ans.** Division of Internal Control into Components: 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:

(*i*) The control environment;

(*ii*) The entity's risk assessment process;

(*iii*) Monitoring of controls.

(*iv*) Control activities; and

(*v*) The information system, including the related business processes, relevant to financial reporting, and communication;

**20.** Explain the matters which should be included for factors relevant to the auditors' judgement about whether a control is relevant to the audit.

**Ans.** Controls Relevant to the Audit: 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:

(*i*) Materiality.

(*ii*) The significance of the related risk.

(*iii*) The size of the entity.

(*iv*) The nature of the entity's business, including its organisation and ownership characteristics.

(*v*) The diversity and complexity of the entity's operations.

(*vi*) Applicable legal and regulatory requirements.

(*vii*) The circumstances and the applicable component of internal control.

(*viii*) The nature and complexity of the systems that are part of the entity's internal control, including the use of service organisations.

(*ix*) Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

**21.** Saburi Textile Ltd is an established player in the textile manufacturing sector. It has developed strong internal controls in almost every area. It has appointed you as an Internal Audit team head. Internal audit has a very strong relation with internal control of the company. Internal Audit analyses the effectiveness with which the internal control of the company is operating and also makes suggestions for improvement in that internal control. Explain stating clearly activities relating to Internal Control.

**Ans.** 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 activities Relating to Internal Control:

(*i*) Evaluation of internal control: The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.

(*ii*) Examination of financial and operating information: The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.

(*iii*) Review of operating activities: The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including nonfinancial activities of an entity.

(*vi*) Review of compliance with laws and regulations: The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

Internal audit has a very strong relation with internal control of a company. Internal Audit analyzes the effectiveness with which the internal control of a company is operating and also makes suggestions for improvement in that internal control.

**22.** Z Ltd. is a manufacturer of ready-made garments. During the year 2021-22, they have opened two new branches and there is a substantial increase in their sales. The management has appointed CA R to review the internal control system of the company as they feel that there are lapses in the control environment of the company. What is included in the control environment and what will the auditor evaluate in order obtain an understanding of the control environment?

**Ans.** Control Environment:

The control environment includes:

(*i*) the governance and management functions and

(*ii*) the attitudes, awareness, and actions of those charged with governance and management.

(*iii*) the control environment sets the tone of an organization, influencing the control consciousness of its people.

The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

(*a*) Management has created and maintained a culture of honesty and ethical behavior; and

(*b*) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

**23.** ABC Ltd. has many divisions and branches across the country. They have an internal control system which is well established maintained by the management on a regular basis. Explain the meaning of internal control as per SA-315 and also state the benefits of understanding the internal controls of a company.

**Ans.** Meaning and benefits of understanding 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 designed, implemented and maintained by those charged with governance, management and other personnel 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." 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.

**24.** Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. Explain stating clearly the objectives of Internal Control.

**Ans.** Objectives of Internal Control: 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 of such controls 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 financial statement 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 financial statement audit.

Objectives of Internal Control are:

(*i*) transactions are executed in accordance with managements general or specific authorization;

(*ii*) all transactions are promptly recorded in the correct amount in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;

(*iii*) assets are safeguarded from unauthorised access, use or disposition; and

(*iv*) the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

**25.** Define Monitoring of Controls and in respect of monitoring of controls, answer the following questions:

(*i*) How monitoring of controls would be helpful in assessing the effectiveness of controls?

(*ii*) How can management accomplish monitoring of controls?

(*iii*) What is included in the Management's monitoring activities?

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

(*i*) 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.

(*ii*) 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 & include regular management and supervisory activities.

(*iii*) 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.

**26.** The review of internal controls will enable the auditor to know the areas where control is weak. Explain stating clearly the benefits of evaluation of internal control to the auditor.

**Ans.** Benefits of Evaluation of Internal Control to the Auditor The review of internal controls will enable the auditor to know:

(*i*) whether errors and frauds are likely to be located in the ordinary course of operations of the business;

(*ii*) whether an adequate internal control system is in use and operating as planned by the management;

(*iii*) whether an effective internal auditing department is operating;

(*iv*) whether any administrative control has a bearing on his work (for example, if the control over worker recruitment and enrolment is weak, there is a likelihood of dummy names being included in the wages sheet and this is relevant for the auditor);

(*v*) whether the controls adequately safeguard the assets;

(*vi*) how far and how adequately the management is discharging its function in so far as correct recording of transactions is concerned;

(*vii*) how reliable the reports, records and the certificates to the management can be;

(*viii*) the extent and the depth of the examination that he needs to carry out in the different areas of accounting;

(*ix*) what would be appropriate audit technique and the audit procedure in the given circumstances;

(*x*) what are the areas where control is weak and where it is excessive; and

(*xi*) whether some worthwhile suggestions can be given to improve the control system.

**27.** Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. Explain stating clearly the objectives of Internal Control.

**Ans.** Objectives of Internal Control 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 of such controls 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 financial statement 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 financial statement audit.

Objectives of Internal Control are :

(*i*) transactions are executed in accordance with managements general or specific authorization;

(*ii*) all transactions are promptly recorded in the correct amount in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;

(*iii*) assets are safeguarded from unauthorised access, use or disposition; and

(*iv*) the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

**28.** It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Explain with the help of example in respect of the procedure for sales.

**Ans.** It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Procedural tests simply mean testing of the compliance with the procedures laid down by the management in respect of initiation, authorisation, recording and documentation of transaction at each stage through which it flows.

For example, the procedure for sales requires the following:

1. Before acceptance of any order the position of inventory of the relevant article should be known to ascertain whether the order can be executed in time.
2. An advice under the authorisation of the sales manager should be sent to the party placing the order, internal reference number, and the acceptance of the order. This advice should be prepared on a standardised form and copy thereof should be forwarded to inventory section to enable it to prepare for the execution of the order in time.
3. The credit period allowed to the party should be the normal credit period. For any special credit period a special authorisation of the sales manager would be necessary.
4. The rate at which the order has been accepted and other terms about transport, insurance, etc., should be clearly specified.
5. Before deciding upon the credit period, a reference should be made to the credit section to know the creditworthiness of the party and particularly whether the party has honoured its commitments in the past.

**29.** Generally, IT benefits an entity's internal control by enabling an entity to enhance the timeliness, availability, and accuracy of information. Discuss explaining the other relevant points in the above context.

**Ans.** Generally, IT benefits an entity's internal control by enabling an entity to:

(*i*) Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;

(*ii*) Enhance the timeliness, availability, and accuracy of information;

(*iii*) Facilitate the additional analysis of information;

(*iv*) Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;

(*v*) Reduce the risk that controls will be circumvented; and

(*vi*) Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

***Notes to Add***

## WHAT IS AN AUTOMATED ENVIRONMENT

**A Business Environment**

Where

Process | Operation | Accounting | Decisions

Are carried out

↓

Using computer system

↓

Also known as

Information System | Info Technology System

## KEY FEATURES OF AUTOMATED ENVIRONMENT

Key Features

(1) Enables faster business operations
(2) Accuracy in → Data Processing → Computation
(3) Better → Security → Control
(4) Less prone to human errors
(5) Provides Latest info.
(6) Ability to process large volume of transactions
(7) Connectivity → Networking → Capabilities

## UNDERSTANDING AND DOCUMENTING AUTOMATED ENVIRONMENT

(1) Info system being used (One/more application system + What they are)
(2) Their purpose (Financial or Non-Financial)
(3) Location of IT system (Local V/s Global)
(4) Architecture (Desktop Based, Cloud Based, Client – Server Based)
(5) Version (Functions & Risks could vary in different versions)
(6) Interfaces with systems (in case of multiple → Entries → Exits)
(7) In house v/s packaged
(8) Outsourced Activities
(9) Key Persons (CIO)

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. Nowadays, it is very common to see computer systems being used in almost every type of business.

***Notes to Add***

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. Key features of an automated environment are as under:

- Enables faster business operation
- Accuracy in data processing and computation
- Ability to process large volume of transactions
- Integration amongst business operations
- Better security and controls
- Less prone to human errors Provides latest information
- Connectivity and networking capability

If a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered more complex to audit. On the other hand, if a company is using an off-the-shelf accounting software, then it is likely to be less automated and hence less complex environment.

In an audit of financial statements, an auditor is required to understand the entity and its business, including IT. Understanding the entity and its automated environment involves understanding how IT department is organised, IT activities, the IT dependencies, relevant risks and controls. 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.

## RISKS ARISING FROM USE OF IT SYSTEMS

(1) Inaccurate processing of data, processing in accurate data, or both
(2) Unauthorized access to data
(3) Direct Data Δs
(4) Excessive Access / Privileged (Super Users)
(5) Lack of Adequate Segregation of Duties
(6) Unauthorized Δs to → Systems → Programs
(7) Lose of Data

***Notes to Add***

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.

## QUESTIONS

### Theory Questions

**32.** Briefly mention three reasons why IT should be considered relevant to an audit of financial statements.

**Ans.** The auditor should consider relevance of IT in an audit of financial statements for the following reasons:

(*a*) Since auditors rely on the reports and information generated by IT systems, there could be risk in the IT systems that could have an impact on audit.

(*b*) Standards on auditing SA 315 and SA 330 require auditors to understand, assess and respond to risks that arise from the use of IT systems.

(*c*) By relying on automated controls and using data analytics in an audit, it is possible to increase the effectiveness and efficiency of the audit process.

**33.** In an audit of financial statements, the auditor should plan response to all IT risks.

**Ans. Incorrect:** The auditor should plan response to those IT risks that are relevant to financial reporting and not "all" IT risks.

**34.** When a business operates in a more automated environment, we are likely to see several business functions and activities happening within the systems. List down the business functions and activities happening within the systems.

**Ans.** Relevance of Information Technology in an Audit: When a business operates in a more automated environment it is likely that we will see several business functions and activities happening within the systems.

Consider the following aspects instead of:

(*i*) Computation and Calculations are automatically carried out (for example, bank interest computation and inventory valuation).

(*ii*) Accounting entries are posted automatically (for example, sub-ledger to GL postings is automatic).

**35.** The auditor should understand and consider the risks that may arise from the use of Information Technology (IT) Systems.

**Ans.** 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

**36.** When the company is working in an automated environment, it is not necessary for its auditor to understand its automated environment and depends upon the professional judgement of the auditor as to whether gaining knowledge of company's IT systems is required or not. Do you agree with this statement?

**Ans.** Understanding and Documenting Automated Environment: When a business operates in a more automated environment it is likely that auditor will see several business functions and activities happening within the systems.

Consider the following aspects instead of:

(*i*) Computation and Calculations are automatically carried out (for example, bank interest computation and inventory valuation).

(*ii*) Accounting entries are posted automatically (for example, sub-ledger to GL postings is automatic).

(*iii*) Business policies and procedures, including internal controls, are applied automatically (for example, delegation of authority for journal approvals, customer credit limit checks are performed automatically).

(*iv*) Reports used in business are produced from systems. Management and other stakeholders rely on these reports and information produced (for example, debtors ageing report).

(*v*) User access and security are controlled by assigning system roles to users (for example, segregation of duties can be enforced effectively).

Companies derive benefit from the use of IT systems as an enabler to support various business operations and activities. Auditors need to understand the relevance of these IT systems to an audit of financial statements.

While it is true that the use of IT systems and automation benefit the business by making operations more accurate, reliable, effective and efficient, such systems also introduce certain new risks, including IT specific risks, which need to be considered, assessed and addressed by management.

To the extent that it is relevant to an audit of financial statements, even auditors are required to understand, assess and respond to such risks that arise from the use of IT systems.

From the above discussion, it is quite apparent that it is necessary for an auditor to understand the automated environment.

### Alternative Solution

Understanding and Documenting Automated Environment: In an audit of financial statements, an auditor is required to understand the entity and its business, including IT as per SA 315. Understanding the entity and its automated environment involves understanding how IT department is organised, IT activities, the IT dependencies, relevant risks and controls.

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

(*i*) Information systems being used (one or more application systems and what they are).

(*ii*) Their purpose (financial and non-financial).

(*iii*) Location of IT systems - local vs global.

(*iv*) Architecture (desktop based, client-server, web application, cloud based).

(*v*) Version (functions and risks could vary in different versions of same application).

(*vi*) Interfaces within systems (in case multiple systems exist).

(*vii*) In-house vs Packaged.

(*viii*) Outsourced activities (IT maintenance and support).

(*ix*) Key persons (CIO, CISO, Administrators).

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

From the above discussion, it is quite apparent that it is necessary for an auditor to understand the automated environment.

***Notes to Add***

## IMPACT OF IT RELATED RISKS

(1) Substantive Audit

- (a) Cannot rely on data Obtained from system
- (b) System → Data → Reports → Should be tested substantively for more → Completeness → Accuracy

(2) Controls

- (a) Cannot relay on automated controls, system calculations & A/c.ing procedures
- (b) More substantive Audit work is needed

(3) Reporting

- (a) Communication to TCWG
- (b) Modified Audit Report

***Notes to Add***

The above risks have to be mitigated. If not mitigated, such risks, could have an impact on audit in different ways discussed as under:

### Impact on substantive checking

Inability to address above discussed risks may lead to non-reliance of data obtained from systems. In such a case, all information, data, and reports would have to be tested thoroughly for their completeness and accuracy. It could lead to increased substantive checking i.e., detailed checking.

### Impact on controls

It can lead to non-reliance on automated controls, system calculations and accounting procedures built into applications. It may result in additional audit work.

### Impact on reporting

Due to regulatory requirements in respect of internal financial controls (discussed in subsequent paras) in case of companies, it may lead to modification of auditor's report in some instances.

***Notes to Add***

## TYPES OF CONTROLS IN AN AUTOMATED ENVIRONMENT

- General IT Controls
- Application Controls
- IT Dependent Control

(Known as pervasive controls or Indirect Controls)

**General IT Controls**

(1) P & P → that relates to many → Applications + Support effective function of Application controls

(2) They apply to → Main frames → Mini frames

(3) General IT controls that → Maintain integrity of info → Security of Data → Commonly includes controls over

- Data Centre & Network Operations
- Program Δs
- Access Security
- Application System
  - Acquisition
  - Development
  - Maintenance

**Application Controls**

(1) Include → Automated → Manual → Controls → that operate at Business process level

(2) Automated controls are embedded into IT applications via ERPs

+

Help in ensuring — Completeness / Accuracy / Integrity — of those system

**IT Dependent Controls**

(1) Basically → Manual Controls → That make use of some form of — Data / Info. / Report — Produced from — IT Sys. / Applications

(2) Even though → Controls are performed manually → The → Design → Effectiveness → of such controls → Depends upon → The reliability of Source of Data

(3) Due to Internet dependency on IT → The → Effectiveness → Reliability → of

- Automation
- IT Dependent

Controls

Requires General IT Controls to be Effective

Controls in an automated environment can be categorized as under:

(a) General IT controls
(b) Application controls
(c) IT-dependent controls

**General IT controls** are policies and procedures that relate to many applications and support the effective functioning of application controls. 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 (Business Applications)

These are IT controls generally implemented to mitigate the IT specific risks and applied commonly across multiple IT systems, applications and business processes. Hence, General IT controls are known as "pervasive" controls or "indirect" controls.

**(a) 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.

**(b) 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 etc.

**(c) 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 etc.

**(d) 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 etc.

## QUESTIONS

### Multiple choice Questions (MCQ)

**5.** Which of the following is not an example of "General IT controls"?

(*a*) Controls pertaining to Disaster recovery plan
(*b*) Controls pertaining to batch preparation
(*c*) Controls pertaining to data security
(*d*) Controls pertaining to validation of input data in an application

**Ans.** (*d*)

**Correct/Incorrect**

**State with reasons (in short) whether the following statements are correct or incorrect:**

**37.** General IT controls support the functioning of Application controls.

**Ans. Correct:** General IT controls support the functioning of automated application controls and IT dependent controls.

**Theory Questions**

**38. Explain** the objective and enlist the activities involved in the General IT Controls over "Program Change".

**Ans.** Program Change

**Objective:** To ensure that modified systems continue to meet financial reporting objectives.

**Activities:**

Change Management Process – definition, roles & responsibilities

Change Requests – record, manage, track

Making Changes – analyze, design, develop

Test Changes – test plan, test cases, UAT

Apply Changes in Production

Emergency & Minor Changes

Documentation – user/technical manuals

User Training

**39.** In an automated environment, General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. One such area is access security. What is the objective of access security and what are the activities included in it?

**Ans.** Access Security in Automated Environment:

Objective of access security: The objective of Access Security is to ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives.

**Activities:**

(*i*) Security Organization & Management

(*ii*) Security Policies & Procedures

(*iii*) Application Security

(*iv*) Data Security

(*v*) Operating System Security

(*vi*) Network Security – internal network, perimeter network

(*vii*) Physical Security – access controls, environment controls

(*viii*) System Administration & Privileged Accounts – Sysadmins, DBAs, Super users

***Notes to Add***

## GENERAL IT ROLS VS. APPLICATION CONTROLS

- These 2 category of controls over IT system → Interrelated
- The relationship between them is such that
  - General IT controls are needed to support the functioning of application controls
  - Both are needed to ensure complete & accurate info. Processing through IT System

## TESTING METHODS IN AN AUTOMATED ENVIRONMENT

**Testing Methods**

- Inquiry + Reperformance + Inspection + Observation
- Inquiry → Most **efficient** → But gives least A.E.
  - To be used in combination of — Reperformance, Inspection, Observation
  - ↓ Alone not **sufficient**
- Reperformance → most effective + gives Best A.E. → But → Time Consuming → Least **Efficient**
- Inspection → Most Eff. & Eff. A.E. → But → Which → When → What → Test to use
  - \+ Inquiry
  - Test to use — Is a matter of professional Judgement ↓ Depends up on
    - Risk Assessment
    - Control Env.
    - Desired Level of A.E. required
    - History of Errors / Mistakes
    - Complexity of Business
    - Assertions being addressed?
- Auditor should document the Test + Judgement Applied (SA 230)

**Most Common Method of Testing**

(1) Obtain Understanding → of how an Automated Transaction is processed
- By doing → Reperformance → Using
  - Inquiry
  - Observation
  - Inspection

(2) Observe → How user processes transaction → under different scenarios

(3) Inspect → the configurations defined in application

### 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 viz., 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. 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.

- 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.

Having learnt about the various IT risks and controls, let us understand the different ways testing is performed in an automated environment. There are basically four types of audit tests that should be used. These 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. However, 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. The auditor should document the nature of test (or combination of tests) applied along with the judgements in the audit file.

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.

Where the general IT controls are not existing or existing but ineffective, the auditor should assess the impact of IT risks and complexity of the automated environment in which the business operations take place and plan alternative audit procedures in order to rely on the system-based information.

## QUESTIONS

### Correct/Incorrect

State with reasons whether the following statements are correct or incorrect:

**40.** In an automated environment, the relationship between the application controls and the General IT controls over IT systems are not interrelated.

**Ans. Incorrect:** 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. These two categories of control over IT systems are interrelated.

**41.** Discuss relationship between "General IT controls" and "application controls" in an automated environment.

**Ans.** Refer to heading on "General IT controls vs. Application controls".

**42.** Describe how risks in IT systems, if not mitigated, could have an impact on audit.

**Ans.** When risks in IT systems are not mitigated the audit impact could be as follows:

(*a*) The auditor may not be able rely on the reports, data obtained, automated controls, calculations and accounting procedures in the IT system.

(*b*) The auditor has to perform additional audit work by spending more time and efforts.

(*c*) The auditor may have to issue a modified opinion, if necessary. Program Change

**43.** Inquiry is often the most efficient audit testing method, but least effective.

**Ans. Correct:** Inquiry is the most efficient but least effective. Moreover, testing through inquiry alone is not sufficient. Inquiry should be corroborated by applying any one or a combination of observation, inspection or reperformance.

**44.** Generally, applying inquiry in combination with re performance as audit testing method gives the most effective and efficient audit evidence

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

### Theory Questions

**45.** What are the different testing methods used when auditing in an automated environment. Which is the most effective and efficient method of testing?

**Ans.** When auditing in an automated environment, the following testing methods are used:

(*a*) Inquiry

(*b*) Observation

(*c*) Inspection

(*d*) Reperformance

A combination of inquiry and inspection is generally the most effective and efficient testing method. However, determining the most effective and efficient testing method is a matter of professional judgement and depends on the several factors including risk assessment, control environment, desired level of evidence required, history of errors/misstatements, complexity of business, assertions being addressed.

### *Notes to Add*

## CHARACTERISTICS OF MANUAL & AUTOMATED ELEMENTS OF IC RELEVANT TO AUDITOR'S RISK ASSESSMENT

→ An entity's system of I.C. → contains — Manual / Automated — elements

→ Use of — Manual / Automated — Elements in I.C. → Affects the manner

↓

in which transactions are

- I
- R
- P
- R

→ Controls in Manual

(1) Procedures
- Approval
- Review
- Reconciliations
- Follow up

(2) May use Automated Procedures → Electronic format

↓

Replaces paper document

- I
- R
- P
- R

→ Controls in IT System

(1) Combination of — Automated / Manual — Controls

(2) Manual Controls → May be
- → Independent of IT
- → use Info. produced by IT
- → limited to monitoring
- → Handling exceptions

***Notes to Add***

An entity's system of internal control contains manual elements and often contains automated elements. The characteristics of manual or automated elements are relevant to the auditor's risk assessment and further audit procedures based thereon. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported:

(a) Controls in a manual system may include such procedures as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace paper documents.

(b) Controls in IT systems consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions.

***Notes to Add***

## MANUAL ELEMENT VS. AUTOMATED ELEMENT

→ Manual → More Suitable — Judgement / Discretion — Required

↓

**Example**

- **Transaction** ↓ **Large Unusual Non-Recurring**
- **Circumstances** ↓ **Errors are dificult to**
  - Define
  - **Anticipate**
  - **Predict**
- **Δ Circumstances** ↓ **Required a controlled response**
- **Monitoring** ↓ **Effectiveness of Automated Control**

→ Less Reliable than Automated

- Easily
  - Bypassed
  - Ignored
  - Overridden
- More prone to simple
  - Error
  - Mistake

Consistency cannot → be assumed

→ Less suitable
- High volume / Recurring transaction
- Where specific way to perform

***Notes to Add***

Manual elements in internal control may be more suitable where judgment and discretion are required such as for the following circumstances:

- Large, unusual or non-recurring transactions.
- Circumstances where errors are difficult to define, anticipate or predict.
- In changing circumstances that require a control response outside the scope of an existing automated control.
- In monitoring the effectiveness of automated controls.

Manual elements in internal control may be less reliable than automated elements because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed. Manual control elements may be less suitable for the following circumstances:

- 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.

The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. The entity responds to the risks arising from the use of IT or from use of manual elements in internal control by establishing effective controls in light of the characteristics of the entity's information system.

***Notes to Add***

## AUDIT APPROACH IN AN AUTOMATED ENVIRONMENT

| Risk Assessment | Understand and Evaluate | Test for Operating Effectiveness | Reporting |
|---|---|---|---|
| • Identify significant accounts and disclosures<br>• Qualitative and Quantitative considerations<br>• Relevant Financial Statement Assertions (FSA)<br>• Identify likely sources of misstatement<br>• Consider risk arising from use of IT systems | • Document understanding of business processes using Flowcharts/ Narratives<br>• Prepare Risk and Control Matrices (RCM)<br>• Understand design of controls by performing walkthroughts of end-to-end process<br>• Process wide considerations for Entity Level Controls, Segregation of Duties<br>• IT General Controls, Application Controls | • Assess Nature, Timing and Extent (NTE) of controls testing<br>• Assess reliability of source data; completeness of population<br>• Testing of key reports and spreadsheets<br>• Sample testing<br>• Consider competence and independence of staff/team performing controls testing. | • Evaluate Control Deficiencies<br>• Significant deficiencies, Material Weaknesses<br>• Remediation of control weaknesses<br>• Internal Controls Memo (ICM) or Management Letter<br>• Auditor's report |

***Notes to Add***

## DATA ANALYTICS FOR AUDIT

Combination of — Processes / Tools / Techniques — That are used to tap

↓

vast amount of

↓

Electronic Data

↓

To obtain meaningful information

↓

DATA ANALYTICS

→ Tools / Techniques — that Auditor uses → CAATs

***Notes to Add***

In today's digital age when companies rely on more and more on IT systems and networks to operate business, the amount of data and information that exists in these systems is enormous. 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. While it is true that companies can benefit immensely from the use of data analytics in terms of increased profitability, better customer service, gaining competitive advantage, more efficient operations, etc., even 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. 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
- Fraud investigation.
- Evaluating impact of control deficiencies.

## QUESTIONS

### Theory Questions

**46.** A company functions in an automated environment. Discuss in what areas data analytics can be useful for auditor of the company.

**Ans.** Refer to heading on "data analytics"

***Notes to Add***

## DIGITAL AUDIT

Entities
- Embracing Digitisation
- New Technologies
- Business model restructured
- Automation

Auditors → use Digital Technology → Planning to Final opinion

## IFC AS PER REGULATORY REQUIREMENTS

**Internal Financial Controls (IFC) as per Regulatory Requirements**

↓

**Defined** u/s **134 (5)(e) of the companies Act, 2013**

↓

**P&P → Placed by Co. for ensuring**

- **Reliability of Financial Reporting**
- **Compliance with app. → Laws → Regulations**
- **Eff. & Eff. of Operations**
- **Safeguarding of Assets**
- **P & D of Fraud**

Requirements of :

| Ack./Rule | Section/Rule | Responsibility | Applicability |
|---|---|---|---|
| The companies Act, 2013 | Sec.134(5)(e) | B.O.D. | Check – Ch.4 |
| | Sec.149(8) & Schedule IV | Independent Director (I.D) | All Companies having I.D. |
| | Sec.177 | Audit Committee (A.C.) | All Companies Having A.C. |
| | Sec.143(3)(i) | Statutory Auditor | All Companies |
| The Companies (Accounts Rules, 2014 | Rule 8(5) (viii) | BOD | All Companies |

***Notes to Add***

Entities are embracing digitization as part of their operations to keep pace with changing times. New technologies are helping companies revamp their operations and rethink the way business is conducted. Companies are restructuring their business models driven by technology. 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.

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

The Companies Act, 2013 has placed a greater emphasis on the effective implementation and reporting on the internal controls for a company. The term "internal financial controls" is used at some places in Companies Act, 2013 casting responsibilities as under:

| 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.<br>This requirement shall not apply to a private company which –<br>(i) is One Person Company or a small company; or<br>(ii) has turnover less than ₹50 crore as per latest audited Financial Statements; 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.

## QUESTIONS

### Theory Questions

**47.** The auditor's responsibility includes reporting on Internal Financial Controls over Financial Reporting which includes an understanding IT environment of the company and relevant risks and controls. Mention the situations where IT will be relevant to an audit.

**Ans.** With the introduction of the Companies Act 2013, there is greater emphasis given to internal financial controls (IFC) from a regulatory point of view. Directors and those charged with governance (including Board of directors, Audit committee) are responsible for the implementation of internal controls framework within the company. The auditors' responsibilities now include reporting on Internal Financial Controls over Financial Reporting which include and understanding IT environment of the company and relevant risks & controls.

Following are some situations in which IT will be relevant to an audit:

(*i*) Increased use of Systems and Application software in Business (for example, use of ERPs)

(*ii*) Complexity of transactions has increased (multiple systems, network of systems)

(*iii*) Hi-tech nature of business (Telecom, e-Commerce).

(*iv*) Volume of transactions are high (Insurance, Banking, Railways ticketing).

(*v*) Company Policy (Compliance).

(*vi*) Regulatory requirements - Companies Act 2013 IFC, IT Act 2008.

(*vii*) Required by Indian and International Standards - ISO, PCI-DSS, SA 315, SOC, ISAE

(*viii*) Increases efficiency and effectiveness of audit.

**48.** Which are specific risks to the company's internal control having IT environment?

**Ans.** IT poses specific risks to the Company's internal control, which include-

(*i*) Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.

(*ii*) Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or nonexistent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.

(*iii*) The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.

(*iv*) Unauthorised changes to data in master files.

(*v*) Unauthorised changes to systems or programs.

(*vi*) Failure to make necessary changes to systems or programs. Inappropriate manual intervention.

(*vii*) Potential loss of data or inability to access data as required.

**49.** Explain the meaning of Internal Financial Controls clearly stating reporting requirement (with reference to audit) on adequacy of internal financial controls. Also discuss about its (reporting requirement on adequacy of internal financial controls) applicability on various types of Companies.

**Ans.** Explanation given in Clause (e) of Sub-section 5 of Section 134 explains the meaning of internal financial controls as, "the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information."

From the above definition, it is clear that internal financial controls are the policies and procedures adopted by the company for:

(1) ensuring the orderly and efficient conduct of its business, including adherence to company's policies,
(2) the safeguarding of its assets,
(3) the prevention and detection of frauds and errors,
(4) the accuracy and completeness of the accounting records, and
(5) the timely preparation of reliable financial information."

Section 143 (3) (i) of the Act requires an auditor to report whether the company has adequate internal financial controls with reference to financial statements in place and the operating effectiveness of such controls.

However, it may be noted that the reporting requirement on adequacy of internal financial controls (IFCs) with reference to financial statements shall not be applicable to a private company which is a:

(*i*) One person company; or
(*ii*) Small company; or
(*iii*) Company having turnover less than ₹50 crore as per latest audited financial statement and having aggregate borrowings from banks or financial institutions or anybody corporate at any point of time during the financial year less than ₹25 crore.

## DOCUMENTING THE RISKS

→Auditor→ Document

- Discussion
  ↓
  Engagement Team
  +
  Significant Decision
- Key Elements
  - Entity
  - Env.
    +
    Sources of Info. + R.A.P
  - I.C.
- Identified / Assessed — RoMM
  - FS
  - Assertion
  Level
- Identified Risk
  +
  Related Control

## ASSESS AND REPORT AUDIT FINDINGS

At Audit Conclusion →Assess + Report → Findings / Exceptions ← At
↓
IT — Environment, Control

↓
Consider

- Weaknesses
- Impact of weakness
- Deficiencies
- Communicate in writing

* Deficiency in I.C.→Control — Unable / Missing — P / D / C — MM

***Notes to Add***

The auditor shall document:

(a) The discussion among the engagement team and the significant decisions reached

(b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment and of each of the internal control components, the sources of information from which the understanding was obtained; and the risk assessment procedures performed

(c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level and

(d) The risks identified, and related controls about which the auditor has obtained an understanding.

***Notes to Add***

At the conclusion of each audit, it is possible that there will be certain findings or exceptions in IT environment and IT controls of the company that need to be assessed and reported to relevant stakeholders including management and those charged with governance viz., Board of directors, Audit committee.

**Some points to consider are as follows:**

- Are there any weaknesses in IT controls?
- What is the impact of these weaknesses on overall audit?
- Report deficiencies to management – Internal controls memo or Management letter.
- Communicate in writing any significant deficiencies to those Charged with governance.

The auditor needs to assess each finding or exception to determine impact on the audit and evaluate if the exception results in a deficiency in internal control.

A deficiency in internal control exists if 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 the control is missing. Evaluation and assessment of audit findings and control deficiencies involves applying professional judgement that include considerations for quantitative and qualitative measures. Each finding should be looked at individually and in the aggregate by combining with other findings/deficiencies.

***Notes to Add***

## QUESTIONS

### Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

**50.** During the assessment of Internal Controls, if the auditor can test Compensating controls, he should obtain evidence of other mitigating factors.

**Ans. Incorrect:** If the auditor can test Compensating controls , he should obtain additional evidence that may be required.

Obtaining evidence of other mitigating factors is required when he can't test compensating controls during his assessment of the Internal Controls.

**51.** As per section 138 of the Companies Act, 2013 private companies are not required to appoint internal auditor.

**Ans. Correct:** Section 138 of the Companies Act, 2013 requires every private company to appoint an internal auditor having turnover of ₹200 crore or more during the preceding financial year; or outstanding loans or borrowings from banks or public financial institutions exceeding ₹100 crore or more at any point of time during the preceding financial year.

### Theory Questions

**52.** Sweet Fruits Private Limited had a turnover of ₹155 crore for the financial year 2019-20. Explain whether during the financial year 2020-21, Sweet Fruits Private Limited would be required or not required to appoint an internal auditor, keeping in view the provisions of Companies Act, 2013.

**Ans.** During the financial year 2020-21, Sweet Fruits Private Limited would not be required to appoint an internal auditor because according to Section 138 of the Companies Act, 2013 every private company having a turnover of more than or equal to ₹ 200 crore during the preceding financial year is required to appoint an internal auditor.

It is given in the question that Sweet Fruits Private Limited during the financial year 2018-19 had a turnover of ₹155 crore which is less than ₹200 crore. Therefore, during the financial year 2020-21, Sweet Fruits Private Limited will not be required to appoint an internal auditor.

**53.** Internal audit not only analyses the effectiveness with which the internal control of a company is operating but also improves the effectiveness of internal control. Elucidate the statement.

**Ans.** Improvement in Effectiveness of Internal Control: Internal Audit means "An independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system".

**Activities Relating to Internal Control:**

(*i*) Evaluation of internal control: The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.

(*ii*) Examination of financial and operating information: The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.

(*iii*) Review of operating activities: The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non-financial activities of an entity.

(*iv*) Review of compliance with laws and regulations: The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

Therefore, one of the important aspects of internal audit is not only to evaluate internal control system of an organization but also to suggest improvements for adding value and strengthening it.

**54.** List any five points that an auditor should consider to obtain an understanding of the Company's automated environment.

**Ans.** Understanding of the Company's Automated Environment: 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)

## AUDITOR'S RESPONSE TO ASSESSED RISK

SA 330 → Auditor's Responsibility — Design / Implement — F.A.P

↓

Objective → obtain Suff + Appro A.E.

F.A.P ↑ Responses ↓ To Risks

- Identified
- Assessed

SA 315

*** Designing → FAP → Auditor shall**

- **Consider Reason for given Assessment**
  - **Likelyhood of MM (Inherent Risk)**
  - **Risk Assessment takes into Account** ↓ **Relevant Controls (control Risk)**
- **Obtain more Persuasive A.E.**

**Auditor's responses to assessed risks**

- **Tests of Controls**
- **Substantive Procedures**
  - **Tests of Details**
    - **Tests of transactions i.e. vouching**
    - **Tests of balances i.e. verification**
  - **Substantive analytical procedures**

* Auditor — Design / Perform — ToC → to obtain → Suff + Appro A.E.

↓

OPERATING EFFECTIVENESS OF RELEVANTCONTROLS

↓

when

- Auditor's Assessment of ROMM ↓ At Assertion Level ↓ Includes an EXPECTATION ↓ Controls are operating Effectively
- SAP alone CANNOT provide ↓ Suff. + Appro. A.E. ↓ At Assertion Level

SA 330 The auditor's responses to assessed risks deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with SA 315, "Identifying and Assessing Risks of Material Misstatement Through Understanding the Entity and Its Environment" in a financial statement audit. The objective of the auditor is to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

**SA 330 states that:**

(a) The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level.

(b) 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:**

(a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:

  (*i*) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (i.e., the inherent risk); and

  (*ii*) Whether the risk assessment takes into account the relevant controls (i.e., the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and

(b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk.

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) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or 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.

***Notes to Add***

## NATURE (N) & EXTENT (E) OF TOC

↓

In designing & Performing ToC → Auditor Shall

- Perform
  - Other Audit Procedure + Inquiry
  - To obtain A.E. about operating Effectiveness of Control
  - ↓
  - Including
    - How Controls were applied
    - Consistently
    - By whom & What means
- Determine whether the control to be tested
  - ↓
  - Depends upon other controls
  - ↓
  - If so, necessary to obtain A.E.
  - ↓
  - Supporting the operating effectiveness of such controls

***Notes to Add***

## T OF TOC

Timing (T) of ToC

Auditor shall test conrols for → Particular Time → Throughout the period

↓

Which the Auditor intends to rely on those 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.

When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls.

**Matters the auditor may consider in determining the extent of test of controls include the following:**

- The frequency of the performance of the control by the entity during the
- period.
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- The expected rate of deviation from a control.
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.
- The extent to which audit evidence is obtained from tests of other controls related to the assertion.

The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls 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.

***Notes to Add***

## USING A.E. OBTAINED IN THE PREVIOUS AUDIT

In determining whether → It is appropriate to use A.E. → about operating effectiveness of controls → Obtained in the previous Audit → Length of time period that may elapse before retesting the controls

**The Auditor may consider the following points:**

(1) The effectiveness of other elements of I.C.

- Control Environment
- Entity's Monitoring of Control
- Entity's R.A.P.

(2) The risk arising from → Characteristics of control → Manual → Automated

(3) The effectiveness of → General IT Controls

(4) The effectiviness of Control + its application by entity

+

N.E. of deviation in application → Noted in previous audit

+

Whether any personel Δs → That significantly affect application of control

(5) Whether lack of Δs in particular control → Poses a risk Δs → Due to Δing circumstances

(6) The RoMM & the extent of reliance on control

## EVALUATING THE OPERATING EFFECTIVENESS OF CONTROL

Auditor should evaluate → whether Misstatement → detected by substantive procedure

↓

Indicate that control are not operating effectively → Absence of Misstatements → Does not provide A.E. → That control are effective

## SPECIFIC INQUIRIES WHEN DEVIATION FROM CONTROLS ARE DETECTED

Auditor to make specific Inquiries to understand the matter

+

Potential consequences

+

Determining

- ToC provide appropriate basis for reliance on control
- Additional ToC necessary
- Potential RoMM needs to be addressed using Substantive procedure

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.

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.

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:

(a) The test of controls that have been performed provide an appropriate basis for reliance on the controls

(b) Additional test of controls are necessary or

(c) The potential risks of misstatement need to be addressed using 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.

**This requirement reflects the facts that:**

(*i*) the auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement and

(*ii*) there are inherent limitations to internal control, including management override.

Substantive procedures are audit procedures designed to detect material misstatements at the assertion level. Substantive procedures comprise: (i) Tests of details (of classes of transactions, account balances, and disclosures), and (ii) Substantive analytical procedures.

## TESTS OF DETAILS

An audit procedure → designed to detect MM → At assertion Level

- ToD
  - CoT
  - A/c. Balance
  - Presentation & Disclosure
- Substantive Analytical Procedure (SAP)

## SUBSTANTIVE ANALYTICAL PROCEDURES

**Analytical Procedure** → consists of → Evaluation of Finaincial Info.

- Also encompasses
  - Investigation of Identified Fluctuations
  - Relationships that are in consistent with other financial info. OR Deviate significantly from predicted amount
- Made by a study of plausible relationship
  - Among
    - Financial
    - Non-Financial

    DATA

## NATURE AND EXTENT OF SUBSTANTIVE PROCEDURES

(1) It reflects that → Auditor may not identify all RoMM → There are inhervent limitations to I.C. including Mgt. Override

(2) Auditor may determine

   (*i*) SAP will be sufficient

   (*ii*) Only ToD will be appropriate

   (*iii*) Combination of (*i*) & (*ii*)

(3) SAP are generally more applicable → To Large volume of transactions

↓

That tends to be predictable over time

(4) The Nature of → Risk → Assertion → is relevant to design ToD

(5) Because of Assessment of RoMM → Takes account of I.C.

↓

Extent of substantive procedures may need to be increased

↓

When the result from ToC are unsatisfactory

(6) In designing ToD → the extent of Testing → is ordinarily thought of → In terms of sample size

Tests of details are further classified into tests of transactions i.e., vouching and tests of balances i.e., verification.

For example, a purchase transaction may be verified by examining the related purchase invoice, goods received note, inward gate entry register. Such tests of transactions help in establishing the authenticity of transactions recorded in books of accounts.

Tests of balances consist of verification of assets as well as liabilities. Verification of an item of fixed asset, for example, would help in establishing existence of that asset as on date of balance sheet. This may be obtained by reviewing entity's plan for performing physical verification of fixed assets and obtaining evidence for performance of physical verification of fixed assets by management.

Substantive analytical procedures refer to analytical procedures used as substantive procedures by auditor. The term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass 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.

The use of widely recognised ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

Analytical procedures involving, for example, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details.

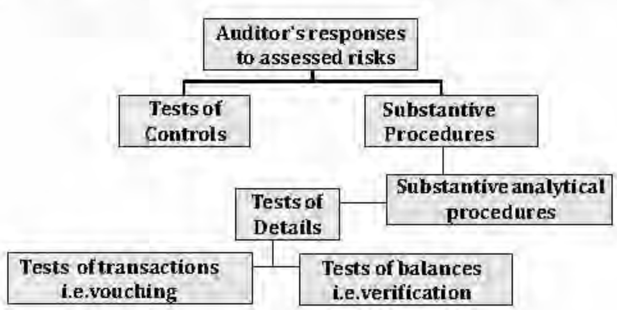
Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.

Depending on the circumstances, the auditor may determine that:

- 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.
- Only tests of details are appropriate.
- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

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.



**Test Your Understanding**

**9.** Zomba Products Private limited is a small company. The control systems in the company are rudimentary. How, you as an auditor of the company, would proceed to evaluate internal control of the company?

**Ans.** In a small company, control systems are basic and not formalized. Therefore, auditor should proceed to evaluate internal control using narrative record.

**10.** A Chartered accountant during course of audit of a company finds that cash is not deposited into bank frequently although concerned staff of company was required to do so. Further, the official responsible for ensuring performance of above function, has also not paid any attention to it. Discuss what does it represent from auditor's perspective.

**Ans.** Cash is not deposited into bank frequently, although, concerned staff of company was required to do so. Further, the official responsible for ensuring performance of above function, has also not paid any attention to it. It means that control is not working as planned. It would not be able to prevent misstatement and very purpose of control is defeated. It represents a "control deficiency".

## CASE STUDY 1

CA Paritosh is auditor of a company. The financial statements of the company have just been received for audit. Following issues have been flagged pertaining to the financial statements of the company for purpose of risk assessment:

- The revenue of company has fallen from ₹ 50 crore in last year to ₹ 5 crore in current year (for which financial statements have been received for audit) due to lack of demand in the market for company's products.
- Due to advent of new products in the market, company's products are fast becoming outdated.
- A large customer having an outstanding balance of ₹ 5 crore has failed to pay to the company despite efforts made by the company.
- Inventory holding period has increased from 30 days in last year to 90 days.
- The company also gets carried out job operations from third parties. Therefore, parts of inventories are lying with third parties.

***Notes to Add***

## QUESTIONS

### Theory Questions

**Based on above, answer the following questions:**

**55.** Regarding drastic fall in revenue of the company, which of the following is an audit risk?

(*a*) Fall in revenue would result in fall of profits for the company.

(*b*) Drastic fall in revenue may imply that company is not able to carry out its operations in foreseeable future due to lack of demand in the market for company's products. There is a risk that going concern disclosure is omitted to be made in financial statements.

(*c*) The company can explore some new line of activity, if demand of its products is falling.

(*d*) Fall in revenue would mean lower tax liabilities for the company.

**Ans.** (*b*)

**56.** The company's products are getting outdated in the market. Which of the following is an audit risk?

(*a*) The company should devise strategies to sell products in the market

(*b*) Inventories may be understated in such a scenario

(*c*) Inventories may be overstated in such a scenario

(*d*) The company should launch a 1+1 free offer for its customers

**Ans.** (*c*)

**57.** A large customer has failed to pay to the company. Identify audit risk from below:

(*a*) Receivables may be misstated if irrecoverable debt is not written off

(*b*) Receivables may be overstated if irrecoverable debt is not written off

(*c*) Writing off irrecoverable debt would impact profits of company adversely

(*d*) Failure to recover outstanding debt would impact cash flows of company adversely

**Ans.** (*b*)

**58.** Identify audit risk involved when inventory holding period has increased from 30 days to 90 days.

(*a*) There is a risk of overstatement of inventories

(*b*) There is a risk relating to existence of inventories

(*c*) There is a risk that slow movement of stocks would increase tax liability when GST rates are increased

(*d*) There is a risk relating to holding and storage cost of inventories

**Ans.** (*a*)

**59.** Part of inventories are lying with third parties. Identify audit risk involved.

(*a*) There is a risk that third parties do not manufacture according to specifications of the company

(*b*) There is a risk that by getting job work done from third parties, company is increasing its costs

(*c*) There is a risk that sufficient and appropriate evidence would not be available in respect of quantity and condition of inventories lying with third parties

(*d*) There is a risk that sufficient and appropriate evidence would not be available for quality control in respect of inventories lying with third parties

**Ans.** (*c*)

## CASE STUDY 2

CA Piyush is understanding internal controls as part of audit exercise of a company.

It is a new client. He has studied controls in place in various operational areas of the company. After studying and gaining an understanding of such controls, he has decided to test few controls to actually see whether these are operating as intended by the management.

Till now, he has studied controls over inventories and bank. Few of such controls are listed below:

| Nature of Control | Control description |
|---|---|
| Control over inventories | Inventories of the company lying at each location should be insured. |
| Control over inventories | There should be inventory counts on a regular basis for each location of the company. |
| Control over Bank operations | Bank reconciliations are to be performed at regular intervals. |

### Theory Questions

**Based on above, answer the following questions:**

**60.** Which of the following most appropriately describes test of control regarding insurance of inventories?

(*a*) Inspect insurance policies to verify that inventories at each location are insured for fire & burglary. The sum insured & period of validity of policy are not relevant.

(*b*) Inspect insurance policies to verify that inventories at each location are comprehensively insured. Ensure adequacy of sum insured by comparing it with value of inventories. Also ensure policy period has not expired.

(*c*) Inspect insurance policies to verify that inventories at each location are comprehensively insured. Ensure policy period has not expired.

(*d*) Inspect insurance policies to verify that inventories at each location are insured for fire and burglary. Ensure policy period has not expired.

**Ans.** (*b*)

**61.** Which of the following most appropriately describes test of control regarding inventory counts?

(*a*) Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure.

(*b*) Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure. Attend inventory count.

(*c*) Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure. Attend inventory count and perform test count.

(*d*) Attend inventory count and perform test count.

**Ans.** (*c*)

**62.** While testing control over bank reconciliations, it has been noticed that bank reconciliations are not being performed at regular intervals. Identify the most appropriate description of "control deficiency" in this regard:

(*a*) Bank reconciliations are not being performed regularly as concerned staff is overburdened.

(*b*) Bank reconciliations are not being performed regularly as concerned staff is overburdened. It could result in errors.

(*c*) Bank reconciliations are not being performed regularly as concerned staff is overburdened. It could result in errors. It may result in misstatement of cash and bank balance in financial statements.

(*d*) Bank reconciliations are not being performed regularly as concerned staff is overburdened. These should be performed monthly and reviewed by senior accountant.

**Ans.** (*c*)

**63.** Since the company is a new client, which of the following statements is most appropriate?

(*a*) There is reduced detection risk.

(*b*) There is increased detection risk.

(*c*) There is no effect on detection risk.

(*d*) Detection risk should be increased to lower audit risk.

**Ans.** (*b*)

**64.** Which of the following statements is most appropriate regarding auditor's response to assessed risk of a new client?

(*a*) More substantive procedures would require to be performed

(*b*) Less substantive procedures would require to be performed

(*c*) There is no effect on substantive procedures

(*d*) There is no effect on substantive procedures as audit risk is low

**Ans.** (*a*)

❑❑❑

# 4 CHAPTER Audit Evidence

| S. No. | Sub Topics | Easy | Moderate | Hard |
|---|---|---|---|---|
| 01. | Meaning of Audit Evidence | | | |
| 02. | Types of Audit Evidence | | | |
| 03. | Relevance and Reliability of audit evidence | | | |
| 04. | Sufficient appropriate audit evidence | | | |
| 05. | Source of audit evidence | | | |
| 06. | Audit procedures for obtaining audit evidence | | | |
| 07. | Assertions | | | |
| 08. | Audit Trail | | | |
| 09. | Information to Be Used as Audit Evidence | | | |
| 10. | Selecting Items for Testing to Obtain Audit Evidence | | | |
| 11. | Inconsistency in or Doubts over Reliability of Audit Evidence | | | |
| 12. | Relying on the work of a management's expert | | | |
| 13. | Evaluation of Audit Evidence | | | |
| 14. | Using the work of Internal Auditors (SA 610) | | | |
| 15. | Definition of Internal Audit Function | | | |
| 16. | Ways in which the external auditor may make use of | | | |
| 17. | Scope of SA 610 | | | |
| 18. | External Auditor's Responsibility for the audit | | | |
| 19. | Objectives of the external auditor, where the entity has an internal audit function | | | |
| 20. | Evaluating the Internal Audit Function | | | |
| 21. | Circumstances When Work of the Internal Audit Function Cannot Be Used | | | |
| 22. | Determining the Nature and Extent of Work of the Internal Audit Function that Can Be Used | | | |
| 23. | Circumstances in which the external auditor shall plan to use less of the work of the Internal audit function and perform more of the work directly | | | |

| | | | | |
|---|---|---|---|---|
| 24. | Using the Work of the Internal Audit Function | | | |
| 25. | Determining Whether, in Which Areas, and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance | | | |
| 26. | Basics of Internal Financial Control and Reporting Requirements | | | |
| 27. | AUDIT SAMPLING (SA 530) | | | |
| 28. | Sampling: An Audit Procedure | | | |
| 29. | Meaning of Audit Sampling | | | |
| 30. | Population | | | |
| 31. | Sampling Unit | | | |
| 32. | Approaches to Sampling | | | |
| 33. | Sampling Vs Traditional method of Auditing | | | |
| 34. | Appropriateness of Sampling Approaches | | | |
| 35. | Sampling Process | | | |
| 36. | Sample Design, Size and Selection of Items for Testing | | | |
| 37. | Performing Audit Procedures | | | |
| 38. | Nature and Cause of Deviations and Misstatements | | | |
| 39. | Projecting Misstatements | | | |
| 40. | Evaluating Results of Audit Sampling | | | |
| 41. | Audit Evidence -Specific Considerations for Selected Items (SA 501) | | | |
| 42. | Meaning of Audit Evidence- Specific Considerations for Selected Items | | | |
| 43. | Objective of the Auditor in respect of Specific Considerations for Selected Items | | | |
| 44. | Inventory | | | |
| 45. | Attendance at Physical Inventory Counting | | | |
| 46. | Matters Relevant in Planning Attendance at Physical Inventory Counting | | | |
| 47. | Physical Inventory Counting Conducted other than at the Date of the Financial Statements | | | |
| 48. | If the auditor unable to Attend Physical Inventory Counting due to Unforeseen Circumstances | | | |
| 49. | Attendance at Physical Inventory Counting becomes impractical | | | |
| 50. | When inventory under the custody and control of a third party- What will the auditor do? | | | |
| 51. | Litigation and Claims | | | |

| | | | | |
|---|---|---|---|---|
| 52. | If the Auditor Assesses a Risk of Material Misstatement regarding Litigation or Claims - Communication with the Entity's External Legal Counsel | | | |
| 53. | Segment Information | | | |
| 54. | Obtaining sufficient appropriate audit evidence regarding the presentation and disclosure of segment information | | | |
| 55. | Auditor's responsibility regarding the presentation and disclosure of segment information | | | |
| 56. | Understanding of the Methods Used by Management | | | |
| 57. | External Confirmations (SA 505) | | | |
| 58. | Scope of this SA | | | |
| 59. | Definition of External Confirmation | | | |
| 60. | Definitions of other terms | | | |
| 61. | External Confirmation Procedures adopted by the Auditor to Obtain Audit Evidence | | | |
| 62. | Management's refusal to allow the auditor to send a confirmation request-steps taken by the Auditor | | | |
| 63. | Negative Confirmations | | | |
| 64. | Evaluating the Evidence Obtained | | | |
| 65. | Initial Audit Engagements - Opening Balances (SA 510) | | | |
| 66. | Scope of this SA | | | |
| 67. | Definitions | | | |
| 68. | Objective of Auditor with respect to Opening Balances– in conducting an Initial Audit Engagement | | | |
| 69. | Obtaining sufficient appropriate Audit evidence about opening balances by the Auditor | | | |
| 70. | Procedures adopted by the Auditor to Obtain Audit Evidence regarding opening balances | | | |
| 71. | Consistency of Accounting Policies relating to opening balances | | | |
| 72. | Reporting by the auditor with regard to opening balances | | | |
| 73. | Related Parties (SA 550) | | | |
| 74. | Scope of this SA | | | |
| 75. | Definition of Related Party | | | |
| 76. | Meaning of control and significant influence in reference to related party | | | |
| 77. | Meaning of Related Parties with Dominant Influence | | | |
| 78. | Meaning of Special-Purpose Entities as Related Parties | | | |
| 79. | Nature of Related Party Relationships and Transactions | | | |

| | | | | |
|---|---|---|---|---|
| 80. | Understanding the Entity's Related Party Relationships & Transactions | | | |
| 81. | Considerations specific to smaller entities by the auditor | | | |
| 82. | Analytical Procedures (SA520) | | | |
| 83. | Meaning of Analytical Procedures | | | |
| 84. | Scope of SA 520 | | | |
| 85. | Purpose and timing of Analytical Procedures | | | |
| 86. | Substantive Analytical Procedures | | | |
| 87. | Factors to be considered for Substantive Audit Procedures | | | |
| 88. | Techniques available as Substantive Analytical Procedures | | | |
| 89. | Analytical Procedures used as Substantive Tests | | | |
| 90. | Suitability of particular analytical procedures for given assertions | | | |
| 91. | The reliability of DATA | | | |
| 92. | Evaluation of whether the expectation is sufficiently | | | |
| 93. | Amount of difference of recorded amounts from expected values that is acceptable | | | |
| 94. | Investigating results of Analytical Procedures | | | |
| 95. | Analytical procedures that assist when forming an overall conclusion | | | |

***Notes to Add***

## OVERVIEW

- **Audit Evidence**
  - By using work of Internal Auditors
  - By audit sampling
  - By specific considerations of selected Items
  - By external confirmations
  - By checking opening balances
  - By checking related parties transactions
  - By analytical procedures

- **Audit Sampling (SA 530)**
  - Meaning of audit sampling
  - Approaches to audit sampling
  - Sample design, size and selection of items for testing
  - Performing audit procedures
  - Nature and cause of deviations and misstatements
  - Projecting misstatements
  - Evaluating results of audit sampling

- **Analytical Procedures**
  - Meaning
  - Reliance on Analytical Procedures
  - Purpose & Timing
  - Investigating the Results
  - Substantive Analytical Procedures

***Notes to Add***

"Audit evidence" is the very core on the basis of which conclusions are drawn and opinion is formed by an auditor. In fact, it is the foundation upon which edifice of auditing is built. On a Sunday evening, Sameer was interacting with one of his friends, Shekhar, who had joined articleship and was part of an engagement team conducting audit of a company engaged in manufacturing activities. He got to know that Shekhar was part of team attending physical count process of inventories of the company as at year end. Besides, he was also responsible for going through sales of the company, checking few sales invoices and tracing those entries in books.

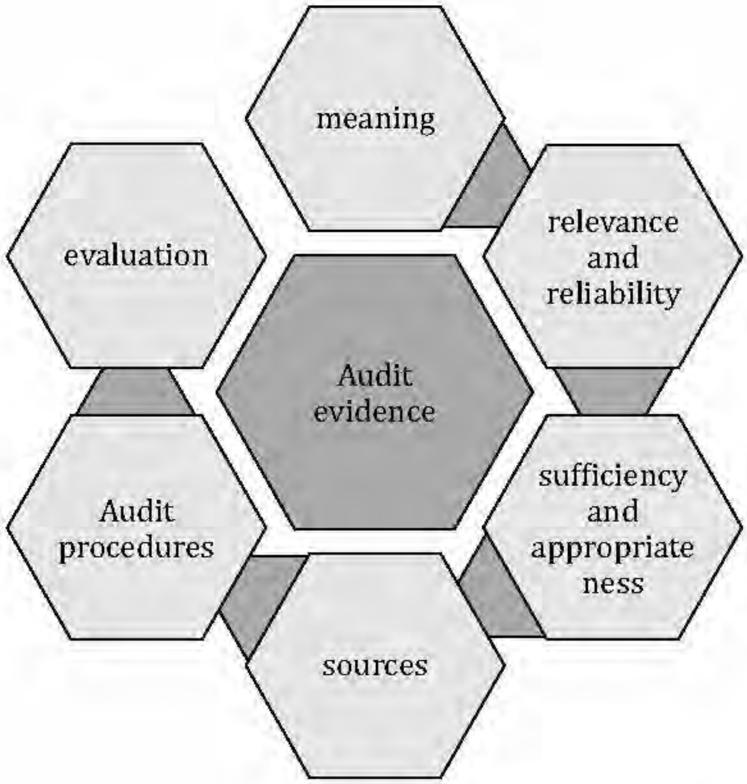
After some days, both of them had a chance to meet again. Informal conversations between them drifted towards audit of that company. Sameer was visibly excited to know that his friend was helping seniors in designing and sending confirmation requests to the entities to whom this company had sold goods. "Such a process must be providing sufficient appropriate evidence for the purpose of audit"- He murmured in between.

He had an inkling that evidence should provide satisfaction to the auditor. What are the contours of it? Whether a piece of evidence coming from outside the company can only provide comfort to the auditor? What about company's internal documents and records? Aren't these also pieces of information which form part of audit evidence? His inquisitiveness was prompting him to know whether audit evidence has only to be in writing. Or can it take some other forms? Whether evidence in other forms can suffice for purpose of audit?

Besides, he was also trying to understand about nuances of inventory counting process which had cropped up in their previous discussion. Such procedures help auditor to obtain audit evidence. He precisely wanted to understand what such procedures are called as. Are there other procedures also?

He also recalled his earlier discussion where Shekhar had told him regarding his responsibility of checking "few sales invoices". How the team would have arrived at the decision to check those sample invoices? Are some methods or techniques involved in it? How does team ensure that items being selected for checking are truly representative? Recapitulating that choosing of inappropriate sampling methods can lead to increase in detection risk and consequent rise in audit risk, significance of selecting appropriate samples was not lost on him.

***Notes to Add***


meaning
relevance and reliability
sufficiency and appropriate ness
sources
Audit procedures
evaluation
Audit evidence

***Notes to Add***

## INTRODUCTION

Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively.

Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs. An opinion founded on a rather reckless and negligent examination and evaluation may expose the auditor to legal action with consequential loss of professional standing and prestige.

He needs evidence to obtain information for arriving at his judgement.

In accordance with SA 500, the objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to draw reasonable conclusions on which to base the auditor's opinion.

***Notes to Add***

## AUDIT EVIDENCE

Auditing → Logical Process

* Auditor → Assess the Actualities / Review A/cs / Give Expert Opinion — Not possible

↓

Unless

↓

F.S. → Examined → Objectively

Connote

Critical Examination | Scrutiny

A/c. Statements

↓

To assess

Critical Examination | Scrutiny

A/c. Statements

How for FS present | FS present

↓ | ↓

Actual State of Affairs | True & Fair view

* SA 500 → Objective of the Auditor — Design / Perform — Audit Procedures

↓

As to enable the Auditor

↓

To obtain

Critical Examination | Scrutiny

A/c. Statements

How for FS present | FS present

↓ | ↓

Actual State of Affairs | True & Fair view

* SA 500 → Objective of the Auditor — Design / Perform — Audit Procedures

↓

As to enable the Auditor

↓

To obtain

Suff. | Appro.

A.E.

↓

To draw Reasonable Conclusion

↓

To base the Auditor's Opinion

*Notes to Add*

## MEANING OF AUDIT EVIDENCE AS PER SA 500

**Audit Evidence (A.E.)**

Info. Used by the Auditor → In arriving at conclusion → on which → Auditor's opinion is based

- Contained in the Records
- Other Info. (Member of Meetings. Written Confirmation, etc.)

***Notes to Add***

**Meaning of Audit Evidence as per SA 500**

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

**Illustration 1:** The auditor of JPJ Limited explained to the audit team members about the relationship between Audit Evidence and Opinion of Auditor. Explain what relationship exists between Audit Evidence and Opinion of Auditor.

**Solution:** There exists a very important relationship between Audit Evidence and 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 financial statements of that company.

**Explaining this further, audit evidence includes:**

(1) Information contained in the accounting records

**Accounting records include**

- the records of initial accounting entries and supporting records, such as cheques and records of electronic fund transfers;
- invoices;
- contracts;
- the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and
- records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

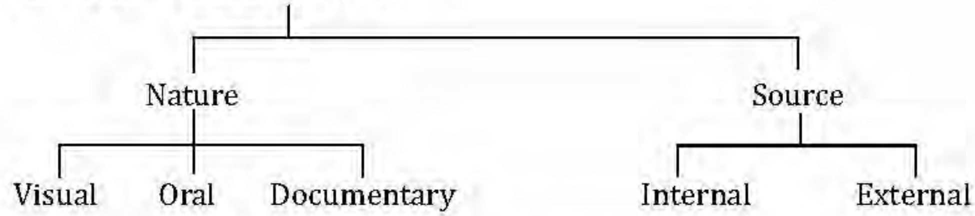
(2) Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements Other information which the auditor may use as audit evidence includes, for example

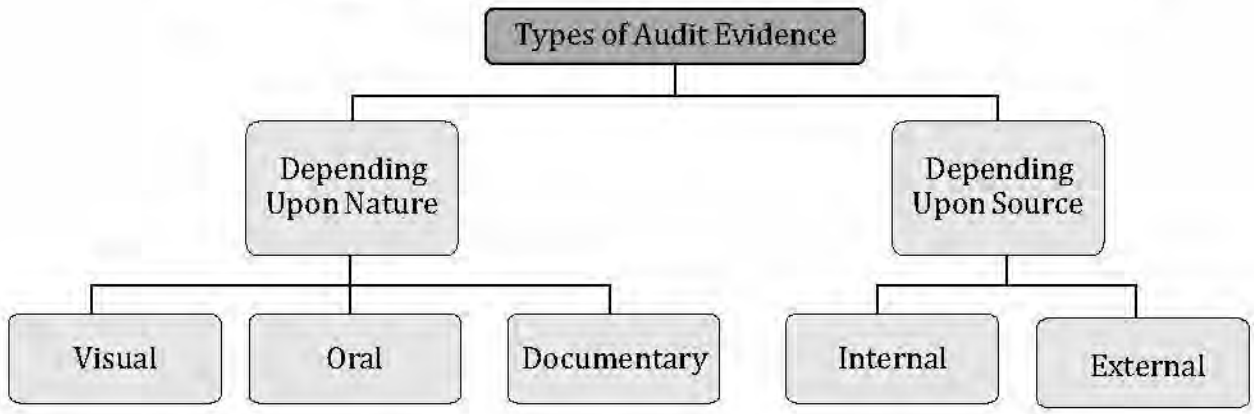
- minutes of the meetings,
- written confirmations from trade receivables and trade payables,
- manuals containing details of internal control etc.

***Notes to Add***

## ■ TYPES OF AUDIT EVIDENCE

**Types of AE → Depends up on**




***Notes to Add***

**(a) Depending upon nature:**

(1) Visual: For example, observing physical verification of inventory conducted by the client's staff.

(2) Oral: For example, discussion with the management and various officers of the client.

(3) Documentary: For example, fixed deposit certificate, loan agreement, sales bill, etc.

**(b) Depending upon source:**

(1) Internal Evidence: Evidence which originates within the organisation being audited is internal evidence.

**Example:** Sales invoice, Copies of sales challan and forwarding notes, goods received note, inspection report, copies of cash memo, debit and credit notes, etc.

(2) External evidence: The evidence that originates outside the client's organization is external evidence.

**Example:** Purchase invoice, supplier's challan and forwarding note, debit notes and credit notes coming from parties, quotations, confirmations, etc.

In an audit situation, the bulk of evidence that an auditor gets is internal in nature. However, substantial external evidence is also available to the auditor. Since in the origination of internal evidence, the client and his staff have the control, the auditor should be careful in putting reliance on such evidence. It is not suggested that they are to be suspected; but an auditor has to be alive to the possibilities of manipulation and creation of false and misleading evidence to suit the client or his staff.

The external evidence is generally considered to be more reliable as they come from third parties who are not normally interested in manipulation of the accounting information of others. However, if the auditor has any reason to doubt the independence of any third party who has provided any material evidence e.g. an invoice of an associated concern, he should exercise greater vigilance in that matter.

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

**Illustration 2:** An audit team member of the auditors of Genuine Limited was of the view that audit evidence obtained internally from within the company under audit are more appropriate from the reliability point of view as compared to audit evidence obtained externally as evidence obtained internally are obtained from the company whose audit is being conducted.

Give your views as auditor of Genuine Limited.

**Solution:** Audit evidence obtained externally is more appropriate from reliability point of view as compared to those which are obtained internally. The reason that audit evidence obtained externally is more appropriate from the point of view of reliability is that there is a very low risk that they can be altered or changed.

***Notes to Add***

........................................................................................................................................

........................................................................................................................................

## RELEVANCE AND RELIABILITY OF AUDIT EVIDENCE

Quality of an Audit → Affected by

- Relevance
  - ↓ Logical Connection
    - Purpose of Audit Procedures
    - Assertions under considerations
  - Affected by
  - ↓ DIRECTION OF TESTING
- Reliability Influenced by
  - Source
  - Nature
  - Circumstances
  - Controls
    - Preparation
    - Maintenance

## RELEVANT AE IN DESIGNING

- ToC
  - ↓ Identifying
    - Conditions
    - Characteristics
    - Attributes
  - Indicate
    - Performance
    - Deviation
  - of a control
- Substantive Procedure
  - ↓ Identifying
  - ↓ Conditions
  - ↓ Relevant to the PURPOSE OF THE TEST
  - ↓ that constitute MM

***Notes to Add***

The auditor has to express opinion on the truth and fairness on the financial statements. He shall consider the relevance and reliability of the information to be used as audit evidence.

The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based.

Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing.

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, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant.

Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing.

**Example:** If the purpose of an audit procedure is to test for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure.

On the other hand, when testing for understatement in the existence or valuation of accounts payable, testing the recorded accounts payable would not be relevant, but testing such information as subsequent disbursements, unpaid invoices, suppliers' statements, and unmatched receiving reports may be relevant.

A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others. For example, inspection of documents related to the collection of receivables after the period end may provide audit evidence regarding existence and valuation, but not necessarily cut-off. Similarly, obtaining audit evidence regarding a particular assertion, for example, the existence of inventory, is not a substitute for obtaining audit evidence regarding another assertion, for example, the valuation of that inventory. On the other hand, audit evidence from different sources or of a different nature may often be relevant to the same assertion.

Tests of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. Designing tests of controls to obtain relevant audit evidence includes identifying conditions (characteristics or attributes) that indicate performance of a control, and deviation in conditions which indicate departures from adequate performance. The presence or absence of those conditions can then be tested by the auditor.

Substantive procedures are designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures. Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.

## RELIABILITY

Information to be used as audit evidence should be reliable.

Reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant.

Therefore, 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:

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

***Notes to Add***

**Reliability of Audit Evidence**

Increases when

- Obtained from Independent Sources
- Related Control are Effective
- Obtained directly by the auditor
- Obtained in documentary form
- Provided by Original Documents

## SUFFICIENCY AND APPROPRIATENESS ARE INTERRELATED

**Sufficiency** ← Inter Related → Appropriateness

- **Sufficiency** ↓ Measure of Quantity ↓ Affected by Auditor's assessment
  - RoMM ↓ Higher Risk More A.E. required
  - Quality of A.E ↓ Higher Quality Less A.E. required
- **Appropriateness** ↓ Measure of Quality
  - Relevance
  - Reliability
    - Source
    - Nature
    - Circumstances

## OBTAINING SUFFICIENT AND APPROPRIATE AUDIT EVIDENCE BY THE AUDITOR

A.E.→ necessary to support→ Auditor's → Opinion / Report

↓

(1) Cumulative in Nature

(2) Primarily Obtained→ Audit Proudures

- Inquiry
- Inspection
- Observation
- Recalculation
- RePerformance
- External **Confirmation**
- Analytical Procedures

(3) Alsoinclude info → previous audit / Other sources (Inside / Outside) / A/c Records

(4) Prepared → using work of → Mgt. Expert

(5) Could → Support / Contradict ← Mgt's Assertions

(6) Absence of info. = A.E.

The auditor has to obtain sufficient appropriate audit evidence to draw reasonable conclusions on financial statements.

***Notes to Add***

The sufficiency and appropriateness of audit evidence are interrelated.

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)

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. The reliability of evidence is influenced by its source and nature, and is dependent on the individual circumstances under which it is obtained.

| | |
|---|---|
| **Sufficiency** | measure of quantity of audit evidence |
| **Appropriateness** | measure of quality of audit evidence |

***Notes to Add***

## FURTHER, AUDITOR'S JUDGEMENT AS TO SUFFICIENCY MAY BE AFFECTED BY THE FACTORS SUCH AS:

Auditor's Judgement as to sufficiency may be affected by

- Materiality ↓ **Signif**icance of
  - COT
  - A/c. Balance
  - Disclosure & Presentation
  - To user of F.S
    - Less A.E. Required ↓ Assertions are less material to the user of F.S. & Vice Versa
- RoMM ↓ Risk that the F.S. are MM
  - Prior to Audit ↓ Consists of Components ↓ Described @ Assertion Level
    - Inherent Risk
    - Control Risk
- Size & Characteristic of population ↓ No. of items included in the population ↓ Less A.E. required in case of smaller, More homogenous population but not vice versa

***Notes to Add***

The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient and appropriate audit evidence.

Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is 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. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence.

Also, information that may be used as audit evidence may have been prepared using the work of a management's expert.

Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions.

In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. The auditor uses various audit procedures to obtain audit evidence such as inspection, observation, confirmation, recalculation, reperformance and analytical procedures, often in some combination, in addition to inquiry.

Reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level.

SA 330 requires the auditor 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.

SA 200 contains discussion of such matters as the nature of audit procedures, the timeliness of financial reporting, and the balance between benefit and cost, which are relevant factors when the auditor exercises professional judgment regarding whether sufficient appropriate audit evidence has been obtained.

**Illustration 3:** There was a Partnership Firm of Chartered Accountants VM and Associates. Mr. M, one of the partners of VM and Associates, while explaining to his audit team members about importance of audit evidence informed them about sufficiency and appropriateness of audit evidence. Mr. A, one of the members of audit team of VM and Associates was of the view that sufficiency of audit evidence means simplicity of audit evidence and appropriateness of audit evidence means ease of obtaining audit evidence. Explain whether sufficiency and appropriateness of audit evidence mean simplicity and ease of obtaining audit evidence.

**Solution:** Sufficiency and Appropriateness of audit evidence does not mean simplicity and ease of obtaining audit evidence rather sufficiency of audit evidence is related to the quantity of audit evidence and appropriateness of audit evidence is related to quality of audit evidence.

***Notes to Add***

## QUESTIONS

### Theory Questions

**1.** Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Explain

**Ans. Audit evidence is necessary to support the auditor's opinion and report.** It is cumulative in nature and is 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. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared using the work of a management's expert. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, re- performance and analytical procedures, often in some combination, in addition to inquiry. 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.

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 (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. The sufficiency and appropriateness of audit evidence are interrelated.

***Notes to Add***

## FURTHER, AUDITOR'S JUDGEMENT AS TO SUFFICIENCY MAY BE AFFECTED BY THE FACTORS SUCH AS

**Factors affecting auditor's judgement as to sufficiency of audit evidence**

- Materiality
- Risk of Material Misstatement
- Size & characteristics of the population

***Notes to Add***

(a) 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.

(b) Risk of material misstatement: It may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components described as follows at the assertion level:

- Inherent risk: The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls.
- Control risk: The risk that a misstatement that could occur in an assertion that could be material will not be prevented or detected and corrected on a timely basis by the entity's internal control.

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.

(c) Size & characteristics 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.

**Theory Questions**

**2.** What is meant by sufficiency of Audit Evidence? Explain the factors affecting the auditor's judgement as to the sufficiency of audit evidence.

**Ans.** 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.

Following are the factors affecting the auditor's judgement as to the sufficiency of audit evidence:

(a) 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.

(b) Risk of material misstatement: It may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components described as follows at the assertion level:

- Inherent risk: The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls.
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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.

(c) 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.

**Correct/Incorrect**

**State with reasons (in short) whether the following statements are correct or incorrect:**

**3.** Inquiry alone is sufficient to test the operating effectiveness of controls.

**Ans. (Incorrect)**

Inquiry along with other audit procedures (for example observation, inspection, external confirmation etc.) would only enable the auditor to test the operating effectiveness of controls. Inquiry alone is not sufficient to test the operating effectiveness of controls.

**4.** Sufficiency is the measure of the quality of audit evidence.

**Ans. (Incorrect)**

Sufficiency is the measure of the quantity of audit evidence. On the other hand, appropriateness is the measure of the quality of audit evidence.

**5.** Purchase invoice is an example of internal evidence.

**Ans. (Incorrect)**

Internal evidence is the evidence that originates within the client's organisation. Since purchase invoice originates outside the client's organisation, therefore, it is an example of external evidence.

***Notes to Add***

## SOURCE OF AUDIT EVIDENCE

Some A.E. → Obtained by → Audit Procedures → A/c. Records

↓

Auditor Determine

↓

A/c. Records
- Internally Consistent
- Agree to F.S.

More Assurance → Consistent A.E. → Different
- Source
- Nature

***Notes to Add***

## AUDIT PROCEDURES FOR OBTAINING AUDIT EVIDENCE

A.E.→ Obtained by performing
- R.A.P
- F.A.P
  - ToC
  - Substantive Procedure
    - ToD
    - SAP

***Notes to Add***

**Source of audit evidence**

Some audit evidence is obtained by performing audit procedures to test the accounting records.

**Example:**

- through analysis and review,
- reperforming procedures followed in the financial reporting process,
- and reconciling related types and applications of the same information.

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.

**Example:**

Corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from audit evidence that is generated internally, such as evidence existing within the accounting records, minutes of meetings, or a management representation.

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

(*a*) Risk assessment procedures; and

(*b*) Further audit procedures, which comprise:

  (*i*) Tests of controls, when required by the SAs or when the auditor has chosen to do so; and

  (*ii*) Substantive procedures, including tests of details and substantive analytical procedures.

***Notes to Add***

## AUDIT PROCEDURES TO OBTAIN AUDIT EVIDENCE CAN INCLUDE

(*i*) Inquiry → Seeking Info. → Knowledgeable Person

Inside | Outside

(*ii*) Inspection → Examining — Records / Docs.

(*iii*) Observation → Looking at — Process / Procedure

(*iv*) Recalculation → Mathematical accuracy

(*v*) Reperformance → Independent execution — Procedure / Controls

(*vi*) External Confirmation → Direct written Response
↓
To Auditor → from 3rd Party

(*vii*) Analytical Procedure → Evaluation → Financial info.
↓
Study of plausable Relationship

Financial | Non financial

Data + Investigation

Identified Fluctuation | Inconsistent Relationship

(*i*) Inspection
(*ii*) Observation
(*iii*) External Confirmation
(*iv*) Recalculation
(*v*) Reperformance
(*vi*) Analytical Procedures
(*vii*) Inquiry

**Audit Procedures to Obtain Audit Evidence**

Inspection | Observation | External Confirmation | Recalculation | Reperformance | Analytical Procedure | Inquiry

**(i) Inspection:** Inspection involves 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, in the case of internal records and documents, on the effectiveness of the controls over their production.

An example of inspection used as a test of controls is inspection of records for evidence of authorisation.

Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.

Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

**Illustration 4:** While auditing the books of accounts of AB Limited for the financial year 2022 -23, the auditor of the company used an audit procedure according to which complete documents and records of the company were checked in detail in order to obtain audit evidence. Explain the audit procedure used by the auditor of Extremely Distinct Limited.

**Solution:** The audit procedure used by auditor of AB Limited is known as Inspection because inspection is an audit procedure in which complete documents and records of a company are checked in detail for the purpose of obtaining audit evidence.

**(ii) Observation:** Observation consists of looking at a process or procedure being performed by others.

**For Example:** The auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities.

The audit procedure used by auditor of AB Limited is known as Inspection because inspection is an audit procedure in which complete documents and records of a company are checked in detail for the purpose of obtaining audit evidence.

Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed.

**(iii) 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.

**Example:** The auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are.

External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions. The absence of a "side agreement" that may influence revenue recognition.

**(iv) Recalculation:** Recalculation consists of checking the mathematical accuracy ofdocuments or records. Recalculation may be performed manually orelectronically.

**(v) Reperformance:** Reperformance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

**Example:** Re-performing the reconciliation of bank statement, re-performing the aging of accounts receivable.

**(vi) Analytical Procedures:** Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data.

Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

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

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.

Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries.

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.

***Notes to Add***

## THE FOLLOWING POINTS ARE ALSO RELEVANT IN RESPECT OF AUDIT PROCEDURES FOR AUDITOR'S CONSIDERATION

The audit procedures inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry 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 evidence obtained from previous audits may, in certain circumstances, provide appropriate audit evidence where the auditor performs audit procedures to establish its continuing relevance.

***Notes to Add***

## NATURE AND TIMING OF THE AUDIT PROCEDURES

→ Some A/c. Data & Other info. → may be available only in Electronic form

↓

The Auditor can Request retention of some info.

↓

Depends up on Entity's Data Retention Policy

***Notes to Add***

## RISK ASSESSMENT PROCEDURES

R.A.P. → Audit Procedure Performed → to obtain understanding of the

Entity +I.C. Environment

To Identify & Assess

↓

RoMM

↓

Whether due to F/E

↓

At the → Assertion → F.S. → Level

## TESTS OF CONTROLS

Test of Controls (ToC)

An Audit procedure → Designed to evaluate → Operating effectiveness of controls

Prevention (P) Detecting(D) Correction (C)

MM @ Assertion Level

The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time.

**For Example:**

Source documents, such as purchase orders and invoices, may exist only in electronic form when an entity uses electronic commerce, or may be discarded after scanning when an entity uses image processing systems to facilitate storage and reference.

Certain electronic information may not be retrievable after a specified period of time.

**For Example:**

If files are changed and if backup files do not exist. Accordingly, the auditor may find it necessary as a result of an entity's data retention policies to request retention of some information for the auditor's review or to perform audit procedures at a time when the information is available.

At this stage, it would be pertinent to discuss the concept of Risk assessment procedures and Further audit procedures.

Risk assessment procedures refer to the audit procedures 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, whether due to fraud or error, at the financial statement and assertion levels.

- Risk assessment procedures are the audit procedures performed to obtain an understanding of the entity and its environment to identify and assess the risks of material misstatement, at the financial statement and assertion levels.

Further Audit Procedures comprise of:

(*i*) Tests of controls, when required by the SAs or when the auditor has chosen to do so; and

(*ii*) Substantive procedures, including tests of details and substantive analytical procedures.

Further Audit Procedures comprise of:

(*i*) Tests of Controls; and

(*ii*) Substantive of procedures

Test of controls may be defined as an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

- Audit procedures designed
- to evaluate the operating effectiveness of controls
- in preventing or detecting and correcting material misstatement at the assertion level

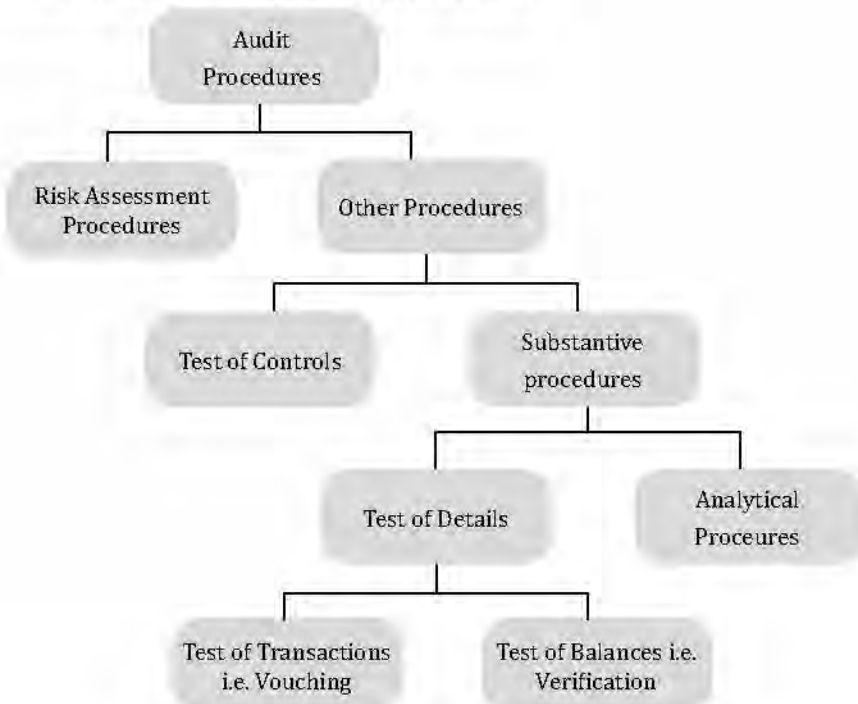
## SUBSTANTIVE PROCEDURES-TESTS OF DETAILS AND SUBSTANTIVE ANALYTICAL PROCEDURES

**Substantive Procedure**

An audit procedure → designed to detect MM → At assertion Level

- ToD
  - CoT
  - A/c. Balance
  - Presentation & Disclosure
- Substantive Analytical Procedure (SAP)

The following chart illustrates different audit procedures:



Substantive procedures are designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures.

Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.

In other words, Substantive procedure may be defined as an audit procedure designed to detect material misstatements at the assertion level.

- Audit procedures designed
- to detect material misstatement
- at the assertion level

Substantive procedures comprise:

(*i*) Tests of details (of classes of transactions, account balances, and disclosures), and

(*ii*) Substantive analytical procedures.

**Test Your Understanding**

**1.** On perusal of financial statements of a company, auditor of company finds that notes to accounts contain aging of trade payables in accordance with requirements of Schedule III of Companies Act, 2013. The accountant of company is responsible for ensuring proper aging of trade payables included in notes to accounts. The auditor wants to verify whether aging of trade payables made in financial statements is proper or not. Identify what he is trying to do.

**Ans.** The auditor is verifying aging of trade payables. He is "reperforming" the control which was mandated by the management.

**2.** CA Sooryagaythri is conducting audit of an entity. During the course of audit, she has made oral inquiries from head accountant regarding preparing of bank reconciliations every month as has been laid down by the management. Discuss, whether inquiries as stated above would provide satisfaction to her that controls in respect of preparing bank reconciliations statements have operated effectively.

**Ans.** 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. Mere inquiry does not lead to obtaining of sufficient appropriate audit evidence. In the instant case, CA Sooryagaythri should verify whether proper bank reconciliations have been carried out monthly as stipulated by management. Only then, she can be satisfied about operating effectiveness of controls in this regard.

**3.** A company has stipulated a control that reconciliations of its records showing quantitative details of its property, plant and equipment are carried out at regular intervals with physical verification of such items. The auditor has found that such reconciliations are being carried out as stipulated. Discuss, whether above factor, increases reliability of other internally generated evidence within the company relating to existence of such items.

**Ans.** The management is carrying out reconciliations of items contained in Property, Plant and Equipment records with physical verification of such items at regular intervals. It means that controls in this regard have operated effectively. 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.

In obtaining audit evidence from substantive procedures, the auditor is concerned with the following assertions:

## ASSERTIONS

Assertion → Representation by Mgt — Explicit / Implicit

↓

That are embodied in F.S

↓

As used by Auditor to consider different types of

↓

Potential Misstatement that may occur

Use of Assertions (Refer Ch.5)

(1) F.S. are in accordance with F.R.F.

↓

As per Mgt. — Explicit / Implicit ← Make Assertion

Disclosure | Recognition | Measurement | Presentation

of Various elements of → F.S. → Related Disclosures

(2) Categories of Assertions about

**COT & Events**

- Occurrence
- Completeness
- Classification
- Accuracy
- Cut-off

**A/c. Balance**

- Existence
- Rights & Obligations
- Completeness
- Valuation & Allocation

**Presentation & Disclosures**

- Occurrence, Rights & Obligations
- Completeness
- Classification & Understandability
- Accuracy & Valuation

(3) If all aspects are covered → Auditor may describe them differently

(4) Additional Assertions → In Special Entities → Laws & Regulation

↓

Eg.: Govt.

→ Negative Assertion
- Express → No contingent Liability
- Implied → No mention in F.S.

***Notes to Add***

.......................................................................................................

.......................................................................................................

**Assertions**

Assertions refer to representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

Representations by management

↓

that are embodied in the financial statements

↓

to consider different types of potential misstatements

## QUESTIONS

**Correct/Incorrect**

6. Assertions refer to the representations by the auditor to consider the different types of the potential misstatements that may occur.

**Ans. (Incorrect)**

Assertions refer to representations by management that are embodied in the financial statements as used by the auditor to consider the different types of the potential misstatements that may occur.

***Notes to Add***

## ASSERTIONS CONTAINED IN THE FINANCIAL STATEMENTS

(1) In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.

(2) Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following three categories and may take the following forms:

| Classes of transactions and events | Account balances | Presentation and Disclosure |
|---|---|---|
| Occurence | Existence | Occurence and rights and obligations |
| Completeness | Rights and obligations | Completeness |
| Accuracy | Completeness | Classification and understandability |
| Cut - Off | Valuation and allocation | Accuracy and valuation |
| Classification | | |

***Notes to Add***

(a) **Assertions about classes of transactions and events for the period under audit:**

   (*i*) **Occurrence:** transactions and events that have been recorded have occurred and pertain to the entity.

   (*ii*) **Completeness:** all transactions and events that should have been recorded have been recorded.

   (*iii*) **Accuracy:** amounts and other data relating to recorded transactions and events have been recorded appropriately.

   (*iv*) **Cut-off:** transactions and events have been recorded in the correct accounting period.

   (*v*) **Classification:** transactions and events have been recorded in the proper accounts.

**(b)** Assertions about account balances at the period end:

   (*i*) **Existence:** assets, liabilities, and equity interests exist.

   (*ii*) Rights and obligations; the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

   (*iii*) **Completeness:** all assets, liabilities and equity interests that should have been recorded have been recorded.

   (*iv*) **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.

(c) **Assertions about presentation and disclosure:**

   (*i*) **Occurrence and rights and obligations:** disclosed events, transactions, and other matters have occurred and pertain to the entity.

   (*ii*) **Completeness:** all disclosures that should have been included in the financial statements have been included.

   (*iii*) **Classification and understandability:** financial information is appropriately presented and described, and disclosures are clearly expressed.

   (*iv*) **Accuracy and valuation:** financial and other information are disclosed fairly and at appropriate amounts.

(3) The auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered.

   **For example,** the auditor may choose to combine the assertions about transactions and events with the assertions about account balances.

(4) When making assertions about the financial statements of certain entities, especially, for example, where the Government is a major stakeholder, in addition to those assertions set out in paragraph 2, management may often assert that transactions and events have been carried out in accordance with legislation or proper authority. Such assertions may fall within the scope of the financial statement audit.

Let us elaborate this with the help of two Illustrations. We must clearly understand that each item contained in financial statements asserts something to the readers of the accounts to indicate the ownership, existence, quantity of various things, etc. Auditing is concerned with the testing of the authenticity of the information thus conveyed.

**Example:**

When we find in the balance sheet, an item under current assets reading as "cash in hand - ₹ 10,000" the obvious assertions that would strike the mind are the following:

(*i*) The firm concerned had ₹ 10,000 in hand in valid notes and coins on the balance sheet day;

(*ii*) That the cash was free and available for expenditure to the firm; and

(*iii*) That the books of account show a cash balance of identical amount at the end of the day on which the balance sheet is drawn up.

**Example:**

| Particulars | | ₹ |
|---|---|---|
| Plant and Machinery (at cost) | | 2,00,000 |
| Less: Depreciation till the end of previous year | 70,000 | |
| Depreciation for the year | 13,000 | 83,000 |
| | | 1,17,000 |

The assertions are as follows:

(*i*) the firm owns the plant and machinery;

(*ii*) the historical cost of plant and machinery is ₹ 2 lacs;

(*iii*) the plant and machinery physically exists;

(*iv*) the asset is being utilised in the business of the company productively;

(*v*) total charge of depreciation on this asset is ₹ 83,000 to date on which ₹ 13,000 relates to the year in respect of which the accounts are drawn up; and

(*vi*) the amount of depreciation has been calculated on recognised basis and the calculation is correct.

From the above two Illustrations we know the sort of assertions that are implied in the financial statements. Incidentally, the assertions are generally implied and not specifically spelt out, though some explicit assertions are also found in the financial statements.

Explicit assertions are made when otherwise the reader will be left with an incomplete picture; it may even be misleading.

An example of the former category may be found in the following items appearing in the liability side of the balance sheet:

Secured Loans ₹4,00,000

The description does not give us a complete picture. We do not know:

(*i*) the name of the lender, if it is relevant;

(*ii*) the nature of security provided; and

(*iii*) the rate at which interest in payable.

A specific mention is required about these things for a proper appreciation of the item and the financial position.

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.

Every financial statement contains an overall representation in addition to the specific assertions so far discussed. Each financial statement purports to present something as a whole in addition to its component details. For example, an income statement purports to present "the results of operations" a balance sheet purports to present "financial position". The auditor's opinion is typically directed to these overall representations. But to formulate and offer an opinion on the overall truth of these statements he has first to inquire into the truth of many specific assertions, expressed and implied, both positive, and negative, that makes up each of these statements. Out of his individual judgements of these specific assertions he arrives at a judgement on the financial statements as a whole.

### *Notes to Add*

## AUDIT TRAIL

Flow of Transactions ← Documented

↓

Used → to INVESTIGATE → Source Document

- ↓ As A.E.
  - Establish Authentication
  - Integrity of Transaction
- Source Document ↓ Account Entry ↓ Inserted into F.S.

\+ Helps → Maintaining → Record of
- System
- User Activity

\+

(i) Step-by-step RECORD ← can be traced to source

(ii) Used to
- Verify
- Track

Transactions
- Accounting
- Financial

(iii) Record – Keepers → Evidence
- Events
- Procedures
- Operations

(iv) Purpose → Reduce
- Fraud
- Material Errors
- Unauthorized use

(v) Enhance
- I.C.
- Data Security

(vi) Helps in
- Fixing Responsibility
- Rebuilding Events
- Thorough Analysis of problem areas

(vii) Involves → Cost
- System Expenditure
- Time for Analysing Data

↑ Automated Tools can reduce this demerit

(viii) Systems → having Audit Trails
- Inspires ↓ Confidence
- Whether Controls operating ↓ Eff. & Eff.
- Aids ↓ verification of transaction
- Enhance ↓ Data Security
- Increase ↓ Reliability of A.E.

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 financial statement 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.

It is a step-by-step record by which accounting, trade details, or other financial data can be traced to their source. Audit trails are used to verify and track many types of transactions including accounting and financial transactions.

Audit trails (or audit logs) act as record-keepers that document evidence of certain events, procedures or operations, because their purpose is to reduce fraud, material errors, and unauthorized use. Audit trails help to enhance internal controls and data security. Audit trails can help in fixing responsibility, rebuilding events and in thorough analysis of problem areas. For example, audit trails can track activities of users thus fixing responsibility for users. These can also be used to rebuild events upon occurring of some problem. Audit trail analysis can specify reason of the problem. It can also help in ensuring operation of system as intended. In this way, audit trails can help entities in their regular system operations.

However, audit trails involve costs. The cost is not only in terms of system expenditure but also in terms of time involved in analysing data made available by audit trails. However, use of automated tools can be made to analyse large volume of data thrown up by audit trails.

Systems which have a feature of audit trail inspires confidence in auditors. It helps auditors in verifying whether controls devised by the management were operating effectively or not. It aids in verification whether a transaction was indeed performed by a person authorised to do it. Since audit trails also enhance data security, these can be used by auditor while performing audit procedures thus increasing reliability of audit evidence obtained.

## QUESTIONS

**Theory Questions**

7. Maintaining accounts using accounting software having a feature of recording audit trail can be useful for an auditor. Discuss some of the advantages for such a feature in accounting software for auditors.

**Ans.** Refer to heading "Audit trail".

**Correct/Incorrect**

**State with reasons (in short) whether the following statements are correct or incorrect:**

8. When auditor inquires the management as part of the audit procedures it should be formal written form only and not informal oral inquiries.

**Ans. (Incorrect)**

When auditor inquires the management as part of audit procedures such inquiries may range from formal written inquiries to informal oral inquiries.

***Notes to Add***

## INFORMATION TO BE USED AS AUDIT EVIDENCE

Obtaining A.E. ⇄ Accuracy / Completeness ⇄ of Info.

Info → Sufficiently

- Precise
- Detailed

(i) Nature ← Matter
complexity ← Matter

(ii) RoMM

(iii) Alternative source → A.E. → Available?

(iv) Nature / Scope / Objective ← Mgt's Expert's Work

(v) Mgt's Expert → Employed → by Entity
Mgt's Expert → Service Provider

(vi) Extent → Mgt → Exercise control / Influence ← Expert's work

(vii) Expert → subject to → Technical → Standards
Expert → subject to → Professional / Industry ← Requirements

(viii) Nature / Extent ← Entity's I.C. ← OVER Expert's work

(ix) Auditor's → Knowledge / Experience ← Expert's field of work

(x) Auditor's → previous experience → Expert's work

***Notes to Add***

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

When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, including as necessary in the circumstances:

***Notes to Add***

**When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, including as necessary in the circumstances:**

(*a*) Obtaining audit evidence about the accuracy and completeness of the information; and

(*b*) Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes.

Obtaining A.E. → Accuracy / Completeness ← of Info.

Info
↓
Sufficiently
→ Precise
→ Detcrited

**"Selecting Items for Testing to Obtain Audit Evidence"**

When designing → ToC / ToD ← Auditor shall determine
↓
Means of Selecting Items For Testing
↓
Based on Auditor's Judgement

- Selecting ALL Items (100% Examination)
  ↓
  Auditor May Decide
  ↓
  Most Appro
  ↓
  Examine
  - Entire Population
    ↓
    100% Examination
    → Unlikely → ToC
    → Appro. → ToD
    ↓
    Population
    - Large Value Items
    - Significant Risk
    - Process
      - Repetitive
      - Automatic
  - CoT
  - A/c. Bal.
  - Stratum
- Selecting Speci'lc Items
  ↓
  Factors
  - Auditor's Understanding of Entity
  - Assessed RoMM
  - Characteristic of Population

  NON Sampling Risk
  ↓
  (1) High VALUE items
  (2) > Certain amounts
  (3) To obtain Info.
- Audit Sampling
  ↓
  Discussed Later

***Notes to Add***

(1) 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.

***Notes to Add***

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:

(*a*) Selecting all items (100% examination);

(*b*) Selecting specific items; and

(*c*) 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.

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. Audit sampling is discussed in subsequent paragraphs.

***Notes to Add***

## INCONSISTENCY IN OR DOUBTS OVER RELIABILITY OF AUDIT EVIDENCE

IF

AE obtained from ONE Source → INCONSISTENT → A.E. obtained from ANOTHER

Auditor has Doubt → RELIABILITY → Info used as A.E.

Auditor shall

- Determine necessary
  - Modification
  - Addition to Audit Procedures
- Consider the Effect on other effect

Management's Expert → Individual / organisation ← Possessing ↓ EXPERTISE ↓ whose work is used by Entity ↓ Preparation of F.S.

EXPERTISE — Other Than → Accounting / Auditing

## RELYING ON THE WORK OF A MANAGEMENT'S EXPERT

The Auditor MAY rely → Provided → Satisfied

Satisfied ↓ Suff. + Appro. A.E. OBTAINED

The Auditor MAY rely ↓ Shall

- Evaluate
  - Capability
  - Competence
  - Objectivity
  
  (Capability, Competence, Objectivity) — Expert
- Understanding ↓ work of expert
- Experts work ↓ A.E.?

***Notes to Add***

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.

**For Example:**

responses to inquiries of management, internal audit, and others are inconsistent.

SA 230 includes a specific documentation requirement if the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter.

## QUESTIONS

**Theory Questions**

8. Who is management's expert?

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

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 financial statements.

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

(a) Evaluate the competence, capabilities and objectivity of that expert;

(b) Obtain an understanding of the work of that expert; and

(c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

***Notes to Add***

## EVALUATION OF AUDIT EVIDENCE

SA 500 "Audit Evidence" → Applicable to all A.E.

↓

Obtained During the course of Audit

↓

Enable Auditor to draw

↓

REASONABLE CONCLUSION

↓

on which to base Auditor's Opinion

→ Auditor Conclude → Suff. + Appro. A.E. obtained

↓

Reduce the Audit Risk to Acceptably Low Level

↓

Enable the Auditor to draw Reasonable conclusion

↓

To base Auditor's Opinion

↓

MATTER OF PROFESSIONAL JUDGEMENT

***Notes to Add***

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.

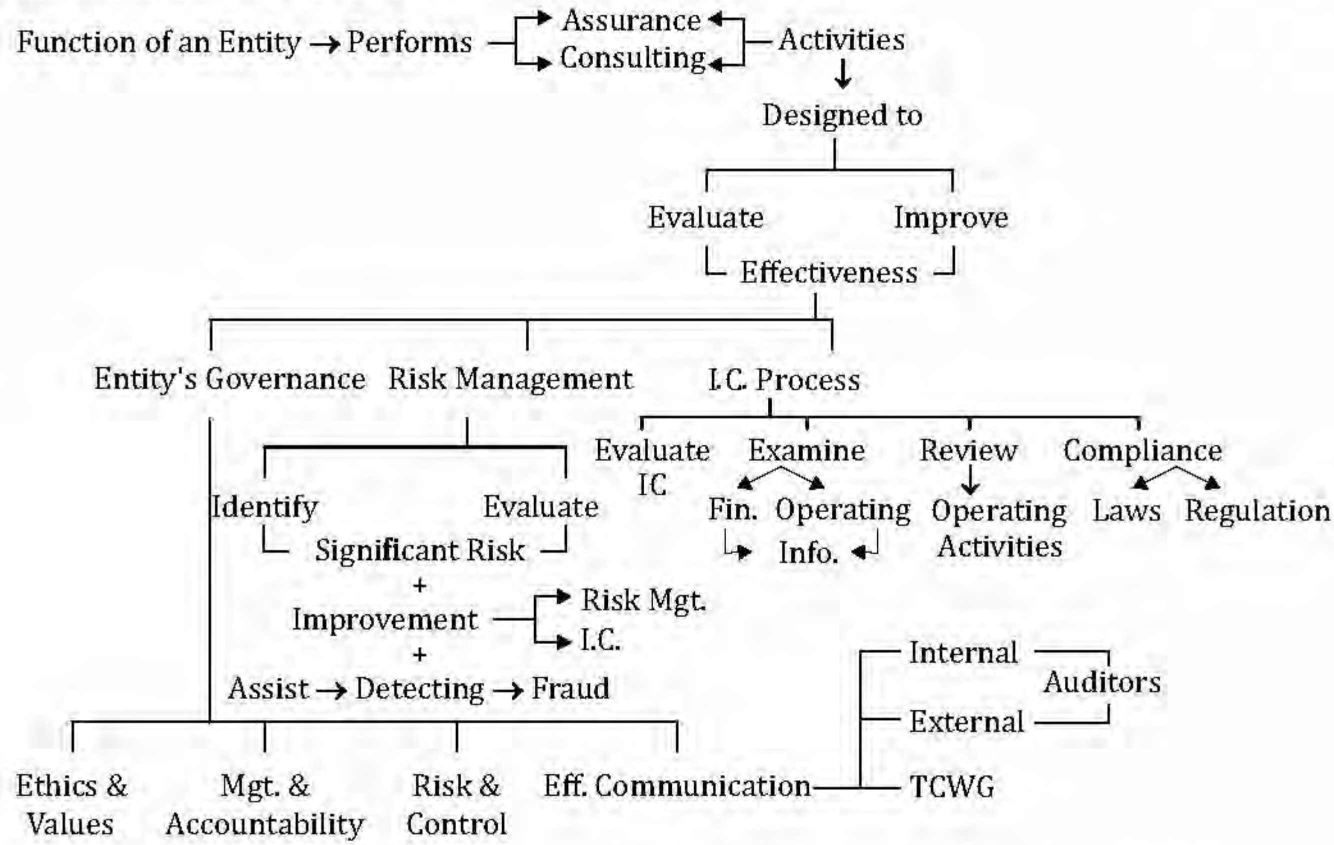
Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.

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.

***Notes to Add***

## "USING THE WORK OF INTERNAL AUDITORS (SA 610)"

**Definition of Internal Audit Function**




***Notes to Add***

Internal audit function refers to

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.

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:

**(1) Activities Relating to Governance:** The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.

**(2) Activities Relating to Risk Management:**

- The 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 (including effectiveness of the financial reporting process).
- The internal audit function may perform procedures to assist the entity in the detection of fraud.

**(3) Activities Relating to Internal Control:**

- Evaluation of internal control. The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation, and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control.

**For Example:**

the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.

- Examination of financial and operating information. The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.
- Review of operating activities. The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non- financial activities of an entity.
- Review of compliance with laws and regulations. The internal audit function may be assigned to review compliance with laws, regulations, and other external requirements, and with management policies and directives and other internal requirements.

***Notes to Add***

## ■ WAYS IN WHICH THE EXTERNAL AUDITOR MAY MAKE USE OF THE FUNCTION FOR PURPOSES OF THE AUDIT

Internal Auditor → OBJECTIVES ← External Auditor

OBJECTIVES ↓ DIFFER SIMILAR ↑ AUDIT PROCEDURES

Internal Auditor → AUDIT PROCEDURES ← External Auditor

→ External Auditor → May make use of function:

(i) To obtain info. → Relevent for assessing RoMM

(ii) As a partial substitution for A.E. to be obtained

- upon Evaluation
- Unless prohibited
  - Law
  - Regulation

(iii) Use 'Direct Assistance' → from Internal Auditor

- Under
  - D
  - S
  - R
- Unless Prohibited
  - Law
  - Regulation

***Notes to Add***

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 financial statements. 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").

***Notes to Add***

## SCOPE OF SA 610

Using

- Work → Of Internal Audit Function → As A.E.
- INTERNAL AUDITOR → To Provide Direct Assistance → Under
  - D S R — External Auditor

External Auditor

- Not required to MODIFY →
  - N, E, T — Audit Procedures
- Establish → O.A.S.

## EXTERNAL AUDITOR'S RESPONSIBILITY FOR THE AUDIT

(i) Sole Responsibility → External Auditor

↓

NOT REDUCED → by use of work

- Internal Audit Function
- Internal Auditor

(ii) May perform → Similar → Audit Procedures

(iii) Internal Audit Function, Internal Auditor — NOT INDEPENDENT → As per SA 200

(iv) SA 610 → Defines

- Necessary Conditions → For External Auditor's → To use work of I.A.
- Necessary work Effort → Obtain Suff. + Appro. A.E.
- Framework → External Auditor's Judgement → Prevent
  - Over
  - Under
  - — Use of IA

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.

***Notes to Add***

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 financial statements 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.

***Notes to Add***

## OBJECTIVES OF THE EXTERNAL AUDITOR, WHERE THE ENTITY HAS AN INTERNAL AUDIT FUNCTION

External Auditor → Expects to use → work of + Function
↓
To Modify NET of Audit Procedures

(i) To determine Whether

- Work of I.A.
- Direct Assistance from I.A.

Can be used + Areas + Extent + Determination

(ii) To determine whether → Work is Adequate

(iii) To Appropriately — D / S / R — In Direct Assistance

***Notes to Add***

The objectives of the external auditor, where the entity has an internal audit function and the external auditor expects to use the work of the function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor, or to use internal auditors to provide direct assistance, are:

(a) To determine whether the work of the internal audit function or direct assistance from internal auditors can be used, and if so, in which areas and to what extent; and having made that determination:

(b) If using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit; and

(c) If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.

***Notes to Add***

## EVALUATING THE INTERNAL AUDIT FUNCTION

Extent → They Support → Objective of I.A.

Level → Competence

Whether they Apply: Systematic Disciplined Approach, QC

Prof. Judgement

(A) Objectivity → Ability to perform → Tasks

Tasks → without being affected by: Bias, **Confl**ict of Interest, Undue **Infl**uence

To override → Prof. Judgement

Objectivity → Factors → Affect Evaluation

(i) Status of I.A. Function → Supports → Ability to function Free from: Bias, **Confl**ict of Interest, Undue **Infl**uence

To override → Prof. Judgement

(ii) TCWG → Oversee → Employment Decisions

(iii) Constraints / Restrictions — by — Mgt. / TCWG — on → I.A. Function

(iv) I.A. Functions → Free From → **Confl**icting Responsibility

(B) Competence → Attainment / Maintenance — Knowledge + Skills

Knowledge + Skills → At a level to enable → Assigned tasks performed: Diligently, Prof. Standards

Competence → Factors → Affect Evaluation

(i) IAF → Adequately / Appro. — Resourced

(ii) Established Policies for: Hiring, Training, Assigning

I.A. → I.A. Assignments

(iii) I.A. → Adequate → Technical Training / Pro'iciency — in Auditing

(iv) I.A. → Possess → Knowledge relating to → Entity's — F.R. / F.R.F

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:

(a) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors;

(b) The level of competence of the internal audit function; and

(c) Whether the internal audit function applies a systematic and disciplined approach, including quality control.

***Notes to Add***

## OBJECTIVITY AND COMPETENCE

**Objectivity and competence may be viewed as a continuum**
↓
**Continuous Series**

More → I.A. Functions → Organisational Status / Relevant P&P — Adequately
↓ Support Objectivity

↓
Higher the level of Competence
↓
More likely E.A. use I.A.F
↓
Objectivity: Cannot Compensate for Lack of Suff. Competence
↓
of I.A.F

**Competence: Cannot Compensate for → Organisational Status / P&P — That do not Support Objectivity of I.A.**

(C) **Systematic & Disciplined Approach → To**

**Planning | Performing | Supervising | Reviewing | Documenting**

**Its Activities**
↓
**Distinguishes the Activities of I.A.F.**
↓
**From other monitoring Control Activities**

Factors → Affect Evaluation
↓
(i) Existence / Adequacy / Use — Documented — I.A. Procedures / Guidance → Risk Assessment / Work Program / Reporting

(ii) I.A.F. → Appro. → Q.C. → P & P

***Notes to Add***

The external auditor exercises professional judgment in determining whether the work of the internal audit function can be used for purposes of the audit, and the nature and extent to which the work of the internal audit function can be used in the circumstances.

The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors and the level of competence of the function are particularly important in determining whether to use and, if so, the nature and extent of the use of the work of the function that is appropriate in the circumstances.

## OBJECTIVITY AND ITS EVALUATION

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 in relation to Objectivity include the following:

(1) Whether the organizational status of the internal audit function, including the function's authority and accountability, supports the ability of the function to be free from bias, conflict of interest or undue influence of others to override professional judgments.

**For example:**

Whether the internal audit function reports to those charged with governance or an officer with appropriate authority, or if the function reports to management, whether it has direct access to those charged with governance.

(2) Whether those charged with governance oversee employment decisions related to the internal audit function.

**For example:**

determining the appropriate remuneration policy.

(3) Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance, for example, in communicating the internal audit function's findings to the external auditor.

(4) Whether the internal audit function is free of any conflicting responsibilities, for example, having managerial or operational duties or responsibilities that are outside of the internal audit function.

### Competence and its evaluation

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 in relation to competence include the following:

(1) Whether the internal audit function is adequately and appropriately resourced relative to the size of the entity and the nature of its operations.

(2) Whether there are established policies for hiring, training and assigning internal auditors to internal audit engagements.

(3) Whether the internal auditors have adequate technical training and proficiency in auditing.

(4) Whether the internal auditors possess the required knowledge relating to the entity's financial reporting and the applicable financial reporting framework.

**Objectivity and competence may be viewed as a continuum.**

Objectivity and competence may be viewed as a continuum. The more the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors and the higher the level of competence of the function, the more likely the external auditor may make use of the work of the function and in more areas. However, an organizational status and relevant policies and procedures that provide strong support for the objectivity of the internal auditors cannot compensate for the lack of sufficient competence of the internal audit function. Equally, a high level of competence of the internal audit function cannot compensate for an organizational status and policies and procedures that do not adequately support the objectivity of the internal auditors.

The application of a systematic and disciplined approach to planning, performing, supervising, reviewing and documenting its activities distinguishes the activities of the internal audit function from other monitoring control activities that may be performed within the entity.

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

***Notes to Add***

## APPLICATION OF A SYSTEMATIC AND DISCIPLINED APPROACH

(1) The existence, adequacy and use of documented internal audit procedures or guidance covering such areas as risk assessments, work programs, documentation and reporting, the nature and extent of which is commensurate with the size and circumstances of an entity.

(2) Whether the internal audit function has appropriate quality control policies and procedures.

IF → E.A. → Determines

- Function's Org. Status + Relevant P & D ↓ Do Not Adequately Support ↓ Objectivity of I.A.
- Function Lacks Suff. Competence
- Function ↓ Does Not APPLY
  - Systematic
  - Disciplined
  - Q.C.

  Approach

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

**E.A. → Shall Consider:**

**(i) Nature / Scope — of work → that → has been performed / is planned to be performed**

- **By I.A.F**
- **Relevance to E.A.'s**
  - **O.A.S.**
  - **Audit Plan**

*** Examples**

**ToC**
**Substantive Procedures**
**Observation → Inventory Count**
**Tracing → I.S.**
**Testing → Compliance → Legal / Regulatory ← Reg.**

***Notes to Add***

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

(a) The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;

(b) The function lacks sufficient competence; or

(c) The function does not apply a systematic and disciplined approach, including quality control.

***Notes to Add***

As a basis for determining the areas and the extent to which the work of the internal audit function 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.

In other words, once the external auditor has determined that the work of the internal audit function can be used for purposes of the audit, a first consideration is whether the planned nature and scope of the work of the internal audit function that has been performed, or is planned to be performed, is relevant to the overall audit strategy and audit plan that the external auditor has established.

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

1. Testing of the operating effectiveness of controls.
2. Substantive procedures involving limited judgment.
3. Observations of inventory counts.
4. Tracing transactions through the information system relevant to financial reporting.
5. Testing of compliance with regulatory requirements.

***Notes to Add***

## CIRCUMSTANCES IN WHICH THE EXTERNAL AUDITOR SHALL PLAN TO USE LESS OF THE WORK OF THE INTERNAL AUDIT FUNCTION AND PERFORM MORE OF THE WORK DIRECTLY

IF

- > Judgeme
  - Planning + Performing ↓ Audit Procedures
  - Evaluating ↓ A.E.
- Higher RoMM
- < I.A.F. ↓ Org's Status + Relevant P & P ↓ Adequately Support Objectivity ↓ I.A.
- < Level ↓ Competence ↓ I.A.F.

## USING THE WORK OF THE INTERNAL AUDIT FUNCTION

E.A. Shall

- Discuss ↓ Panned use of work ↓ With I.A.F. + Coordinate ↓ Activities ↓ Address the following
- Read ↓ Report ↓ I.A.F.
- Perform ↓ Suff. Audit Procedures ↓ On I.A. Body of Work

(i) N
(ii) E
(iii) T

of Audit Work

(iv) DM + PM
(v) Methods of Item Selection + Sample Size
(vi) Documentation
(vii) Review
Reporting

Procedures

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 if:

(a) The more judgment is involved in:

  (*i*) Planning and performing relevant audit procedures; and

  (*ii*) Evaluating the audit evidence gathered;

(b) The higher the assessed risk of material misstatement at the assertion level, with special consideration given to risks identified as significant;

(c) The less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors; and

(d) The lower the level of competence of the internal audit function.

***Notes to Add***

........................................................................................................................................

If the external auditor plans to use the work of the internal audit function, the external auditor shall

(A) discuss the planned use of its work with the function as a basis for coordinating their respective activities.

(B) 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.

(C) perform sufficient audit procedures on the body of 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.

**Discussion and Coordination with the Internal Audit Function**

In discussing the planned use of their work with the internal audit function as a basis for coordinating the respective activities, it may be useful to address the following:

(1) The timing of such work.

(2) The nature of the work performed.

(3) The extent of audit coverage.

(4) Materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures), and performance materiality.

(5) Proposed methods of item selection and sample sizes.

(6) Documentation of the work performed.

(7) Review and reporting procedures.

Coordination between the external auditor and the internal audit function is effective when, for example;

(1) Discussions take place at appropriate intervals throughout the period.

(2) The external auditor informs the internal audit function of significant matters that may affect the function.

(3) The external auditor is advised of and has access to relevant reports of the internal audit function and is informed of any significant matters that come to the attention of the function when such matters may affect the work of the external auditor so that the external auditor is able to consider the implications of such matters for the audit engagement.

## DETERMINING WHETHER, IN WHICH AREAS, AND TO WHAT EXTENT INTERNAL AUDITORS CAN BE USED TO PROVIDE DIRECT ASSISTANCE

I.A. → Perform → Audit Procedures → Under

D S R

of E.A.

↓

May be prohibited

Law Regulation

**If Not Prohibited→E.A Shall→Evaluate**

**Existence + Significance of THREAT** | **Level of Competence**

↓

**To I.A. Objectivity**

↓

**Include**

↓

**Inquiry of I.A.**

**Interest** | **Relationship**

**MAY Create Threat**

***Notes to Add***

The external auditor may be prohibited by law or regulation from obtaining direct assistance from internal auditors.

Direct assistance refers to the use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

If using internal auditors to provide direct assistance is not prohibited by law or regulation, and the external auditor plans to use internal auditors to provide direct assistance on the audit, 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's evaluation of the existence and significance of threats to the internal auditors' objectivity shall include inquiry of the internal auditors regarding interests and relationships that may create a threat to their objectivity.

***Notes to Add***

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

Significant Threat ↓ Objectivity

I.A. Lacks ↓ Suff. Competence

(*a*) There are significant threats to the objectivity of the internal auditor; or

(*b*) The internal auditor lacks sufficient competence to perform the proposed work.

Shall not use internal auditors

- Involve ↓ Significant Judgement
- Higher ↓ RoMM
- Work
  - Already / Will be Reported
    - Mgt. / TCWG by I.A.F.

Relate to Decision ↓ E.A. Makes ↓ In accordance with S.A. + Use of Work + Direct Assistance

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

Obtain → Written Agreement

- Authorized Representative ↓ of Entity
  - I.A. ↓ Allowed to Follow ↓ E.A.'s Instructions
  - Entity Will Not ↓ Intervene
- Internal Auditor (I.A.) ↓ They Will Keep ↓ Confidential ↓ Specific Matters + Inform E.A. ↓ Any Threats to Objectivity

***Notes to Add***

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

(*a*) Involve making significant judgments in the audit;

(*b*) 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;

(*c*) Relate to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or

(*d*) 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.

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

(*a*) 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

(*b*) 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.

***Notes to Add***

**Basics of Internal Financial Control and Reporting Requirements**

(Already Discussed in Chapter 3)

| Internal Financial Control Wider Term | Distinction b/w | Internal Control over financial reporting Narrower Term |
|---|---|---|

↓ P & P ← By Companies

↓ Ensuring

- Reliability of F.R.
- Eff & Eff. of Operation
- Compliance
  - Laws
  - Reg.
- Safeguarding Assets
- P & D of Fraud

↓ Auditor's are REQUIRED To Express an Opinion on it

- Additional
- Distinct

## AUDIT SAMPLING (SA 530) SAMPLING: AN AUDIT PROCEDURE

Traditional Approach → Economically Wasteful → All Efforts Directed

Traditional Approach ↓ 100 % audit ↓ Disregarding → Materiality

All Efforts Directed ↓ All Transactions ↓ Without Exceptions

- Because of I.C. → Possibility of Routine → Error / Fraud

  ↓ Greatly Diminished

* Approach to Audit / Extent of Checking ← Progressive Δ
  - More Attention
    - Principle
    - Control
  - Curtailment of ↓ Routine Checking

***Notes to Add***

You have already read about basics of Internal Financial Control and regulatory/reporting requirements in Chapter 3 in detail. Now, we shall understand distinction between Internal Financial Control and Internal Control over financial reporting.

**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 financial statements.

Therefore, "internal financial control" is a wider term where as "internal controls over financial reporting" is a narrower term restricted to entity's internal controls over financial reporting only.

No conscious effort in human society is divested of economic considerations and auditing is no exception. There is a growing realisation that the traditional approach to audit is economically wasteful because all the efforts are directed to check all transactions without any exception. This invariably leads to more emphasis on routine checking, which often is not necessary in view of the time and the cost involved. With the shift in favour of formal internal controls in the management of affairs of organisations, the possibilities of routine errors and frauds have greatly diminished i.e the internal controls as designed by the management are for the very purpose of prevention, detection and correction of frauds and errors. Thus the auditors often find extensive routine checking as nothing more than a ritual because it seldom reveals anything material Now the approach to audit and the extent of checking are undergoing a progressive change in favour of more attention towards the questions of principles and controls with a curtailment of non- consequential routine checking.

***Notes to Add***

## MEANING OF AUDIT SAMPLING

Application of Audit Procedures

↓

To less than 100% of items → Within a population → of audit relevance

↓

Such that all sampling units

↓

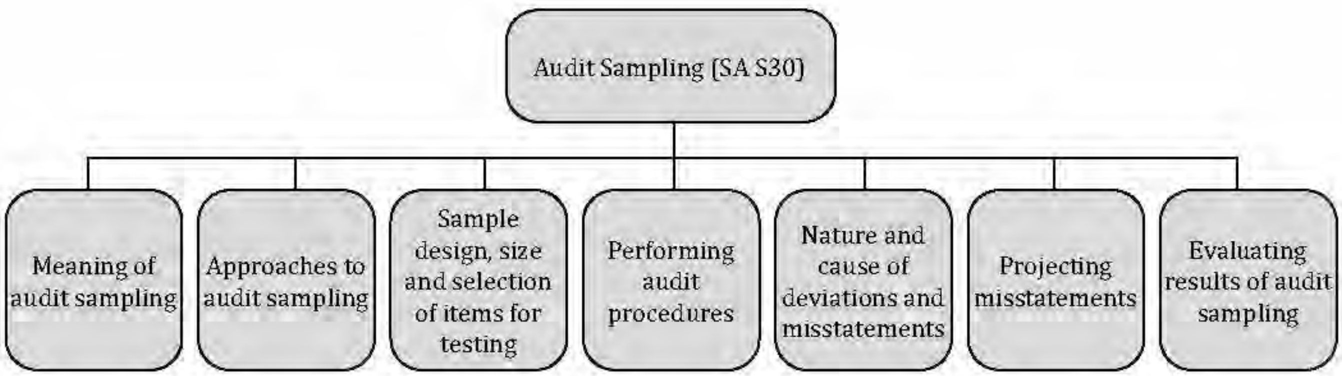
Have a Equal Chance of selection

↓

In order to provide the Auditor → with reasonable basis on which

↓

To draw conclusion about the entire population




***Notes to Add***

By routine checking we traditionally think of extensive checking and vouching of all the entries, disregarding the concept of materiality.

The extent of the checking to be undertaken is primarily a matter of judgment of the auditor, there is nothing statutorily stated anywhere which specifies what work is to be done, how it is to be done and to what extent it has to be done. It is also not obligatory that the auditor must adopt the sampling technique. What he is to do as an auditor is to express his opinion on the financial statements and become bound by that.

To ensure good and reasonable standard of work, he should adopt standards and techniques that can lead him to an informed professional opinion. On consideration of this fact, it can be said that it is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking (i.e sampling), he should adopt standards and techniques which are widely followed and which have a recognised basis.

Since statistical theory of sampling is based on a scientific law, it can be relied upon to a greater extent than any arbitrary technique which lacks in basis and acceptability. This enables the auditor to make conclusions and express fair opinion without having to check all of the items within the financial statements.

**Meaning of Audit Sampling**

According to SA 530 "Audit sampling", 'audit sampling' refers to the application of audit procedures to less than 100% of items within a population relevant under the audit, such that all sampling units (i.e all the items in the population) have a equal chance of selection. This is to ensure that the items selected represent the entire population which enables the auditor to draw conclusions and express his opinion based on a pre-determined objective.

The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.


**Scope of SA-530**

SA 530 becomes applicable when the auditor has decided to use audit sampling in performing audit procedures. This standard deals with the auditor's use of -

- Statistical and
- Non-statistical sampling

when designing and selecting the-

(i) audit sample,

(ii) performing tests of controls and tests of details, and

(iii) evaluating the results from the sample.

SA 500 "Audit Evidence", deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.

SA 500 lays down the means available to the auditor for selecting the items for testing. One of those is audit sampling. Hence SA 530 complements SA 500.

## QUESTIONS

### Correct/Incorrect

**State with reasons (in short) whether the following statements are correct or incorrect:**

**10.** Sample need not be representative.

**Ans. (Incorrect)**

Whatever may be the approach 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.

### Theory Questions

**11.** What is the meaning of Sampling? Also discuss the methods of Sampling. Explain in the light of SA 530 "Audit Sampling".

**Ans. Meaning of Audit Sampling:** "Audit Sampling" means 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.

The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

**Refer to heading "Samples Selection methods".**

***Notes to Add***

## POPULATION

Population : Entire set of DATA

- For which a sample is selected
- About which Auditor wishes to draw ↓ Conclusions

→Auditor should select sample items in such a way

↓

That sample can be expected → To be Representative → of the population

***Notes to Add***

## CHARACTERISTICS OF POPULATION

Characteristics of population

- Appropriateness
- Completeness
- Reliable

***Notes to Add***

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

The auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected.

## QUESTIONS

**Correct/Incorrect**

**State with reasons (in short) whether the following statements are correct or incorrect:**

**12.** In stratified sampling, the conclusion drawn on each stratum can be directly projected to the whole population.

**Ans. (Incorrect)**

In case of stratified sampling, the conclusions are drawn on the stratum. The combination of all the conclusions on stratum together will be used to determine the possible effect of misstatement or deviation. Hence the samples are used to derive conclusion only on the respective stratum from where they are drawn and not the whole population.

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

**Ans. (Incorrect)**

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

1. **Appropriateness:** The auditor will need to determine that the population from which the sample is drawn is appropriate for the specific audit objective. Appropriate means population from which the samples are drawn shall be relevant for the specific objective under audit. This is because when the samples are drawn, the audit procedures are applied on the sample and the conclusions are projected on the population.

   It is important for the auditor to ensure that the population is appropriate to the objective of the audit procedure, which will include consideration of the direction of testing.

   **Example:**

   If the auditor's objective were to test for overstatement of accounts receivable, the population could be defined as the accounts receivable listing. On the other hand, when testing for understatement of accounts payable, the population would not be the accounts payable listing, but rather subsequent disbursements, unpaid invoices, suppliers' statements, unmatched receiving reports, or other populations that would provide audit evidence of understatement of accounts payable.

2. **Completeness:** The population also needs to be complete, which means that if the auditor intends to use the sample to draw conclusions about whether a control activity is operated effectively

during the financial reporting period, the population needs to include all relevant items i.e all the activities that form part of that relevant internal control, throughout the entire period. If population is complete in all respects, the conclusions drawn on the population will be considered to be reasonable.

3. **Reliable:** When performing the audit sampling, the auditor performs audit procedures to ensure that the information upon which the audit sampling is performed is sufficiently complete and accurate. Auditor should obtain evidence about the reliability of population. If population is not reliable with respect to accuracy and source, the sample drawn will definitely not be relevant for the specific audit objective.

## QUESTIONS

**Correct/Incorrect**

**State with reasons (in short) whether the following statements are correct or incorrect:**

14. The method which involves dividing the population into groups of items is knows as block sampling.

**Ans. (Incorrect)**

The method which involves dividing the population into groups of items is known as cluster sampling whereas block sampling involves the selection of a defined block of consecutive items.

***Notes to Add***

## SAMPLING UNIT

Individual Items → That Make up the population

↑

Audit Procedure are applied → Conclusion drawn from them

↓

Projected on the Population

→ Sample must be REPRESENTATIVE → Closely Similar → Not Exactly Same

- Statistical
- Non-Statistical

Approach

***Notes to Add***

## APPROACHES TO SAMPLING (TYPES OF SAMPLING)

**Approach to Sampling**

**Statistical Approach**

**(More** Scientific)

**An approach to sampling that has Random Selection of items**

**+**

**Use of probability theory to**

- **Evaluate sample Results**
- **Measure sampling risk Characteristics**

**Non-Statistical Approach**

**(Neither Objective Nor Scientific)**

**In this Approach →Sample Size →**

**Its components →are determined on the basis of**

- **Personal Knowledge**
- **Experience**

**of the Auditor**

**→ In most cases → A.E. → Not Conclusive → Auditor Takes "Calculated Risk"**

The individual items that make up the population are known as sampling units. The population can be divided into sampling units in a variety of ways. It is a selection from the population that is used as an extrapolation of the population. Audit procedures are applied on these units and the conclusions drawn from them are projected on the population.

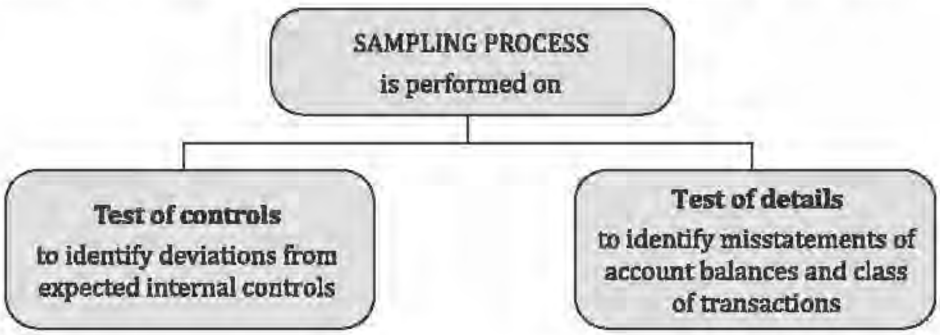
In simple words, conclusions drawn on the sample becomes the conclusion of the population from where it is drawn.

**Example:**

If the auditor's objective were to test the validity of accounts receivables, the sampling unit could be defined as customer balances or individual customer invoices. The auditor defines the sampling unit in order to obtain an efficient and effective sample to achieve the particular audit objectives. The conclusion on the population is based on the audit procedures applied on the sampling unit.

**Sample must be representative**

Whatever maybe the approach 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.




Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion about the population, from which the sample is drawn. Audit sampling can be applied using either.

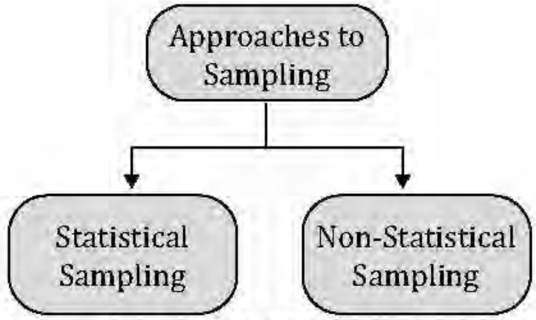
(A) non-statistical or

(B) statistical sampling approaches.

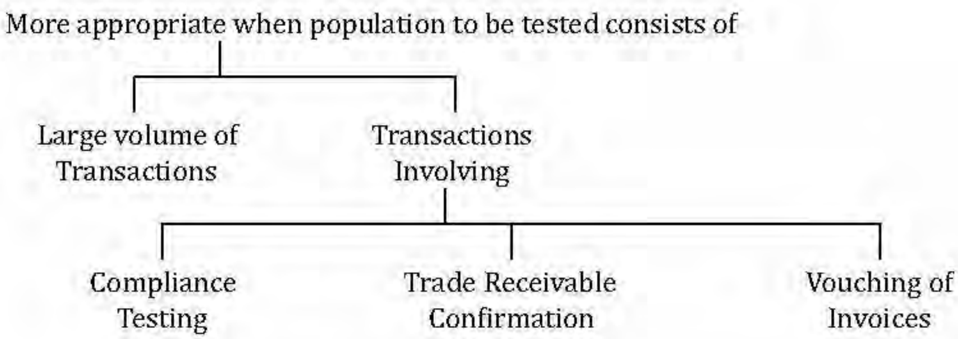
Statistical sampling is an approach to sampling that has the random selection of the sample units; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.

Sample is chosen by applying certain mathematical and statistical methods. A sampling approach that does not have the above features s considered as non- statistical sampling.

***Notes to Add***




## STATISTICAL SAMPLING-MORE SCIENTIFIC




***Notes to Add***

**Characteristics of Statistical sampling approach**

1. An approach to sampling that has the random selections of the sample items
2. The use of probability theory to evaluate sample results, and
3. The use of probability theory including measurement of sampling risk characteristics

**Statistical Sampling-More Scientific**

(1) Audit testing done through this approach is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances.

(2) Statistical sampling has reasonably wide application 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.

(3) There Is no personal bias of the auditor in case of statistical sampling. Since it is scientific, the results of sample can be evaluated and projected on the whole population in a more reliable manner.

In larger organisations, with huge transactions, statistical sampling is always recommended as it is unbiased and the samples selected are not prejudged.

For Example: An auditor while verifying the Purchases during the year realised that the purchase transactions in that year are more than 45000 in number, then in such case, statistical sampling will be highly recommended in the audit program. Random Sampling (discussed ahead in this topic) is the method you decide to choose sample in such a situation.

## QUESTIONS

**Correct/Incorrect**

**State with reasons (in short) whether the following statements are correct or incorrect:**

**15.** In case of Statistical sampling, auditor's bias in choosing sample is involved.

**Ans. (Incorrect)**

Statistical sampling uses scientific method choosing samples from a given population. The use of probability theory is involved in statistical sampling so that every sampling unit has an equal chance of getting selected. In the non statistical sampling, auditor's judgment and past experience is used to choose samples without and scientific method. Hence, personal bias is involved in Non statistical sampling and not Statistical.

***Notes to Add***

## NON-STATISTICAL SAMPLING

Under this approach, the sample size and its composition are determined on the basis of the personal experience and knowledge of the auditor.

This approach has been in common application for many years because of its simplicity in operation. Traditionally, the auditor on the basis of his personal experience will determine the size of the sample and express it in terms that number of pages or personal accounts in the purchases or sales ledger to be checked. For example, March, June and September may be selected in year one and different months would be selected in the next year, On basis of value of items, top 10 highest value. Etc.

An attempt would be made to avoid establishing a pattern of selection year after year, i.e the way of selecting samples, to maintain an element of surprise as to what the auditor is going to check. It is a common practice to check large number of items towards the close of the year so that the adequacy of cut-off procedures can also be determined. Also, because year end transaction are prone to high risk of misappropriation.

The non-statistical sampling is criticized on the grounds that it is neither objective nor scientific. The expected degree of objectivity cannot be assured in non- statistical sampling because the risk of personal bias in selection of sample items cannot be eliminated.

The closeness of the qualities projected by the sample results with that of the whole population cannot be measured because the sample has not been selected in accordance with the mathematically based statistical techniques. However, it may be stated that the auditor with his experience and knowledge of the client's business can evaluate accurately enough the sample findings to make audit decision and the mathematical proof of accuracy in some cases may be a luxury which the auditor cannot afford.

This method is simple to operate but sometimes the sample may not be a true representative of the total population because of personal bias and no scientific method of selection.

## QUESTIONS

**Correct/Incorrect**

**State with reasons (in short) whether the following statements are correct or incorrect:**

**16.** Non statistical sampling is considered to be more scientific than the statistical sampling.

**Ans. (Incorrect)**

Statistical sampling uses scientific method of choosing samples from a given population. The use of probability theory is involved in statistical sampling so that every sampling unit has an equal chance of getting selected. In the non statistical sampling, auditors' judgment and past experience is used to choose samples without any scientific method.

**17.** Non Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.

**Ans. (Incorrect)**

Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.

18. When statistical sampling is used to select a sample, sample need not be representative because the statistical sampling takes care of the representation.

**Ans. (Incorrect)**

Whatever may be the approach 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.

***Notes to Add***

## SAMPLING VS TRADITIONAL METHOD OF AUDITING

Factors to be considered

(1) Size of the organization under Audit
(2) State of I.C.
(3) Adequacy → Reliability → of → Books → Records
(4) Tolerable error range
(5) Degree of desired confidence

| Cannot be 100% Reliable | Cannot give precisely accurate results | It is a process of estimation | May have some errors |
|---|---|---|---|

***Notes to Add***

In most of the circumstances, the evidence available is not conclusive and the auditor always takes a calculated risk in giving his opinion. Even by undertaking hundred percent checking of the transactions, the auditor does not derive absolute satisfaction. This state of uneasiness led pragmatic auditors to adopt the statistical theory of sampling to derive the necessary satisfaction about the state of affairs by checking only a part of the total population of entries.

Auditors realised that they can derive good satisfaction by undertaking a much lesser checking by adoption of this technique in the auditing process. It is a mathematical truth that the sample, if picked purely on a random basis would reveal the features and characteristics of the population.

By adopting the sampling technique, the auditor only checks a part of the whole mass of transactions. The satisfaction he used to derive earlier, by checking all the transactions, can be derived by a sample checking provided he can put reliance on the internal controls and checks within the client's organisation because they provide the reliability of the records. Sampling is used as a part of Tests of controls. Auditor will check few internal controls and their operating effectiveness. Based on the conclusion derived, he can then design the sample size for tests of details (i.e checking of transactions and balances) If the internal control is satisfactory in its design and implementation, a much smaller sample can give the auditor the necessary reliability of the result he obtains.

On the other hand, if in certain areas controls are slack or not properly implemented, the auditor may have to take a much larger sample for getting satisfactory result.

Another truth about the sampling technique should be noted. It can never bring complete reliability; it cannot give precisely accurate results. It is a process of estimation. It may have some error. What error is tolerable for a particular matter under examination is a matter of the individual's judgment in that particular case.

**Example:**

Mr. X may consider that in his estimation of stores valuation, an error of 2% may not be material; he also decides that he needs at least 98% reliability of the result. He is to pick up the requisite number of items of the stores for reliability of the result. The requisite number he can get from the random number table. The question of reliability of the result is directly linked with the reliability of the internal control and of the books and records; when these are satisfactory, lesser degree of reliability of the sampling estimation may suffice – if these are not satisfactory, the auditor may have to decide upon a higher degree of reliability which can only be obtained from a larger sample.

Very often we come across this term when an audit is conducted on the basis of a part checking. This, it is said, owes its origin to the statistical theory of sampling.

The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgement. However, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

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

(i) Size of the organisation under audit.

(ii) State of the internal control.

(iii) Adequacy and reliability of books and records.

(iv) Tolerable error range.

(v) Degree of the desired confidence.

## QUESTIONS

**Correct/Incorrect**

**State with reasons (in short) whether the following statements are correct or incorrect:**

**19.** Low acceptable sampling risk requires larger sample size.

**Ans. (Correct)**

Sampling risk arises from possibility that the auditor's conclusion based upon sample may be different from conclusion that would have been reached if same audit procedures were applied on the entire population. If acceptable sampling risk is low, large sample size is needed.

**Theory Questions**

**20.** Explain the factors to be considered while determining the extent of checking on a sampling plan.

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

(*i*) Size of the organisation under audit.

(*ii*) State of the internal control.

(*iii*) Adequacy and reliability of books and records.

(*iv*) Tolerable error range.

(*v*) Degree of the desired confidence.

***Notes to Add***

## APPROPRIATENESS OF SAMPLING APPROACHES

### Appropriateness of Sampling Approach

Advantage of statistical Sampling

(i) The amount of testing (Sample Size) does not increase in proportion

↓

To the increase in size of area (universe) to be tested

(ii) The sample selection is more objective & thereby more defensible

(iii) The method provides a means of estimating a minimum sample size → Associated with a specific → Risk → Precession

(iv) If provides a means of deriving a i.e. probable difference in result due to use of sample in lieu of examining All the records in the group (Universe) → Using the same Audit Procedure → Calculated Risk → Corresponding Precision(Sampling Error)

(v) It may provide a better description of large mass of data than a complete examination of all the data, since non-sampling errors such as → Processing → Clerical Mistakes → Are not as large

Auditor should NOT attempt to use STATISTICAL Sampling

- Another approach
  - Necessary
  - Provide Necessary Satisfaction
    - Less Time
    - Less Effort
- Audit Staff has ↓ No Knowledge ↓ Sampling Technique

***Notes to Add***

In statistical sampling, the sample results are measurable as to the adequacy and reliability of the audit objectives whereas in non-statistical sampling the auditor's opinion determines the sample size but it cannot be measured how far the sample size would fulfill the audit objective.

**The advantages of statistical sampling may be summarized as follows:**

(1) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.

(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 and precision.

(4) It provides a means for deriving a "calculated risk" and corresponding precision (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), usin`g the same audit procedures.

(5) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.

(6) It is widely accepted way of sampling as it is more scientific, without personal bias and the result of sample can be evaluated and projected in more reliable way.

Under some audit circumstances, statistical sampling methods may not be appropriate. The auditor should not attempt to use statistical sampling when another approach is either necessary or will provide satisfactory information in less time or with less effort. For instance, when exact accuracy is required or in case of legal requirements etc.

Sometimes the audit staff has no knowledge about sampling technique used, in such circumstances using statistical sampling becomes complex and inappropriate.

***Notes to Add***

## SAMPLING PROCESS

Sample Design
↓
Sample Size
↓
Sample Selection
↓
Audit Procedures
↓
Nature And Cause of Deviation And
↓
Projecting
↓
Evaluating Results of Audit

### Sample Design, Size and Selection of Items for Testing

* Sample Design

When Designing an Audit Sample → Auditor's Consideration

- Specific purpose to be achieved
- Combination of Audit Procedures ↓ Likely to best achieve Purpose
- Nature of A.E. ↓ Sought + Possible
  - Deviation
  - Misstatement
- A.E. → Population ↓ COMPLETE

The Auditor's Considerations for the purpose of Audit Procedures Includes

- A Clear Understanding of ↓ What constitute a deviation ↓ So that all & only those conditions that are relevant are included in evaluation of
  - Deviation
  - Projected Misstatements
    - Design an Audit Sample
    - Determine Sample size
- In considering the characteristics of population for
  - ToC
  - ToD
  - The Auditor makes on Assessment of the
    - of the Expected Rate of Deviation ↓ Based on Auditor's Understanding of Relevant Control to
    - of the Expected Misstatement
      - 100% Examination
      - Use of large sample size

When designing an audit sample, the auditor shall consider the purpose of the audit procedures and the characteristics of the population from which the sample will be drawn. The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level. The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection. Sample selected must be representative of the population.

When designing an audit sample,

(i) the auditor's consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose.

(ii) Consideration of the nature of the audit evidence sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling.

(iii) In fulfilling the requirement of SA 500 "Audit Evidence", when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

The auditor's consideration of the purpose of the audit procedure includes a clear understanding of what constitutes a deviation or misstatement so that all, and only, those conditions that are relevant to the purpose of the audit procedure are included in the evaluation of deviations or projection of misstatements.

**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. Also, a wrong posting between customer accounts does not affect the total accounts receivable balance.

Therefore, it may not be appropriate to consider this a misstatement in evaluating the sample results of this particular audit procedure, even though it may have an important effect on other areas of the audit, such as the assessment of the risk of fraud or the adequacy of the allowance for doubtful accounts.

In considering the characteristics of a population, for tests of controls , the auditor makes an assessment of the expected rate of deviation based on the auditor's understanding of the relevant controls or on the examination of a small number of items from the population. This assessment is made in order to design an audit sample and to determine sample size.

**Example:**

If the expected rate of deviation is unacceptably high, the auditor will normally decide not to perform tests of controls.

**Similarly, for tests of details,** the auditor makes an assessment of the expected misstatement in the population. If the expected misstatement is high, 100% examination or use of a large sample size may be appropriate when performing tests of details.

***Notes to Add***

............................................................

............................................................

## STRATIFICATION AND VALUE-WEIGHTED SELECTION

Stratification & Value Weighted Selection

SA-530 provides guidance to the Auditor on the use of:

(A) Stratification (Division of Something into Group)

(i) Audit efficiency May Improve → If Auditor Stratifies a population → by dividing it into → Discrete Sub-Population → Which has an identifying characteristics

(ii) Objective of stratification → To reduce variability of items → within each stratum group

∴ Allows sample size to be reduced → without increasing sample risk

(iii) If → CoT → A/c. Balance → Has been divided into station

Projected misstatements from each station → Are Combined when considering the possible effect of Misstatment on Total → CoT → A/c. Bal.

(B) Value Weighted Selection

→ When Performing ToD → It may be efficient to identify sampling units as Individual Monetary units → That makes up the population → Benefits: Sampling units Audit efforts is directed

↓

To Larger Value Items

↓

Because

- They have a greater chance of selection
- They can be in smaller sample size

***Notes to Add***

**In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection is appropriate.**

SA 530 provides guidance to the auditor on the use of stratification and value- weighted sampling techniques.

**Stratification:** Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic.

The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

When performing tests of details, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement.

Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.

**Stratification:** Dividing a population into discrete sub population which have identifying characteristics is called as Stratification. Each Sub population is called as Stratum and units under those sub population are referred to as Strata.

The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population.

The results of samples from the units drawn under each sub population are projected to that respective stratum. In order to draw an opinion on the overall population, the auditor needs to combine the results of all the stratum to check for possible deviation or risk of material misstatement.

Projected misstatements of each stratum will be combined together to consider the possible effect of misstatement in the account balances and class of transactions.

**Example:** 20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).

**Value-Weighted Selection:** When performing tests of details, it may be efficient to identify the sampling unit as the individual monetary units that make up the population. 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 to defining the sampling unit 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.

In value weighted selection, the sample size, its selection and evaluation will result in a conclusion in monetary amounts.

## QUESTIONS

**Correct/Incorrect**

**State with reasons (in short) whether the following statements are correct or incorrect:**

**21.** Stratified Sampling is used for homogeneous population.

**Ans. (Incorrect)**

Stratified sampling is used when the population is diversified i.e heterogeneous. The population is divided into sub population having similar characteristics. Sample are then chosen from these sub populations which are called as Stratum. Therefore, stratified sampling is not useful in case of homogeneous population.

**22.** The objective of stratification is to increase the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

**Ans. (Incorrect)**

The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

**Theory Questions**

**23.** Write short notes on the following:

(*a*) Advantages of Statistical sampling in Auditing.

(*b*) Stratified sampling.

**Ans.**

(*a*) Advantages of Statistical Sampling in Auditing: Refer to heading "Appropriateness of Sampling Approaches".

(*b*) Stratified Sampling: Refer to heading "Samples Selection methods".

***Notes to Add***

## SAMPLE SIZE

(1) The level of Sampling Risk → That Auditor is willing to accept

↓

Affects the sample size Required

Lower Risk ↔ Greater Sample Size & Vice-Versa

(2) Sample size can be determined by → Statistically based formulae → Exercise of professional Judgement.

(3) When circumstances are similar → The effect on sample size of factors → Which have an effect on determination of sample size → will be similar in → Statistical → Non-Statistical → Approach

(4) Factors Affecting sample size for → ToC → ToD

**ToC**

(1) Greater RELIANCE on I.C. → Greater extent of ToC

(2) ↑ Tolerable Rate of DEVIATION → ↓ in sample size

(3) ↑ Expected Rate of Deviation → ↑ Sample Size

(4) ↑ Desired level of Assurance → ↑ Sample Size

(5) ↑ Homogenous Sampling → No Effect

**ToD**

(1) ↑ RoMM → ↑ Sample Size

(2) ↑ Substantive Procedures → ToD → ↓ sample size; → SP

(3) ↑ Desired Assurance → ↑ Sample Size

(4) ↑ Tolerable Misstatement → ↓ Sample Size

(5) Stratification of Population → ↓ Sample Size

(6) No. of Sampling Units → NEGLIGIBLE EFFECT

***Notes to Add***

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 judgment. There are various factors typically have 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. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

(i) When there is an increase in the extent to which the auditor's risk assessment takes into account relevant controls. The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls. Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of controls (and therefore, the sample size is increased). Thus, sample size will increase.

(ii) If there is an increase in the tolerable rate of deviation. Then sample size will decrease, as lower the tolerable rate of deviation, larger the sample size needs to be. Tolerable error is the maximum error in the population that auditor is ready to accept in a given sample size. Smaller the tolerable error, larger will be the sample size.

(iii) When there is an increase in the expected rate of deviation of the population to be tested then sample size will increase, as higther the expected rate of deviation, larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected rate of deviation include the auditor's understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures.

High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.

(iv) An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population will increase the sample size. Thus, the greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.

(v) In case of large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence. Therefore, there will be negligible effect on sample size due to increase in the number of sampling units in the population.

The following are factors that the auditor may consider when determining the sample size for tests of details. These factors, which need to be considered together, assume the auditor does not modify the approach to tests of controls or otherwise modify the nature or timing of substantive procedures in response to the assessed risks.

(i) The higher the auditor's assessment of the risk of material misstatement, the larger the sample size needs to be. The auditor's assessment of the risk of material misstatement is affected by inherent risk and control risk. For example, if the auditor does not perform tests of controls, the auditor's risk assessment cannot be reduced for the effective operation of internal controls with respect to the particular assertion.

Therefore, in order to reduce audit risk to an acceptably low level, the auditor needs a low detection risk and will rely more on substantive procedures. The more audit evidence that is obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be. Thus we can say that there will be an increase in sample size in case of an increase in the auditor's assessment of the risk of material misstatement.

(ii) The more the auditor is relying on other substantive procedures (tests of details or substantive analytical procedures) to reduce to an acceptable level the detection risk regarding a particular population, the less assurance the auditor will require from sampling and, therefore, the smaller the sample size can be. Hence, if there is an increase in the use of other substantive procedures directed at the same assertion, the size of sample will decrease.

An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population will increase the sample size. Hence, greater the level of assurance that the auditor requires that the results of the sample are in fact indicative of the actual amount of misstatement in the population, the larger the sample size needs to be.

(iii) An increase in tolerable misstatement will decrease the sample size as lower the tolerable misstatement, the larger the sample size needs to be.

(iv) The greater the amount of misstatement the auditor expects to find in the population, the larger the sample size needs to be in order to make a reasonable estimate of the actual amount of misstatement in the population.

Factors relevant to the auditor's consideration of the expected misstatement amount include the extent, to which item values are determined subjectively, the results of risk assessment procedures, the results of tests of control, the results of audit procedures applied in prior periods, and the results of other substantive procedures. So, sample size will increase in case of an increase in the amount of misstatement the auditor expects to find in the population.

(v) When stratification of the population is appropriate then sample size will decrease as when there is a wide range (variability) in the monetary size of items in the population, it may be useful to stratify the population. When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.

(vi) There will be negligible effect on sample size due to number of sampling units in the population. For large populations, the actual size of the population has little, if any, effect on sample size. Thus, for small populations, audit sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence. (However, when using monetary unit sampling, an increase in the monetary value of the population increases sample size, unless this is offset by a proportional increase in materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures.)

## QUESTIONS

### Theory Questions

**24.** With reference to Standard on Auditing 530, state the requirements relating to audit sampling, sample design, sample size and selection of items for testing.

**Ans.** **Audit Sampling:** As per SA 530 on "Audit Sampling", the meaning of the term Audit Sampling is – 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.

The requirements relating to sample design, sample size and selection of items for testing are explained below:

**Sample design:** When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.

**Sample Size:** The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

**Selection of Items for Testing:** The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

***Notes to Add***

## SELECTION OF ITEMS FOR TESTING

Selection of Items for testing

→ Statistical Sampling → items are selected in such a way

↓

That each sampling unit has a known probability of being selected

Non-Statistical Sampling → Judgement is used to select sample

→ It is important that Auditor Selects

↓

Representative Sample

↓

to avoid bias

**Method of Selecting Sample**

- Random
  - Sample Random Sampling → Items selected by using random number table → Appropriate when items are similar & in reasonable range
  - Stratified Random Sampling → Items are selected from strata → Appropriate for highly diversified population
- Systematic or Internal Sampling ↓ Items in population are devide on the basis of sample size (eg.: Every $50^{th}$ Item)
- Haphagard Sampling ↓ Sample is selected without following structured techniques & does not involve judgement
- Block Sampling ↓ Selection of Block(s) of Contiguous items
- Monetary Units Sampling ↓ Type of value weighted selection ↓ Sample size, Evaluation, selection based on monetary amounts

Sample Selection Method
- Random Sampling
- Systematic Sampling
- Monetary Unit Sampling
- Haphazard Sampling
- Block Sampling

***Notes to Add***

The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

With statistical sampling, sample items are selected in a way that each sampling unit has a known probability of being selected. With non-statistical sampling, judgment is used to select sample items. Because the purpose of sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected, it is important that the auditor selects a representative sample, so that bias is avoided, by choosing sample items which have characteristics typical of the population.

The principal methods of selecting samples are the use of random selection, systematic selection and haphazard selection.

***Notes to Add***

Sample should be selected in such a manner that it is representative of the population from which the sample is being selected. It will necessitate that each item in the population has an equal chance of being included in the sample.

***Notes to Add***

**Some of the important methods of selecting the sample are discussed below:**

(1) Random Sampling: Random selection ensures that all items in the population or within each stratum have a known chance of selection. It may involve use of random number tables. Random sampling includes two very popular methods which are discussed below–

(*i*) Simple Random Sampling: Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected. It is considered that 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 random number table either with a help of computer or picking up a number in a random way (may be randomly from a drum). Today random numbers are also generated using various applications on the cellphones like the random number generator.

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

**Example:**

The population can be considered homogeneous, if say, trade receivables balances fall within the range of ₹ 55,000 to ₹ 2,25,000 and not in the range between ₹ 525 to ₹ 10,50,000.

(*ii*) Stratified Sampling: This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment.

**Example:**

(1) In the above case, trade receivables balances may be divided into four groups as follows:

(*a*) balances in excess of ₹ 10,00,000;

(*b*) balances in the range of ₹ 7,75,001 to ₹ 10,00,000;

(*c*) balances in the range of ₹ 5,50,001 to ₹ 7,75,000;

(*d*) balances in the range of ₹ 2,25,001 to ₹ 5,50,000; and

(*e*) balances ₹ 2,25,000 and below.

From these above groups the auditor may pick up different percentage 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 per cent of the items; and from the lowest group 2 per cent of the items may be selected. Random sample is chosen from each stratum using random number tables.

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The reasoning behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each strata. It can be seen that the stratified sampling is simply an extension of simple random sampling.

Stratification means dividing heterogeneous (Diversified) population into Homogeneous (having similar characteristics) sub population, where samples are drawn from each sub population. Therefore, we can say that random selection method is applied through random number generators, for example, random number tables.

(2) Interval Sampling or Systematic Sampling: Systematic selection is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerized random number generator or random number tables.

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 100th item and the sampling interval selected is 100. The result would be that either the auditor would have selected all or none of the sales of that particular branch.

If Accountant A is responsible to record all transaction in a particular month and Accountant B for next month; if this structure is same throughout the year, and the auditor determines as his sample to check every transaction of alternate months, then only one accountant's work is checked by the auditor i.e either Accountant A or B depending upon which month the checking started from. The work of other is overlooked and there could be a possibility of material misstatement in the transactions recorded by him.

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 minimize such risk.

To minimise the effect of the possible known buyers through a pattern in the population, more than one starting point may be taken. The multiple random starting point is taken because it minimises the risk of interval sampling pattern with that of the population being sampled.

(3) Monetary Unit Sampling: It is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.

(4) Haphazard sampling: Haphazard selection, in which the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

(5) Block Sampling: This method involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. 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 valid inferences about the entire population based on the sample.

Haphazard sampling has no structured approach, does not involve judgement and does not even use the random number tables.

Usually, a range of continuous transaction shall have similar characteristics, therefore, selection of a group at one time will not give a reasonable basis for opinion on the overall population as different types of transactions and unusual transactions may not be covered in the group taken all at once. Further, if the client has the idea of the block selection pattern of the auditor, then material misstatements and deviations can be easily overlooked by management's practice of recording them.

**Example:**

Take the first 200 sales invoices from the sales day book in the month of September, alternatively take any four blocks of 50 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.

## QUESTIONS

**Theory Questions**

**25.** While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind?

**Ans.** Risk Factors while applying Sampling Techniques: As per SA 530 "Audit Sampling", sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions-

(*i*) In the case of a test of controls, that controls are more effective than they actually are, or in the case of tests of details, that a material misstatement does not exists when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

(*ii*) In the case of test of controls, the controls are less effective than they actually are, or in the case of tests of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

***Notes to Add***

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## PERFORMING AUDIT PROCEDURES

(1) Auditor should perform Audit procedures → Appropriate to the purpose → on each item selected

(2) If Audit procedure is → Not Applicable → Audit procedure is not be performed on → replacement Item

(3) If Auditor is unable to apply → Designed Audit procedure (Point-1) / → Suitable alternative procedure (Point-2)

↓

On Selected items

↓

The Auditor shall treat that item as

↓

'Deviation from prescribed control'

***Notes to Add***

## NATURE & CAUSE OF DEVIATIONS & MISSTATEMENTS

**Nature & Cause of → Deviation & Misstatement**

In analyzing the → Deviations → Misstatements → identified

↓

The Auditor may observe that → many have common features → then Auditor may

- Identify all items in population ↓ That possesses that common feature
- Extended Audit Procedures ↓ To those items
- May indicate the possibility of Fraud

∴ Auditor should → Investigate → Nature & Causes of Deviations / → Possible effects on Audit

If Anomaly is discovered → Obtain Certainity → Deviation → MM → not representative of population

May be excluded in projecting MM → However → Effects are to be considered → If uncorrected

(i) The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.

(ii) If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item.

(iii) 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.

(iv) An example of when it is necessary to perform the procedure on a replacement item is when a cancelled cheque is selected while testing for evidence of payment authorization. If the auditor is satisfied that the check has been properly cancelled such that it does not constitute a deviation, an appropriately chosen replacement is examined. A replacement would then mean a proper and valid cheque through which payment has been made.

(v) An example of when the auditor is unable to apply the designed audit procedures to a selected item is when documentation relating to that item has been lost. If the documentation of a sales is lost, like the sales order record, sales invoice, document for dispatch etc., then confirmation can be sought from the debtor as per SA 505. If it is a cash sale, the cash book can be cross verified for the existence of such transactions.

(vi) An example of a suitable alternative procedure might be the examination of subsequent cash receipts together with evidence of their source and the items they are intended to settle when no reply has been received in response to a positive confirmation request.

(vii) Another example for replacement of a sample could be, if all transactions of computerized sales are being checked, for example sales recorded through a bar code scanner, and incidentally a sample of manual billing gets selected, then such item can be replaced after adequately checking the correctness of the manual bill with the supporting documents available. If replacement is not possible or reasonable, alternative audit procedure can be applied.]

(i) In analyzing 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.

(ii) 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.

(iii) Therefore, the auditor shall investigate the nature and causes 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.

(iv) 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.

(v) The auditor shall obtain this 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.

## PROJECTING MISSTATEMENTS

- The auditor is required to 'Project Misstatements → for the population

↓

But this projection May not be sufficient

- When a misstatement has been established as an 'Anomaly'

↓

It may be excluded when projecting misstatements

↓

However its effects still needs to be considered

↓

- For ToD → Auditor shall → Project Misstatements
- ToC → No Explicit projection of Deviation

## EVALUATING RESULTS OF AUDIT SAMPLING

The Auditor shall Evaluate:

(*a*) Result of Sample

(*b*) Whether the use of Audit Sampling has provided a Reasonable Basis

↓

for conclusion

↓

About population that has been tested

For ToC → Unexpected High Sample Deviation Rate

↓

May lead to an increase in assessed RoMM

↓

Unless further A.E. Substantiating the initial assessment is obtained

ToD → An Unexpected High Misstatement Amount in a sample

↓

May cause the Auditor to believe that → CoT → A/c. Bal. → is MM

↓

In absence of further A.E. that no MM Exists

***Notes to Add***

(i) 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.

(ii) 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.

(iii) 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.

***Notes to Add***

**The auditor shall evaluate:**

(*a*) The results of the sample; and

(*b*) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

Few Important terms to make the understanding better

**Stratification:** The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).

**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.

***Notes to Add***

**Test Your Understanding**

**4.** A company has stipulated a control through its automated software that interest @ 12% p.a. is charged in case of those customers who fail to make payment within a month of a sales transaction. The internal auditor of the company finds that during a certain period, software has failed to charge interest due to certain technical glitches. Does reporting of above situation fall in domain of internal auditor's work?

**Ans.** One of the functions of internal auditor includes responsibility for reviewing controls, evaluating their operation, and recommending improvements thereto. In the given case, internal auditor has found that controls relating to levying of interest have not operated. The system has not levied stipulated interest in respect of a certain period. It can result in loss of income for the company and improper financial reporting. Such a matter, definitely, falls in the domain of reporting by internal auditor.

**5.** CA Sukesh is external auditor of an entity. He comes to know that there is also an internal auditor in the entity. However, he finds that internal auditor is not reporting directly to higher echelons of the management. CA Sukesh has also assessed risk of material misstatement to be high. Discuss, whether it would be proper for CA Sukesh to rely upon work of internal auditor extensively in above situation.

**Ans.** In the given case, the organizational status of internal audit function is not commensurate with his duties. He is not reporting directly to higher echelons of management. It shows that such a function is not given its due importance in entity. Since risk of material misstatements has also been assessed as high by CA Sukesh, both the above factors suggest that he should not rely upon work of internal auditor extensively.

**6.** An auditor, while conducting audit of an entity, has selected samples based upon his personal experience and knowledge. Later on, it turns out that selected samples were not representative and it has led to faulty selection of samples. The auditor contends that samples were selected based upon his personal experience and knowledge. Can auditor escape from his responsibility in this regard?

**Ans.** In the provided situation, the auditor has selected samples based upon his personal experience and knowledge. It, is a case of non-statistical sampling approach adopted by the auditor. Whatever may be the approach 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 auditor cannot escape his responsibility in this regard.

***Notes to Add***

## AUDIT EVIDENCE-SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS (SA 501)

**Audit Evidence → Specific Considerations for Selected Items (SA-501)**

- Existence & Conditions of Inventory
- Completeness of Litigations & Claims Involving the Entity
- Presentation & Disclosure of Segment Info. In accordance with opp. F.R.F.

→ Objective of Auditor → To obtain Sufficiency + Appropriate A.E. → Regarding

→ **Inventory:**

(i) Attendance @ Physical Inventory Counting → Unless impracticable

(i) Attendance @ Physical Inventory Counting → Unless impracticable

→ Evaluate → Mgt's Instruction

↓

Observe → Performance

↓

Inspect → Inventory

↓

Perform → Test Count

(ii) Performing Audit Procedures → Over Entity's Final Inventory Records

**Attendance at Physical Inventory Counting Involves:**

(i) Inspecting
- → Existence
- → Conditions
- → Perform → Test Count

(ii) Observing → Compliance → Mgt. Instructions

(iii) Obtaining → A.E. → Mgt. Count Procedure

***Notes to Add***

**Audit Evidence-specific Considerations For Selected Items (Sa 501)**

(1) Meaning of Audit Evidence- Specific Considerations for Selected Items

The auditor has to express his opinion on financial statements of an entity. For this, he has to examine the books of accounts. He needs evidence in support of transactions recorded in books of accounts. There are some transactions for which he needs specific considerations. For example, inventory

SA 501 "Audit Evidence- Specific Considerations for Selected Items" deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence with respect to certain aspects of inventory, litigation and claims involving the entity, and segment information in an audit of financial statements.

(2) Objective of the Auditor in respect of Specific Considerations for Selected Items

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.

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

**Inventory**

(1) 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.

(2) 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 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.

These procedures may serve as test of controls or substantive procedures depending on the auditor's risk assessment, planned approach and the specific procedures carried out.

**Matters Relevant in Planning Attendance at Physical Inventory Counting**

- Nature of Inventory
- Stages of WIP
- RoMM of Inventory
- Nature of IC
- Timing of Counting
- Entity Maintains → Perpetual Inventory System?

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

(*a*) Nature of inventory.

(*b*) Stages of completion of work in progress.

(*c*) The risks of material misstatement related to inventory.

(*d*) The nature of the internal control related to inventory.

(*e*) Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.

(*f*) The timing of physical inventory counting.

(*g*) Whether the entity maintains a perpetual inventory system.

(*h*) 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

(*i*) Whether the assistance of an auditor's expert is needed to obtain sufficient appropriate audit evidence.

## QUESTIONS

### Theory Questions

**26.** Explain clearly the examples of matters relevant in planning attendance at physical inventory counting.

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

(*a*) Nature of inventory.

(*b*) Stages of completion of work in progress.

(*c*) The risks of material misstatement related to inventory.

(*d*) The nature of the internal control related to inventory.

(*e*) Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.

(*f*) The timing of physical inventory counting.

(*g*) Whether the entity maintains a perpetual inventory system.

(*h*) 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

(*i*) Whether the assistance of an auditor's expert is needed.

### Physical Inventory Counting Conducted other than at the Date of the Financial Statements

Physical Inv. Counting → Other than the date of F.S

Auditor Shall → Perform → Above Mentioned Audit Procedure + Additional Audit procedures to obtain Sufficiency + Appropriate A.E. about $\Delta$ in Inventory

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

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

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

***Notes to Add***

## IF AUDITOR UNABLE TO ATTEND PHYSICAL INVENTORY COUNTING

**If Auditor unable to Attend Physical Inventory Counting**

↓

**Due to Unforeseen Circumstances**

↓

**Auditor shall**

Make / Observe
↓
Some Physical Count
↓
On an alternative Date

Perform Audit Procedures
↓
On Intervening Transactions

**When inventory under the custody and control of a third party-What will the auditor do?**

→ When Inventory → Material is under the → Custody → Control → of a 3rd Party

Auditor Shall

Request Confirmation from the 3rd Party → Qty. → Condition

Perform → Inspection → Other Audit Procedure appropriate in the circumstances

***Notes to Add***

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 at Physical Inventory Counting becomes impractical**

Attendance of Physical Inventory is Impracticable

**Auditor Shall:**

(i) Perform → Alternative Audit Procedure

↓

If not possible → Modify as per SA 705

(ii) General Inconvenience to Auditor → Not sufficient Reason

When inventory under the custody and control of a third party-What will the auditor do?

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, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory.

**For example:**

where inventory is held in a location that may pose threats to the safety of the auditor.

The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in SA 200, the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

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.

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

(*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.

**Other audit procedure may include -**

**For Example:**

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

**Illustration 5:** JK Exports Ltd is a manufacturer exporter having its own production capacity and also gets the job work done through various job workers. The auditor of JK Exports Ltd. Considers that inventory held with job workers is material to the financial statements.

**Required**

Suggest the audit procedures in the given case.

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

(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.

***Notes to Add***

## LITIGATION AND CLAIMS

Auditor shall → Design → Perform ← Audit Procedures

- Inquire
  - Mgt.
  - Others within the Entity
  - + Legal Counsel
- Review → Minutes of Meeting
  - TCWG
  - External Counsel
- Review → Legal Expenditure

***Notes to Add***

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## IF THE AUDITOR ASSESSES A RISK OF MATERIAL MISSTATEMENT REGARDING LITIGATION OR CLAIMS-COMMUNICATION WITH THE ENTITY'S EXTERNAL LEGAL COUNSEL

↓

Communication with Entity's External Legal Counsel

- Seek Direct Communication → through Letter of Inquiry
  ↓
  With Entity's External Legal Counsel
  → In Certain circumstances
  ↓
  Meet External Legal Council
- If
  - Law
  - Regulation
  - Professional Body

  Prohibits → Communication → Perform Additional Audit Procedure

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 those charged with governance and correspondence between the entity and its external legal counsel; and

(c) Reviewing legal expense accounts.

Litigation and claims involving the entity may have a material effect on the financial statements and thus may be required to be disclosed or accounted for in the financial statements.

In addition to the procedures identified above other relevant procedures include,

**For example:**

Using information obtained through risk assessment procedures carried out as part of obtaining an understanding of the entity and its environment to assist the auditor to become aware of litigation and claims involving the entity.

Audit evidence obtained for purposes of identifying litigation and claims that may give rise to a risk of material misstatement also may provide audit evidence regarding other relevant considerations, such as valuation or measurement, regarding litigation and claims. SA 540 establishes requirements and provides guidance relevant to the auditor's consideration of litigation and claims requiring accounting estimates or related disclosures in the financial statements.

Litigation and Claims

→ Request W.R. → Mgt. → TCWG → that all → Known → Possible → Litigation have been disclosed

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 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.

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) A list of litigation and claims;

(b) 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

(c) 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:

(*i*) The auditor determines that the matter is a significant risk.

(*ii*) The matter is complex.

(*iii*) 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.

Further 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.

**Illustration 6:** Parag India Ltd is a manufacturer of various FMCG (fast moving consumable goods) range of products. The company is having several cases of litigation pending in courts. The auditor wanted to identify litigation and claims resulting to risk of material misstatements.

**Required**

Suggest the auditor with reference to SAs.

**Solution:** 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 those charged with governance 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.

**Test Your Understanding**

**7.** The audit procedures performed so far by auditor of a company indicate that there is a possibility that company has not disclosed all material litigation cases involving the company. Does such a situation warrant direct communication by auditor with external lawyer of the company?

**Ans.** As per requirements of SA-501, 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, seek direct communication with the entity's external legal counsel. The above situation warrants direct communication with company's standing external lawyer.

## *Notes to Add*

## SEGMENT INFORMATION

Auditor Shall obtain → Sufficiency + Approriate A.E. → Regarding

BY

Obtaining an understanding of Methods of determining Segment Info.

Performing Analytical procedure OR other Audit procedure

Presentation

Disclosure

of Segment Info.

In accordance with app F.R.F.

Evaluating → Such Methods → Likely to result in disclosure

Test of Application → of Such Methods

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

↓

Not required → to perform → Audit Procedures

↓

On Stand Alone Basis

## UNDERSTANDING OF THE METHODS USED BY MANAGEMENT

Methods used by Mgt.

↓

Depends up on Circumstances

Example of Methods

(*i*) Sales, Transfer, Elimination of Inter-Segment Amount

(*ii*) Comparison with Budgets

(*iii*) Allocation of → Assets → Costs → Amongst Segments

(*iv*) Consistency with prior periods

***Notes to Add***

**Definition of segment information**

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

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:

(*a*) Obtaining an understanding of the methods used by management in determining segment information, and:

(*i*) Evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework; and

(*ii*) Where appropriate, testing the application of such methods; and

(*b*) Performing analytical procedures or other audit procedures appropriate in the circumstances.

The auditor's responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements 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.

***Notes to Add***

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

(1) Sales, transfers and charges between segments, and elimination of intersegment 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.

## QUESTIONS

**Theory Questions**

**27.** Discuss what is understood by "appropriateness" of audit evidence.

**Ans.** Refer to heading "Sufficient appropriate audit evidence".

***Notes to Add***

## EXTERNAL CONFIRMATIONS (SA 505)

↓

A.E. → Obtained as Direct Written Response → To the Auditor

↓

From a 3rd Party (Conforming Party)

↓

In

Paper | Electronic | Other

Form

**Types of External confirmations**

- '+'ve confirmation Request → Confirming Party Responds-Agrees/Disagrees
- '–' ve confirmation Request → Confirming Party Responds → only when → Disagrees
- Non Response → failure to Respond
- Exception → Info → sought / obtained → are different

**(i) Determine → info → to be → confirmed / Requested**

**(ii) Selecting → Approx. Confirming party**

**(iii) Designing → confirmation request**

- **Properly addressed**
- **Contain Return Info.**

***Notes to Add***

External confirmation Procedures adopted by the Auditor to obtain Audit Evidence.

***Notes to Add***

Designing confirmation Request: Factors to be considered

(*i*) Specific identified RoMM → Including Fraud Risk
(*ii*) The Layout & Presentation of confirmation Request
(*iii*) Prior Experience of Audit & similar Engagements
(*iv*) Mgt. → Authorization → Encouragement → to Confirming Party
(*v*) The method of communication
(*vi*) Ability of intended confirming Party → to confirm
(*vii*) Sending the request + Follow up

Mgt's Resfusal to allow the auditor to send a confirmation Request

The Aduditor shall :

(1) Inquire as to Mgt's → Reasons for Refusal + Seek A.E → Validity → Reasonableness
(2) Evaluate the implications → of Mgt's refused
(3) Perform → Additional Audit Procedure
If Auditor concludes → Refusal → Unreasonable → Unable to obtain → Reliable → Relevant → A.E
Communication with TCWG → as per SA 260

***Notes to Add***

Negative Confirmations

- Less persuasive than '+ve' confirmation
- Auditor Shall Not Use as Sole Substantive Procedure
  - Unless
    - Low ROMM + High I.C
    - Population Comprises Small Homogenous A.C Bal Transaction Condition
    - Low Exception Rate Expected
    - Not aware of circumstance
      - Recipient
        - Disregard Request

***Notes to Add***

..........................................................................................

## 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.

Audit evidence obtained → as a direct written response → to the auditor → from a third party → in paper form, or by electronic or other medium

***Notes to Add***

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SA 500 indicates that the reliability of audit evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

It also includes the following generalisations applicable to audit evidence:

- Audit evidence is more reliable when it is obtained from independent sources outside the entity.
- Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
- Audit evidence is more reliable when it exists in documentary form, whether paper, electronic or other medium.

The Standard on Auditing (SA) 505 "External Confirmations" deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of SA 500.

Accordingly, depending on the circumstances of the audit, audit evidence in the form of external confirmations received directly by the auditor from confirming parties may be more reliable than evidence generated internally by the entity.

SA505 is intended to assist the auditor in designing and performing external confirmations procedures to obtain relevant and reliable audit evidence.

Thus, the objective of the auditor, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence.

**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.**

- **Positive confirmation request:** A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees.
- **Negative confirmation request:** A request that the confirming party respond directly to the auditor only if the confirming party disagrees.
- **Non-response:** A failure of the confirming party to 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.

***Notes to Add***

**Illustration 7:** During the financial year 2022-23, the auditor of Healthy and Wealthy Limited asked a Trade Receivable to respond directly to the auditor whether or not the amount they were required to pay to Healthy and Wealthy Limited was ₹ 1,23,000. That trade receivable confirmed to the auditor of Healthy and Wealthy Limited, that they were required to pay an amount of ₹ 1,23,000 to Healthy and Wealthy Limited. State and explain the type of Confirmation Request as required by the auditor.

**Solution:** The above-mentioned situation is an example of Positive Confirmation Request because in Positive Confirmation Request the party confirms the auditor of a company whether such party agrees or whether such party disagrees with the information for which the confirmation is required by auditor of that company.

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.

**(*a*) 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".

**(*b*) 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.

**(*c*) Designing Confirmation Requests:**

(1) 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 responses.

(2) 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).

(3) 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.

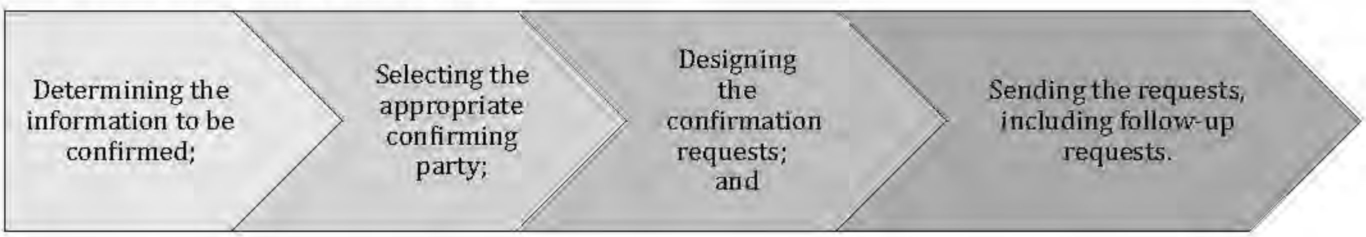
(4) Determination of properly addressed requests

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.

**(d) 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.




***Notes to Add***

## QUESTIONS

**Theory Questions**

**28.** When using external confirmation procedures, the auditor shall maintain control over external confirmation requests including sending the requests, including follow-up requests when applicable, to the confirming party. Explain the other points as to when using external confirmation procedures, the auditor would be required to maintain control over external confirmation requests.

**Ans.** 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.

***Notes to Add***

## INQUIRE AS TO MANAGEMENT'S REASONS FOR THE REFUSAL

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

(a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;

(b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and

(c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

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 those charged with governance 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.

**Inquire as to management's reasons for the refusal:**

- Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement; and
- Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

### Reasonableness of Management's Refusal

A refusal by management to allow the auditor to send a confirmation request is a limitation on the audit evidence the auditor may wish to obtain. The auditor is therefore required to inquire as to the reasons for the limitation.

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.

The auditor may conclude that it would be appropriate to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit procedures.

**For example:**

### Implications for the Assessment of Risks of Material Misstatement

If management's request to not confirm is unreasonable, this may indicate a fraud risk factor that requires evaluation in accordance with SA 240.

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.

**Illustration 8:** While conducting the audit of AB Ltd, the auditor K of KLM and Associates, Chartered Accountants observes that there are large number of Trade payables and receivables standing in the books of accounts as on 31st March. The auditor wanted to send confirmation request to few trade receivables, but the management refused the auditor to send confirmation request.

**Required**

How would the auditor proceed?

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

(*a*) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;

(*b*) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and

(*c*) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

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 those charged with governance 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.

## NEGATIVE CONFIRMATIONS

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:

**Negative Confirmations**

(*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.

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.

***Notes to Add***

## EVALUATING THE EVIDENCE OBTAINED

Auditor → Evaluate → Result → Provide R & R .A. E / → Performing FAP necessary

↓

May categories as follows

Response → Indicate →Agreement
→ Unreliable
→ Non - Response
→ Exception

***Notes to Add***

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*) A response by the appropriate confirming party indicating agreement with the information provided in the confirmation request, or providing requested information without exception;

(*b*) A response deemed unreliable;

(*c*) A non-response; or

(*d*) 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, as required by SA 330.

**Test Your Understanding**

**8.** CA Jignesh Desai is in midst of audit of a company. The company is fairly large one and has a well-functioning internal audit department. While considering sending out external confirmation requests to trade receivables outstanding as on date of financial statements, he has delegated the process of choosing trade receivables, designing requests and receiving responses from customers to internal audit department. The responses are also received on the mail id of internal audit department. Is approach of CA Jignesh Desai proper?

**Ans.** 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.

In the given case, it appears that external auditor has delegated entire work of sending out external confirmation requests to internal audit department over which he has no control. Further, responses to external confirmation requests are received on mail id of internal audit department. All these acts are not in line with requirements under SA 505.

**9.** On reviewing schedule of trade receivables of a company, CA Mary finds that in respect of one outstanding balance, the CFO of the company is not willing to allow her to send external confirmation request due to the reason that sending out such request could spoil precariously placed business relations with the customer. On further inquiry, she finds out that there is a dispute going on with the company relating to some quality issues of goods sent to the customer and matter is sub judice. Efforts are also being made by the company for out of court settlement. Reviewing correspondence with the customer, she finds that issue is near resolution and no fraud risk factors exist. Is unwillingness of CFO justifiable?

**Ans.** In terms of requirements of SA 505, 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.

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. Further, fraud risk factors do not exist. Keeping in view, unwillingness of CFO is justifiable.

## INITIAL AUDIT ENGAGEMENTS - OPENING BALANCES (SA 510)

Initial Audit Engagement – Opening Balance SA – 510

↓

An Auditor Engagement → In which → Either → F.S. for the prior period

- Were not Audited
- Were Audited ↓ By a Predecessor Auditor

**Objective of Auditor with respect to Opening Balance – in conducting as initial Audit Engagement**

- Opening Balance → Contain MM ↓ Affect C.Y. F. S
- Approx. A/c Policies ↓ Opening Balance
  - Consistently Applied
  - ΔProperly
    - Accounted
    - Presented
    - Disclosed

Auditor should obtain → Suff. + Approx. A.E → Whether Op. Balance → Contain MM → That Affects C.Y.F.S

- Prior Pd F.S ↓ Correctly B/f
- Opening Balance Reflects ↓ Application of Appro. A/c. Policy
- Performing the following
  - Prior Pd F.S ↓ Were Audited?
  - Evaluate Audit Procedure of C.Y ↓ Provide A.E Relevant to Opening Balance
  - Performing ↓ Specific Audit Procedure

***Notes to Add***

The Standard on Auditing (SA) 510 "Initial Audit Engagements-Opening Balances" deals with the auditor's responsibilities relating to opening balances when conducting an initial audit engagement. In addition to financial statement amounts, opening balances include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments. When the financial statements include comparative financial information, the requirements and guidance in SA 710 also apply.

***Notes to Add***

If misstatements are found → communicate to Mgt./TCWG

↓

As per SA 450 'Evaluating the Misstatement identified during the Audit'

Nature and extent of Audit Procedures → Depends upon

- A/c Policies → Followed
- Nature
  - COT
  - A/c Bal. + ROMM
  - Disclosure
- Op. Bal → Significance ← C.Y.F.S
- Prior Pd F.s. → Audited → If SO → Modified Opinion

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

↓

C.Y Auditor → To Obtain → Suff. + Appro. A.E

↓

Perusing the copies

- Audited F.S
- Other Relevant Docs.

❖ Ordinarily → C.Y Auditor → Place reliance

↓

Except

↓

Possibility of MM

| | |
|---|---|
| → C.Y Audit Procedures ↓ Provide Little A.E ↓ Op. Inventory | → Certain cases ↓ Through con'irmation ↓ Third Parties |
| → Additional Audit Procedure<br>→ Observe → Physical count; → Reconciliation<br>→ Valuation<br>→ Audit Procedure → G.P; → Cut - Off | |

**Definitions**

(1) Initial audit engagement refers to an engagement in which either:

(i) The financial statements for the prior period were not audited; or

(ii) The financial statements for the prior period were audited by a predecessor auditor.

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

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

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

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

**Procedure adopted by the Auditor to obtain Audit Evidence regarding opening balances:**

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 financial statements; and

(b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

## QUESTIONS

**Theory Questions**

**29.** Discuss the objective of Auditor with respect to Opening balances in conducting an initial audit engagement.

**Ans.** Refer to heading "Objective of Auditor with respect to Opening Balances – in conducting an Initial Audit Engagement'

***Notes to Add***

## OBTAINING SUFFICIENT APPROPRIATE AUDIT EVIDENCE ABOUT OPENING BALANCES BY THE AUDITO

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

(a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;

(b) Determining whether the opening balances reflect the application of appropriate accounting policies; and

(c) Performing one or more of the following:

(*i*) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;

(*ii*) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

(*iii*) Performing specific audit procedures to obtain evidence regarding the opening balances.

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

If the auditor concludes that such misstatements exist in the current period's financial statements, the auditor shall communicate the misstatements with the appropriate level of management and those charged with governance.

## 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 financial statements.
- The significance of the opening balances relative to the current period's
- financial statements.
- Whether the prior period's financial statements were audited and, if so,
- whether the predecessor auditor's opinion was modified.

## QUESTIONS

**Theory Questions**

**30.** M/s PQR and associates are the statutory auditors of TUV Ltd. for the FY 2022-23-. They have been appointed as statutory auditors of TUV Ltd. for the first time. What is the objective of the engagement partner in terms of SA 510?

**Ans.** As per SA 510, "Initial Engagement- Opening balances" the objective of the auditor with respect to the opening balances is to obtain sufficient and appropriate audit evidence about whether:

(*a*) Opening balances contain misstatements that materially affect the current period's financial statements; and

(*b*) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

## IF THE PRIOR PERIOD'S FINANCIAL STATEMENTS WERE AUDITED BY A PREDECESSOR AUDITOR

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

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

**For current assets and liabilities**

For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures.

**For example:**

The collection (payment) of opening accounts receivable (accounts payable) during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.

In the case of inventories, however, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional audit procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence:

- 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,**

(i) such as property plant and equipment, investments and long-term debt, some audit evidence may be obtained by examining the accounting records and other information underlying the opening balances.

(ii) In certain cases, the auditor may be able to obtain some audit evidence regarding opening balances through confirmation with third parties.

**For example:**

for long-term debt and investments audit evidence may be obtained through confirmation with third parties. In other cases, the auditor may need to carry out additional audit procedures.

### Consistency of Accounting Policies relating to opening balances

Appro. A/c Policies
↓
Opening Bal.
↓
- Consistently applied
- Δproperly
  - Accounted
  - Presented
  - Disclosed

→Auditor Concludes → Policies Not Consistently Applied
→ Δin policies Not Properly Accounted
↓
Qualified/Adverse → Opinion → SA 705

***Notes to Add***

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### Reporting by the auditor with regard to opening balances

Auditor → Unable to Obtain → Suff. + Appro. A.E
- Qualified
- Disclaimer

→ Opinion ←

Auditor → Concludes [Obtained ] → Suff. + Appro. A.E
- Qualified
- Adverse

→ Opinion ←

***Notes to Add***

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The auditor shall obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, and whether changes in the accounting policies have been properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

**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.

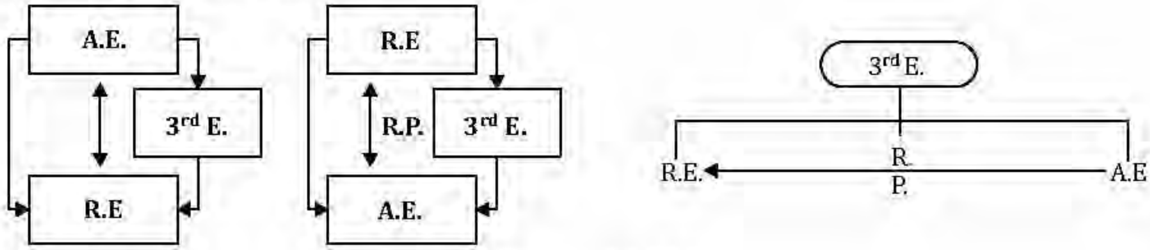
***Notes to Add***

(1) If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with SA 705.

(2) If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, 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.

***Notes to Add***

## RELATED PARTIES (SA 550)




Related Party – SA 550

- As per app. F.R.F.
- Minimal or No Requirement as per F.R.F
  - As person/Entity ↓ That has
    - Control
    - Significant Influence

    Through One / More Intermediaries → Directly / → Indirectly

    ↓

    Over Reporting Entity
  - Another Entity over which ↓ The Reporting Entity has
    - Control
    - Significant Influence
  - Another Entity that is ↓ Under Common Control ↓ With Reporting Entity ↓ Through Having

    Through One / More Intermediaries
    - Directly Through having
      - Common Ownership
      - Owner Close family Members
      - Common Key Mgt.
    - Indirectly

→ Entity under Common Control of State → Govt.

↓

Are Not Considered as related Party

↓

Unless

- They engage in significant Transactions
- Share Resources to a significant Extent

## SCOPE OF THIS SA

The Standard on Auditing (SA)550 "Related Parties" deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements. Specifically, it applies in relation to risks of material misstatement associated with related party relationships and transactions.

**Definition of Related Party**

A party that is either:

(1) A related party as defined in the applicable financial reporting framework; or

(2) 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.

***Notes to Add***

**Meaning of control and significant influence in reference to related party**

Control → Power to Govern → Financial / Operating ← Policies

↓ of an Entity

↓ To obtain Benefits from activities

Significant Influence → Gained by → Ownership / Statute / Agreement

Power to participate → Financial / Operating ← Policies

Of an Entity

But Not control over those policies

Existence → of following Relationship → Indicate → Control / Significant Influence

(i) Direct / Indirect — Equity Holding + Other Fin. Interest

(ii) Being part of → TCWG / KMP

(iii) Close Family Members

(iv) Significant Business Relationship

**Meaning of Related Parties with Dominant Influence**

May be in a position → to exert D. I → Mgt. / Entity

↓

Should be considered → R.A.P (SA 315)

***Notes to Add***

**Meaning of control and significant reference to related party**

Many financial reporting frameworks discuss the concepts of control and significant influence. They generally explain that:

(*a*) Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities; and

(*b*) Significant influence (which may be gained by share ownership, statute or agreement) is the power to participate in the financial and operating policy decisions of an entity, but is not control over those policies.

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 those charged with governance 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)

***Notes to Add***

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.

***Notes to Add***

**Meaning of special – Purpose Entities as Related Parties**

Certain circumstances → May be Related party

↓

Because the entity may → 'In – substance' control it

↓

Even if owns → Little / None ← Equity

**Nature of Related Party Relationship and Transactions**

Many Related Party Transactions → Normal course of Business

↓

May carry No Higher Risk of MM

Auditor shall → Inquire Mgt.

↓

- Identity of Related Party + Δ from prior pd.
- Nature of Relationship
- Entity entering into any transaction
  - Type
  - Purpose

***Notes to Add***

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.

***Notes to Add***

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 financial statements 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 financial statements than transactions with unrelated parties.

**For example:**

(A) 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.

(B) Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.

(C) 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.

***Notes to Add***

## QUESTIONS

**Theory Questions**

**31.** The nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. Explain with the help of at least three examples.

**Ans.** 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 financial statements 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 financial statements than transactions with unrelated parties.

**Example:**

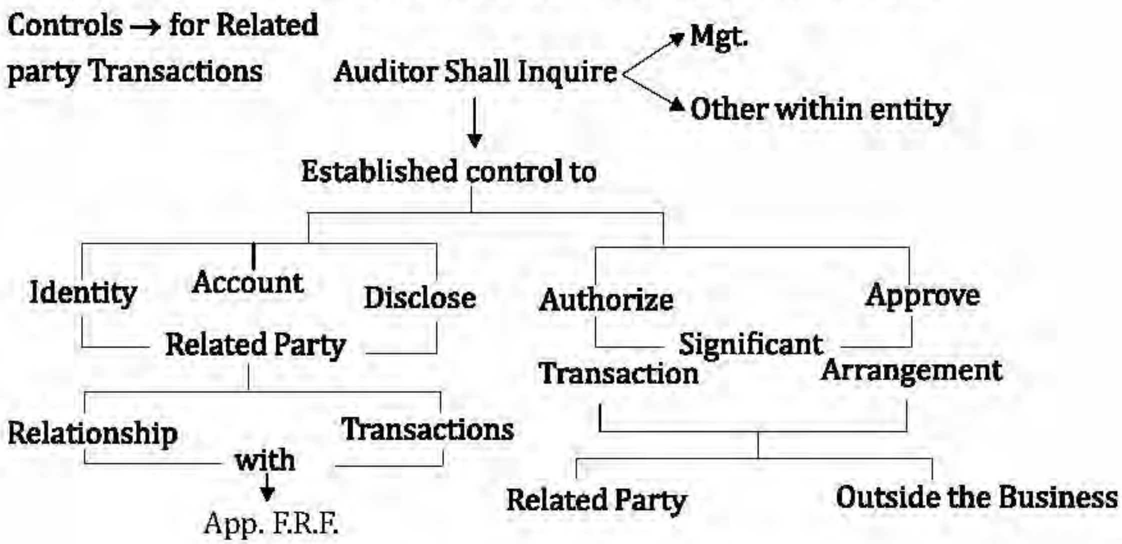
- Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
- Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an 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.

**32.** Many related party transactions are in the normal course of business. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. Give few examples of such areas.

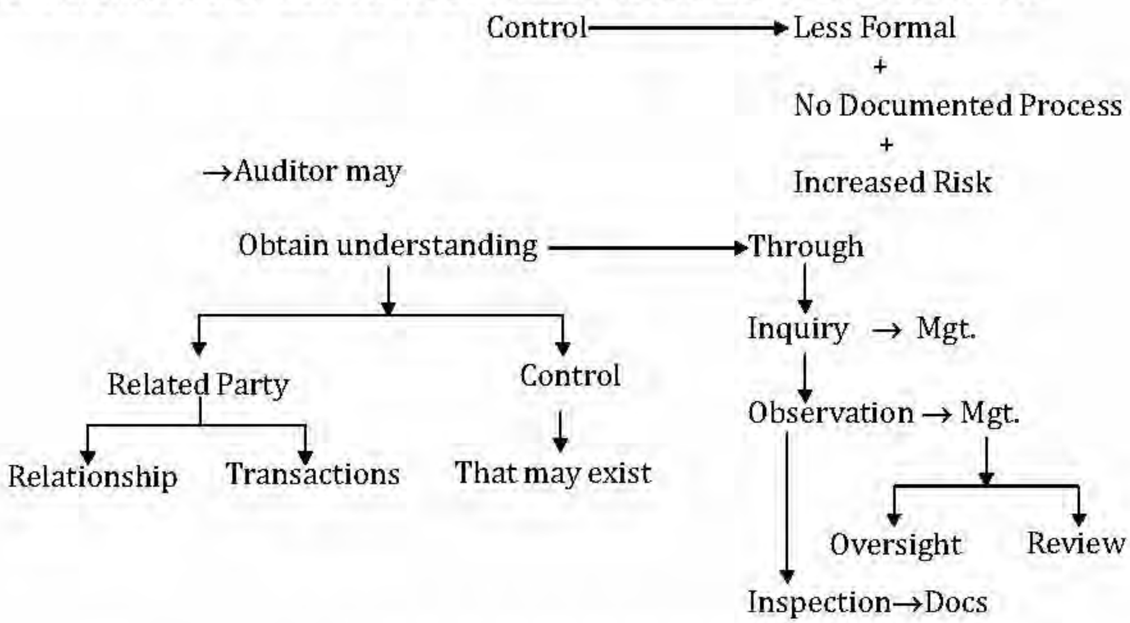
**Ans.** Refer to heading " Nature of related party relationships and transactions"

***Notes to Add***

## ENTITY'S RELATED PARTY RELATIONSHIPS & TRANSACTIONS




## CONSIDERATIONS SPECIFIC TO SMALLER ENTITIES BY THE AUDITOR




***Notes to Add***

## UNDERSTANDING THE ENTITY'S RELATED PARTY RELATIONSHIPS & TRANSACTIONS

The auditor shall inquire of management regarding:

(a) The identity of the entity's related parties, including changes from the prior period;

(b) The nature of the relationships between the entity and these related parties; and

(c) 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, that management has established to:

(a) Identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework;

(b) Authorise and approve significant transactions and arrangements with related parties; and

(c) Authorise and approve significant transactions and arrangements outside the normal course of business.

Control environment in smaller entities is likely to be different from larger entities. In particular those charged with governance 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, the auditor may obtain an understanding of the related party relationships and transactions, and any controls that may exist over these, through inquiry of management combined with other procedures, such as observation of management's oversight and review activities, and inspection of available relevant documentation.

1. How can an auditor verify the existence of 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) Shareholder registers to identify the entity's principal shareholders.

   (4) Statements of conflicts of interest from management and those charged with governance.

   (5) Records of the entity's investments and those of its pension plans.

   (6) Contracts and agreements with key management or those charged with governance.

   (7) Significant contracts and agreements not in the entity's ordinary course of business.

(8) Specific invoices & correspondence from the entity's professional advisors.

(9) Life insurance policies acquired by the entity.

(10) Significant contracts re-negotiated by the entity during the period.

(11) Internal auditors' reports.

(12) Documents associated with the entity's filings with a securities regulator e.g, prospectuses)

Control environment in smaller entities is likely to be different from larger entities. In particular those charged with governance 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.

***Notes to Add***

*Notes to Add*

## Analytical Procedures (SA520)

(1) Evaluation of Financial Info – through analysis of Plausable Relationship among

Financial —— Data —— Non-Financial

(2) Analytical Procedures include → 'the consideration of comparisons'

↓

of Entity's financial info.

↓

with & as well as considerations

- Industry Data
- Similar prior period data
- Expected results using Non-financial Data
- Client / Auditor Determined Expected Results

Analytical Procedures

- Meaning
- Reliance on Analytical Procedures
- Purpose & Timing
- Investigating the Results
- Substantive Analytical Procedures

### Scope of SA 520

It deals with
- → Auditor's use of Analytical Procedure ↓ As SAP
- → Procedures → Near the End of Audit

### *Notes to Add*

**Meaning of Analytical Procedures**

Since routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like comparisons, trend and ratio analysis in addition to reasonable tests. These collectively are known as overall tests. With the passage of tests, analytical procedures have acquired lot of significance as substantive audit procedure. SA-520 on Analytical Procedures discusses the application of analytical procedures during an audit. Let us try to understand the concept discussed above with the help of the following Illustration:

**Illustration 9:** CA Aarav wants to verify the payments made by XYZ Ltd. on account of building rent during the FY 2022-23. The rent amounts to ₹50,000/- per month for the year. The monthly rent payments are consistent with the rent agreement. However, the other companies in the similar industry are paying rent of ₹ 10,000/- per month for a similar location. How will applying the analytical procedures impact the verification process of such rental payments by XYZ Ltd.?

**Solution:** If CA Aarav checks in detail the monthly rent payments, he may find that such payments are consistent with the rent agreement i.e. XYZ Ltd. paid ₹ 50,000/- per month as rent and the same is getting reflected in the rent agreement. Here, CA Aarav may not be able to find out the inconsistency in the rent payment with respect to rent payment prevalent in the similar industry for rent of the similar location.

If CA Aarav applies analytical procedure i.e. compares the rent payment by XYZ Ltd. with the similar payments made by companies in similar industry and similar area, he will notice an inconsistency in such rent payments as the other companies are paying a very less monthly rent in similar industry for similar area.

However, if CA Aarav does not make such comparison and only checks the monthly payments and rent agreement of XYZ Ltd., he would not have found such inconsistency and as such the misstatement may remain undetected.

**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. Analytical procedures also encompass 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.

Analytical Procedures means → evaluations of financial information → through analysis of plausible relationships → among both financial and non-financial data.

**Illustration 10:** Analytical procedure involves analysis of relationship among financial and non-financial data. Explain with the help of an example as to how, the statutory auditor of ABC Ltd. will analyse such relationship with respect to the total wages paid by ABC Ltd. during the FY 2022-23.

As per SA 520, Analytical Procedures means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. The following example explains the analysis of relationship between financial and non-financial data while applying analytical procedures.

The statutory auditor of ABC Ltd. has to verify the total wages paid by the company having factories in various states. He can verify the same by analyzing the relationship between wages per worker and total number of workers across all the factories.

i.e. Total wages = Wages per worker × Total number of workers.

Here wages per worker is financial data i.e. in ₹ and total number of workers is a number which is a non financial data. Thus, the statutory auditor of ABC Ltd. is evaluating financial information i.e. total wages paid (in ₹) by analyzing the relationship between wages per worker (in ₹) which is financial data and number of workers which is a non financial data.

Analytical procedures include the consideration of comparisons of the entity's financial information with as well as consideration of relationships.

Comparisons of the entity's financial information with + Consideration of relationships + Various other procedures = Analytical Procedures

Examples of Analytical Procedures having consideration of comparisons of the entity's financial information are:

- Comparable information for prior periods.

Examples of Analytical Procedures having consideration of comparisons of the entity's financial information are:

- Comparable information for prior periods.

**Example:**

CA Brijesh, while verifying the travelling expenses of PRT Ltd., may compare the travelling expenses of current year amounting to ₹ 2.50 lakhs with previous year travelling expense of PRT Ltd. amounting to ₹ 2 lakhs and infer that there has been an increase of 25% in the travelling expense incurred by the company. CA Brijesh may compare such percentage increase with the trend of the earlier several years. Thus, CA Brijesh, can use comparable information for prior periods of PRT Ltd. while applying analytical procedure with respect to the expenses incurred by the company.

- 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.

**Examples of Analytical Procedures having consideration of relationships are:**

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

**Illustration 11:**

| Particulars | Client | | Industry | |
|---|---|---|---|---|
| Year | 2021-22 | 2022-23 | 2021-22 | 2022-23 |
| Inventory Turnover | 2.8 | 2.9 | 3.1 | 2.8 |
| Gross Margin | 22.5% | 22.7% | 23.6% | 22.2% |

- Various methods may be used to perform analytical procedures.
- These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques.
- Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

**Thus, we can say that Analytical Procedures may be segregated into the following major types:**

- as comparison of client and industry data,
- comparison of client data with similar prior period data,
- comparison of client data with client-determined expected results,
- comparison of client data with auditor-determined expected results and
- comparison of client data with expected results, using non financial data.

## QUESTIONS

**Correct/Incorrect**

**33.** The statutory auditor of the company can apply analytical procedures to the standalone financial statements of a company only and not to the consolidated financial statements.

**Ans. (Incorrect)**

Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

**Theory Questions**

**34.** Define Analytical Procedures.

**Ans. 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. Analytical procedures also encompass 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.

Thus, analytical procedures include the consideration of comparisons of the entity's financial information with as well as consideration of relationships.

***Notes to Add***

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## SCOPE OF SA 520

SA 520 deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.

## OBJECTIVES OF SA-520

(1) To Obtain → Relevant → Reliable → A.E. → when using SAP

(2) To → Design → Perform → Analytical Procedures → Near the end of Audit → to assist → in forming overall Audit Conclusion

**Objectives**

The objectives of the auditor are:

(*a*) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and

(*b*) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

## QUESTIONS

Correct/Incorrect

**State with reasons (in short)whether the given statements are correct/incorrect:**

**35.** 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 financial data only.

**Ans. (Incorrect)**

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.

***Notes to Add***

## *Notes to Add*

## PURPOSE & TIMING OF ANALYTICAL PROCEDURES

(1) It was→Comparisons→Relationships→to assess→Reasonableness of Data

A/c. Bal. | Other

(2) These are helpful→in detection of

Unusual State of affairs | Mistakes in A/c.

(3) The overall test can be extended for making → Inter → Intra → Firm Comparision→of trading result

(4) If MM are found→Auditor would

Ascertain the reasons | Assess whether A/c. has been manipulated

**Timing of Analytical Procedures**

Planning Phase | Testing Phase | Completion Phase

Planning Phase

(1) Understand
→ Client Business

(2) Identify
→ Potential Risk

(3) Determine
→ N,E,T of other audit Procedure

(4) Use
→ Fin DATA
→ Non Fin INFO.

***Notes to Add***

Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable.

For instance, establishing the relationship that exists between certain balances included in the Balance Sheet and the Statement of Profit and Loss and comparing them with those that existed between the same set of balances in the previous year, reconciling the physical balances of assets with the relevant financial record; obtaining of account from the bankers, account receivables and account payables and reconciling with relevant balances in books of account; confirming amounts of outstanding income and expenses by preparing reconciliation statements, etc. These are helpful in the detection of unusual state of affairs and mistakes in accounts.

**Example:**

In XYZ Ltd., after applying analytical procedures as comparison of the gross profit ratio with that of the previous year, it is discovered that there has been fall in the ratio. Therefore, it became necessary for the auditor to make further enquiries as it may be due to pilferage of inventories/misappropriation of a part of the sale proceeds/a change in the cost of sales without a corresponding increase in the sales price.

On verifying the balances of sundry account receivables by obtaining the confirmation of their statements of account, it will be possible for the auditor to find out whether the discrepancy in the balance of an account receivable is due to the failure to debit his account with the cost of goods supplied to him or is the result of non-adjustment of a remittance received from him.

Also whether in the case of account payable, the discrepancy is due to failure to afford him credit for one or more consignments of goods supplied by him or failure to debit him with an amount of remittance.

In case of inventories of raw materials and stores at the end of the year any excesses or shortages therein shall be detected. The investigation of their causes might disclose that the shortages were the result of a misappropriation of inventory or that the excess were due to requisitions having been entered before the inventories were issued.

By reconciling the amounts of interest and dividends collected with the amounts which had accrued due and that which are outstanding for payment, the mistake, if any, in the adjustment of such an income would be detected.

The overall tests can be extended for making inter-firm and intra-firm comparison of trading results.

**Example:**

If balances included in the Statement of Profit and Loss of an entity are compared with those contained in the Statement of Profit and Loss for the same period of another entity engaged in the same trade and working under similar circumstances, it would be possible to find out the cause of the variation in the rate of profitability that exists.

- Similarly, it would also be possible to compare the balances on the Statement of Profit and Loss with that of the previous period, it would be possible to find out the reasons for increase or decrease in the amount of profits of those years.
- By setting up certain expenses ratios on the basis of balances included in the Statement of Profit and Loss, for the year under audit, comparing them with the same ratios for the previous year, it is possible to ascertain the extent of increase or decrease in various items of expenditure in relation to sales and that of trading profit in relation to sales.

- If differences are found to be material, the auditor would ascertain the reasons thereof and assess whether the accounts have been manipulated to inflate or suppress profits.

An abnormal fall in the cost of manufacture or that in the administrative cost, apart from economy in expenses, there could be no provision or less provision for expenses incurred in the year. When it is suspected, the auditor should compare the entries in the outstanding book with those in the previous year. He must also check the vouchers for one month immediately before the close of the following years.

To verify that none of the expenses in the accounts under audit have been charged to the accounts of the following years.

Often it is possible to independently verify the correctness of some of the items of expenses included in the Statement of Profit and Loss.

For instance, the cost of importing goods which are subjected to an ad-valorem duty at uniform rate can be verified from the amount of duty paid. Similarly, a quantity of sugar sold by sugar mill can be verified independently from the amount of GST paid.

Similarly, the amount of any income or expenses which has a direct relationship with the amount of profits or that of sales can be verified independently, e.g., commission paid to a manager calculated on the basis of net profits, commission paid to a selling agent as percentage of sales, etc. Such calculation of ratios, trends and comparisons is also termed as analytical review.

Thus, it is important to note that Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, 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 misstatement due to fraud.

### 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.

Timing of Analytical Procedures

Planning Phase | Testing Phase | Completion Phase

### Analytical Procedures in Planning the Audit

In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures. Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.

**For example:**

Analytical procedures may help the auditor during the planning stage to determine the nature, timing and extent of audit procedures that will be used to obtain audit evidence for specific account balances or classes of transactions.

## QUESTIONS

**Correct/Incorrect**

**36.** Analytical Procedures are required in the planning phase only.

**Ans. (Incorrect)**

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.

**Theory Questions**

**37.** Explain how a statutory auditor of a company can apply analytical procedures at the planning phase of audit.

**Ans.** 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.

**Analytical Procedures in Planning the Audit**

In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures. Analytical procedures in planning the audit use both financial data and non- financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.

***Notes to Add***

## SUBSTANTIVE ANALYTICAL PROCEDURE

- Substantive Procedures @ Assertion Level
  - ToD
  - SAP
  - Both
- Which procedure to perform → is based on Auditor's Judgement of Eff. & Eff. of →
- Available Audit procedures → to reduce risk @ acceptably low level
- Auditor may Inquire Mgt.
  - Availability + Reliability — Amounts of Info.
  - Result of Analytical procedures performed by Mgt.
- Factorstobeconsidered
  (1) Availability of Data → Relevant & Reliable
  (2) Disaggregation Breaking Down of Data → Degree of Disaggregation in available data
  (3) A/c. Type → Income St. → Predictable → as gives accumulated transactions
  B/S. → Net of transactions→ at a point of time → Subjected to Mgt. Judgement
  (4) Source → Some Sources (Rotine) are better than others (Non-Routine) & SCoTs
  (5) Predictability → Better
  (6) Nature of Assertion → More evidence for assertions
  (7) Inherent Risk or WCGW → Consider nature of RoMM in order to determine. If SAP can be used to obtain A.E.
  - When inherent Risk is Higher → ToD is to be designed
  - When Significant Risk has been identified → A.E. from SAP unlikely to be sufficient

***Notes to Add***

The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and the results of any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

**Factors to be considered for Substantive Audit Procedures**

- Availability of Data
- Disaggregation
- Account type
- Source
- Predictability
- Nature of Assertion
- Inherent Risk or "What can go Wrong"

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

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

(ii) **Disaggregation:** The degree of disaggregation in available data can directly affect the degree of its usefulness in detecting misstatements.

(iii) **Account Type:** Substantive analytical procedures are more useful for certain types of accounts than for others. 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 judgment.

**Example:**

We can analyze data to understand the relationship to another account and through this, disaggregate the transactions flowing to and from the balance sheet account (e.g., sales and cash receipts flowing through trade receivables), or to compare ratios over time as this enhances our ability to obtain audit evidence for balance sheet accounts.

(iv) **Source:** Some classes of transactions tend to be more predictable because they consist of numerous, similar transactions, (e.g., through routine processes). Whereas the transactions recorded by non-routine and estimation SCOTs (Significant Classes of Transactions) are often subject to management judgment and therefore more difficult to predict.

**Example:**

Transactions of routine nature like transactions related to sales and purchases are predictable and repetitive in nature. Therefore, on such data analytical procedures can be efficiently applied.

However, Significant Classes Transactions are those classes of transactions in a company's operations that are key to the financial statements and are not frequent in nature. Example: Expenditure on Research & Advertisement is not of routine nature and are subject to management judgement and therefore more difficult to predict.

(v) **Predictability:** Substantive analytical procedures are more appropriate when an account balance or relationships between items of data are predictable (e.g., between sales and cost of sales or between trade receivables and cash receipts). A predictable relationship is one that may reasonably be expected to exist and continue over time.

(vi) **Nature of Assertion:** Substantive analytical procedures may be more effective in providing evidence for some assertions (e.g., completeness or valuation) than for others (e.g., rights and obligations). Predictive analytical procedures using data analytics can be used to address completeness, valuation/measurement and occurrence.

(vii) **Inherent Risk or "What Can Go Wrong":** When 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.

**Example:**

When side agreements with respect to revenue recognition have been identified as a significant or fraud risk, it is unlikely that an analysis of sales compared to cash receipts or cost of sales would be appropriate to respond to that risk.

***Notes to Add***

## *Notes to Add*

## SUBSTANTIVE ANALYTICAL PROCEDURE

**Techniques available as SAP**

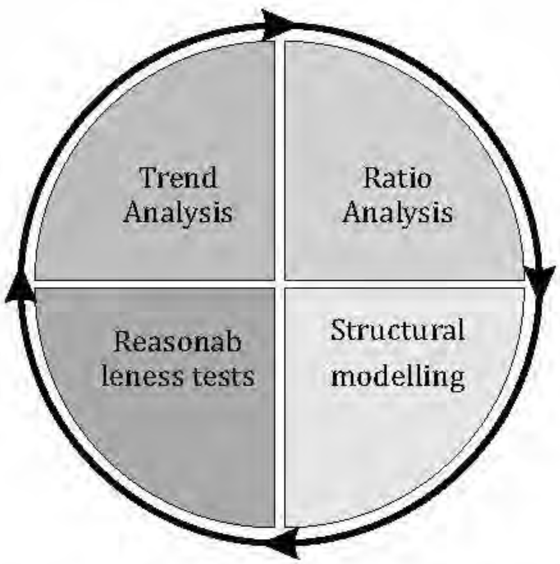
(1) Trend Analysis → Commonly used technique

(2) Ratio Analysis

(3) Reasonableness Test (Rely on Non-financial Data like interest rates to estimate interest incomes, etc.) → Unlike Trend Analysis

(4) Structural Modeling (Constructs a statistical Model from financial & Non-financial data of prior A/c. period to predict current A/c. Bal.)
(Eg. Linear Regussion)

## TECHNIQUES AVAILABLE AS SUBSTANTIVE ANALYTICAL PROCEDURES




***Notes to Add***

***Notes to Add***

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The design of a substantive analytical procedure is limited only by the availability of reliable data and the experience and creativity of the audit team. Substantive analytical procedures generally take one of the following forms:

(i) **Trend analysis:** Trend analysis is a commonly used technique. It is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. The auditor evaluates whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

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.

**Example:**

The auditor may compare the salary paid by the company during the year under audit with the salary paid by the company for several earlier years. There may be some percentage increase in the salary expense over the years. However, an unusual increase in such expense amount may indicate that fraudulent payments are being made to fake employees.

(ii) **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.

**Example:**

Financial ratios may include:

- Trade receivables or inventory turnover
- Freight expense as a percentage of sales revenue

**Example:**

The statutory auditor can review the Gross profit ratio of the company for the year under audit. The auditor can further compare such GP ratio with the GP ratio of the company in the earlier years or the GP ratio of the other companies in the same industry for the year under audit.

(iii) **Reasonableness tests:** Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts. In other words these tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts.

**Example:**

- Interest expense against interest bearing obligations
- Raw Material Consumption to Production (quantity)
- Wastage & Scrap % against production & raw material consumption (quantity)
- Work-in-Progress based on issued of materials & Sales (quantity)
- Sales discounts and commissions against sales volume
- Rental revenues based on occupancy of premises

(iv) **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 (e.g., linear regression).

## QUESTIONS

### Correct/Incorrect

**38.** Reasonableness test rely only on the events of the prior period like other analytical procedures.

**Ans. (Incorrect)**

Unlike trend analysis, Reasonableness test does not rely on events of prior periods, but upon non-financial data for the audit period under consideration.

**39.** Ratio analysis is useful in analyzing revenue and expense account only.

**Ans. (Incorrect)**

Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts

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

**Ans. (Incorrect)**

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

### Theory Questions

**41.** While applying the Substantive Analytical Procedures what techniques can be used by the statutory auditor of a company to obtain sufficient and appropriate audit evidence?

**Ans.** While applying the Substantive Analytical Procedures the statutory auditor of a company may use the following techniques to obtain sufficient and appropriate audit evidence

**Trend analysis:** Trend analysis is a commonly used technique. It is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

**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:** Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts. In other words these tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts.

***Notes to Add***

## ANALYTICAL PROCEDURES USED AS SUBSTANTIVE TEST

When — Designing / Performing — SAP Either — Alone / Combination with ToD — Auditor shall

(1)
Determine the suitability
↓
For given assertion
↓
Taking A/c. of
Assessed RoMM — ToD
For these assertions

(2)
Evaluate the Reliability of Data
↓
Taking A/c. of
Source — Nature — Relevance
of Info. & Controls
↓
Over Population

(3)
Develop an expectation of Recorded — Amounts / Ratios
↓
To evaluate whether
↓
Expectation is Sufficiently precise to identify misstatements

(4)
Determine the amount of any difference
↓
of any recorded amount from expected value that is acceptable without further investigation

Suitability of SAP for given assertion

→ SAP → generally more applicable to large volume of transaction → that tend to be predictable over time

→ Applicability of SAP → is based on expectation that

- Relationship among Data Exists
- Continue in absence of known conditions to the contrary

→ Suitability of SAP → depends upon Auditor's Judgement

→ Sometimes 'unsophisticated predictive Model's → may be effective (No. of Employers × Rate / Employee = Total Payroll Cost)

→ Different SAP provides different levels of Assurance → some provide

- More persvasive A.E. (Rental Income of Building = No. of Apartments × Rental Rates × Vacancy Rates)
- Less Persvasive A.E.
  But may provide useful corroboration
  ↓
  If used in combination with other Audit proedures
  (Grass Margin % as the means for confirming Revenue figure)

→ The determination of Suitability → Depends upon

- Nature of Assertion
- Auditor's Assessment of RoMM

### *Notes to Add*

Extent of Reliance on Analytical Procedure

Following points are relevant for determining whether data is reliable for the purpose of designing SAP:

(1) Source of Info. Available (more reliable if from Independent Source)

(2) Comparability of Info. Available (Industry data may need to be supplemental to be comparable with Entity that sells Specialised products)

(3) Nature & Relevance of Info. Available (Budgets have been established as a result to be expected rather than goals to be achieved)

(4) Control over preparation of Info. → that are designed to ensure

- Completeness
- Accuracy
- Validity

(3) Evaluation of whether the expectation is sufficiently Precise

RoMM Includes

- The Accuracy with which the expected result of SAP can be predicted
- The degree to which Info. Can be disaggregated
- The Availability of Info.
  - Financial
  - Non-Financial

**(4) Amount of difference of Recorded Amounts → from → Expected Values**

**That is acceptabl e →without further investigation**

**In** influenced **by** — **Materiality** / **Consistency** — **With the desired level of assurance→ Taking A/c. of possibility that a misstatement → May Cause F.S. to be MM**

- **Individually**
- **Aggregate**

- SA 330 requires Auditor → to obtain → More persuasive A.E..

  ↓

  If the Auditor's assessment of Risk is Higher

- Accordingly → As assessed Risk Increases

  ↓

  The amount of difference considered acceptable → without investigation

  ↓

  Decreases

  ↓

  In order to achieve the desired level of persvasive A.E.

***Notes to Add***

**Topic: Analytical Procedures used as substantive Test**

Investigating results of Analytical Procedure

(1) Its fluctuations
(2) Relationships that are in consistent with other relevant Info.
(3) That differ from expected values by significant amount

***Notes to Add***

**Auditor Shall**

Inquire Mgt. + Obtain Oppro A.E.
↓
Relevant to Mgt.'s Response
↓
By Auditor's Understanding of → Entity
→ Its Environment
↓
With other A.E. obtained during the course of Audit

Performing other Audit Procedures
↓
As necessary in the circumstances
↓
If Mgt. is unable to provide an explanation OR A.E. obtained for explanation is not odequate

**Analytical procedures that assist when forming an overall conclusion**

Conclusion drawn from Analytical Procedures
↑
Intended to corroborate
↓
Conclusion formed → during audit of individual

Component

This assist + Auditor → to draw → Reasonable conclusion
↓
on which to base Auditor's opinion

Element

The result of Analytical procedure → may identify
↓
Previously unrecognised ROMM

In such circumstances → Auditor

Revise ROMM
SA 315

Modify
F.A.P.

***Notes to Add***

**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:

- Determine suitability of analytical procedure
- Evaluate reliability of data
- Develop an expectation
- Determine acceptable difference

(i) 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;

(ii) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;

(iii) 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

(iv) 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**

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

(2) The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary.

(3) However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

(4) In some cases, even an unsophisticated predictive model may be effective as an analytical procedure.

**Example:**

If 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. The use of widely recognized trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

Different types of analytical procedures provide different levels of assurance. Analytical procedures involving, for example, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments 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. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may provide less persuasive evidence, but may provide useful corroboration if used in combination with other audit procedures.

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. For example, if controls over sales order processing are weak, the auditor may place more reliance on tests of details rather than on substantive analytical procedures for assertions related to receivables.

Particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion. For example, when obtaining audit evidence regarding the valuation assertion for accounts receivable balances, the auditor may apply analytical procedures to an aging of customers' accounts in addition to performing tests of details on subsequent cash receipts to determine the collectability of the receivables.

## QUESTIONS

**Theory Questions**

**State with reasons (in short) whether the given statement is correct/incorrect:**

**42.** Only purpose of analytical procedures is to obtain relevant and reliable audit evidence when using substantive analytical procedures.

**Ans. (Incorrect)**

Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. Analytical procedures are used for the following purposes:

(*i*) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and

(*ii*) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

## 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:

(i) Source of Information

(ii) Comparability of the information

(iii) Nature & Relevance of Information

(iv) Controls over the preparation of the information

(i) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;

(ii) 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;

(iii) 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

(iv) 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.

The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls.

**For example:**

In establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. SA 500 establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures.

## QUESTIONS

**Theory Questions**

**43.** What are the factors that determine the extent of reliance that the auditor places on results of analytical procedures? Explain with reference to SA-520 on "Analytical procedures".

**Ans.** Refer to heading 'The reliability of data (SA-520)'

***Notes to Add***

## 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, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include:

(i) The accuracy with which the expected results of substantive analytical procedures can be predicted.

For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.

(ii) The degree to which information can be disaggregated.

For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.

(iii) 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 units produced or sold, 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, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

SA 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of risk. Accordingly, 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 identify 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:

(i) 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.

(ii) 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.

## QUESTIONS

**Theory Questions**

**44.** The statutory auditor of MNO Ltd., CA Kishore identifies certain inconsistencies while applying analytical procedures to the financial and non financial data of MNO Ltd. What should CA Kishore do in this case with reference to SA 520 on "Analytical Procedures"?

**Ans.** As per SA 520- "Analytical Procedures" If while applying analytical procedures in accordance with SA 520, the statutory auditor identifies 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:

(*i*) 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.

(*ii*) **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.

In the present case, CA Kishore identifies certain inconsistencies while applying analytical procedures to the financial and non financial data of MNO Ltd. CA Kishore should inquire the management of MNO Ltd. and obtain sufficient and appropriate audit evidence relevant to management response. Further, CA Kishore should also perform other audit procedures if required in the circumstances of the case to obtain further sufficient and appropriate audit evidence.

***Notes to Add***

## ANALYTICAL PROCEDURES THAT ASSIST WHEN FORMING AN OVERALL CONCLUSION

The conclusions drawn from the results of analytical procedures designed and performed in accordance with, are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements. This assists the auditor to draw reasonable conclusions on which to base the auditor's opinion.

The results of such analytical procedures may identify a previously unrecognized risk of material misstatement. In such circumstances, SA 315 requires the auditor to revise the auditor's assessment of the risks of material misstatement and modify the further planned audit procedures accordingly.

**Test Your Understanding**

**10.** An auditor of a company intends to apply analytical procedures for verifying revenue. Discuss any two analytical procedures which may be performed by auditor relating to revenues.

**Ans.** Analytical procedures in relation to revenue can include:

(*i*) Comparing revenue of current year with previous year and investigating significant fluctuations

(*ii*) Comparing revenue of current year with budgeted targets and investigating significant fluctuations.

**CASE STUDY-1**

CA Drishti Khandelwal is conducting audit of a company engaged in manufacturing of towels and bedspreads. The company is having its own manufacturing set-up. However, it also gets some manufacturing processes outsourced from third parties. The company has three locations having substantial quantities of inventories in the same city. Besides, due to outsourcing of some processes, inventories are also held in premises of third parties in the same city. As part of audit procedures, she is performing many audit procedures required by different Standards on Auditing.

In particular, she is attending physical inventory count process of the company at year end in accordance with requirements of SA 501.The inventory of the company includes raw materials consisting mainly of natural and dyed yarns, work in process in different stages of manufacturing and finished stocks of towels and bedspreads.

She is also planning sending confirmations to parties to whom the company has sold goods. On reviewing trade receivables list, she finds that the list also contains large number of parties having small balances. She further finds that these receivables have arisen due to sale of bedspreads to small time retailers and possibility of difference in balances as per company's records and as per records of these small-time retailers is low. Risk of misstatements in relation to trade receivables has been assessed as low. Besides, there is nothing to suggest that small-time retailers would disregard such requests.

While conducting audit, she is testing controls operating in the company. She is also conducting tests of various items of income and expenditure as well as balances appearing in balance sheet. She intends to rely upon sampling extensively.

## QUESTIONS

**Theory Questions**

**Based on above description, answer the following questions:**

**45.** Which of the following statements is most appropriate regarding inventory count by auditor in accordance with SA 501?

(*a*) She should inspect the inventory to ascertain its existence and condition at all locations, observe how company personnel are carrying out count procedures and perform test counting.

(*b*) She should inspect the inventory to ascertain its existence at all locations, observe how company personnel are carrying out count procedures and perform test counting. The matter of condition of inventories falls in domain of expert.

(*c*) She should inspect the inventory to ascertain its existence at selected location, observe how company personnel are carrying out count procedures and perform test counting. The matter of condition of inventories falls in domain of expert.

(*d*) She should inspect the inventory to ascertain its existence and condition at all locations and perform counting of each and every item.

**Ans.** (*a*)

**46.** As regards inventories lying with third parties, which of following statements meets requirements of SA 501?

(*a*) She should request confirmation from third parties regarding quantity and condition of inventories held on behalf of the company as well as request third parties to allow her to inspect inventories held by them. Both requirements are necessary to be complied with.

(*b*) She should request confirmation from third parties regarding quantity and condition of inventories held on behalf of the company or request third parties to allow her to inspect inventories held by them. Compliance of any one of these or both is required for purposes of SA 501.

(*c*) There is no obligation cast upon an auditor in respect of inventories lying with third parties.

(*d*) She should request confirmation from third parties regarding quantity, condition and value of inventories held on behalf of the company or request third parties to allow her to inspect inventories held by them. Compliance of any one of these is sufficient for purposes of SA 501.

**Ans.** (*b*)

**47.** Keeping in view description regarding trade receivables, identify the most appropriate statement in context of SA 505?

(*a*) She should not plan and design confirmation requests for large number of parties having small balances.

(*b*) She should plan and design positive confirmation requests for large number of parties having small balances.

(*c*) She should plan and design positive confirmation requests for large number of parties having small balances and meticulously analyse exception rate

(*d*) She should plan and design negative confirmation requests for large number of parties having small balances.

**Ans.** (*d*)

**48.** As regards sampling, which of the following statements is most appropriate in terms of requirements of SA 530?

(*a*) Sampling is used in tests of transactions as well as tests of controls.

(*b*) Sampling is used in tests of balances as well as tests of controls.

(*c*) Sampling is used in tests of details.

(*d*) Sampling is used in tests of details as well as tests of controls.

**Ans.** (*d*)

**49.** Since she intends to rely upon sampling extensively, which of the following statements is true about sampling risk?

(*a*) Sampling risk can be eliminated.

(*b*) Increase in sampling risk would lead to decrease in detection risk.

(*c*) Decrease in sampling risk would lead to increase in detection risk.

(*d*) Sampling risk will always be in existence.

**Ans.** (*d*)

## CASE STUDY-2

1. Financial statements of a firm have been put up for audit before CA Manushi. On going through financial statements, she wants to verify assertions contained in financial statements and has planned certain procedures for carrying out detailed checking.

   (*a*) She plans to verify some major bills debited in "Machinery repair" account. The purpose of it is to ensure that bills are entered correctly and their classification is proper.

   (*b*) She plans to verify that all balances appearing under trade payables are genuine and not fake.

   (*c*) She plans to compare amount of wages paid in current year and last year. It is also planned to verify relationship between the number of employees and wages paid in both years.

   (*d*) She is of the view that it is necessary to examine title deeds of "land" appearing in financial statements of the firm.

   (*e*) The firm is engaged in export of goods to Europe. The sales invoices raised in Euros are converted into Indian rupees as per applicable norms.

Based on above description, answer the following questions:

**50.** As regards description given regarding verification of bills debited in "Machinery repair" account, identify what she intends to perform?

(*a*) Tests of Controls
(*b*) Tests of transactions
(*c*) Tests of balances
(*d*) Risk assessment procedures

**Ans.** (*b*)

**51.** Identify which type of assertion she intends to focus when she wants to ensure genuineness of trade payables.t

(*a*) Occurrence
(*b*) Cut-off
(*c*) Existence
(*d*) Accuracy

**Ans.** (*c*)

**52.** As regards comparison of wages of current year and last year and comparison of relationship between the number of employees and wages paid in both years, identify what she is trying to do?

(*a*) She is intending to perform tests of details.
(*b*) She is intending to perform tests of transactions.
(*c*) She is intending to perform tests of balances.
(*d*) She is intending to perform substantive analytical procedures.

**Ans.** (*d*)

**53.** In case of examination of title deeds of "land", which of the following fits into most appropriate description of such an audit procedure?

(*a*) Observation
(*b*) Inspection
(*c*) External confirmation
(*d*) Enquiry

**Ans.** (*b*)

**54.** She wants to verify whether conversion of foreign currency into Indian rupees is proper or not. Identify what she is trying to do?

(*a*) Reperformance
(*b*) Recalculation
(*c*) Observation
(*d*) Inspection

**Ans.** (*b*)

**Multiple Choice Questions (MCQ)**

1. Which of the following is not one of functions of internal auditor of an organization?
   (*a*) Performing assurance activities
   (*b*) Performing consulting activities to improve governance of organization
   (*c*) Performing risk management activities
   (*d*) Expressing independent opinion on financial statements of organization

**Ans.** (*d*)

2. An auditor finds during course of an audit that the entity has entered into many related party transactions. Which of the following statements is true?
   (*a*) The risk that management may override controls in respect of related party transactions is lower
   (*b*) The risk that management may override controls in respect of related party transactions is higher.
   (*c*) There is no effect on the risk that management may override controls in respect of related party transactions.
   (*d*) Risk of overriding of controls by management has no relationship at all with related party transactions.

**Ans.** (*b*)

3. Which of the following is not an objective of a company's policies for ensuring "internal financial controls"?
   (*a*) Efficient conduct of business
   (*b*) Safeguarding of assets
   (*c*) Prevention and detection of frauds and errors
   (*d*) Assessing audit risk

**Ans.** (*d*)

4. Which of the following is not an advantage of statistical sampling?
   (*a*) Sample size does not increase in proportion to size of area tested.
   (*b*) Sample selection is more objective.
   (*c*) It provides a means of deriving a calculated risk and corresponding precision.
   (*d*) In case of verifying compliance with specific legal requirements, it is suitable.

**Ans.** (*d*)

5. A company auditor receives external confirmation from an entity to whom company has sold goods. The said amount is properly classified in financial statements of company. Which of the following statements is not true in this regard?
   (*a*) It shows that said trade receivable exists.
   (*b*) It shows that said trade receivable is properly valued.
   (*c*) It shows that company has a right to said trade receivable.
   (*d*) It shows that amount of said trade receivable has been recorded in proper account

**Ans.** (*b*)

**55.** Auditor can depend on routine checks to disclose all the mistakes or manipulation that may exist in accounts.

**Ans. (Incorrect)**

Routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like trend and ratio analysis in addition to reasonable tests.

**56.** What precautions should be taken by the auditor while applying test check techniques?

**Ans.** Precautions to be taken while applying test check techniques are

- 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.

❑❑❑

5

CHAPTER

# Audit of Items of Financial Statements

| S. No. | Sub Topics | Easy | Moderate | Hard |
|---|---|---|---|---|
| 01. | Income Statement Assertions | | | |
| 02. | Balance Sheet Assertions | | | |
| 03. | Share Capital | | | |
| 04. | Reserve and Surplus | | | |
| 05. | Borrowings | | | |
| 06. | Trade Receivables | | | |
| 07. | Cash and Cash Equivalents | | | |
| 08. | Inventories | | | |
| 09. | PPE | | | |
| 10. | Intangible Assets | | | |
| 11. | Trade Payables and Other Current Liabilities | | | |
| 12. | Loans and Advances, and Other Current Assets | | | |
| 13. | Provisions and Contingent Liabilities | | | |
| 14. | Sale of Products and Services | | | |
| 15. | Other Income | | | |
| 16. | Purchases | | | |
| 17. | Employee Benefits Expense | | | |
| 18. | Depreciation and Amortisation | | | |
| 19. | Other Expenses | | | |

***Notes to Add***

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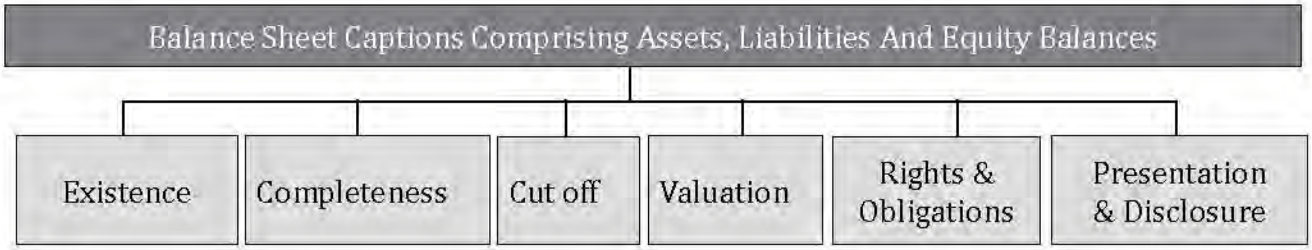
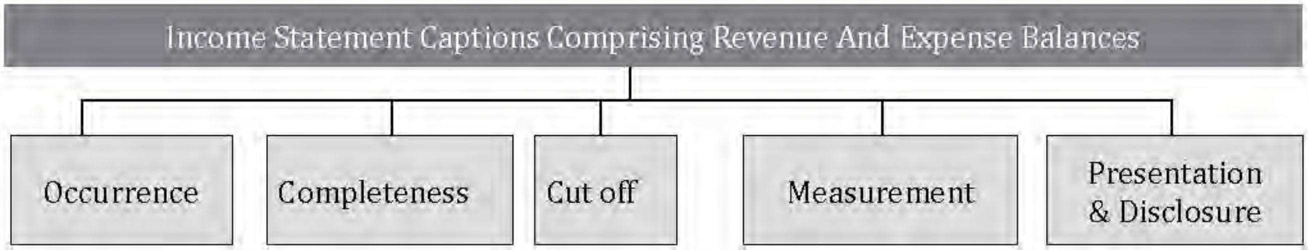


Balance Sheet Captions Comprising Assets, Liabilities And Equity Balances
Existence
Completeness
Cut off
Valuation
Rights & Obligations
Presentation & Disclosure

Income Statement Captions Comprising Revenue And Expense Balances
Occurrence
Completeness
Cut off
Measurement
Presentation & Disclosure


***Notes to Add***

Full import of "Substantive audit procedures" was already ingrained by Sameer. However, he wanted to know how such procedures are actually applied. How such detailed checking is carried out by team carrying out audit? Are there separate yardsticks for verifying "transactions" and "balances"? And what is logic behind detailed checking of "transactions" and "balances"? Recalling the basic premise of preparation of financial statements by the management, it flowed to him logically that such preparation of financial statements ought to involve expressly stated or implied statements. While carrying out detailed checking, auditor basically tries to verify these assertions.

Shekhar had told him that while verifying transactions and balances of the manufacturing company they were auditing, all assertions backing up these were verified. For example, while verifying sales of the company, it was verified that sales pertaining to the company have, in fact, taken place. It was also verified that data in respect of these transactions was recorded correctly. Nonetheless, it was made sure to verify recording of transactions in correct accounting period. And there were others too!

Similarly, while verifying trade receivables, procedures were applied to confirm existence of these balances. It was also checked that money represented by trade receivables was, in fact, recoverable. Were some balances under litigation or under dispute? All such aspects were gone through to obtain assurance that the balances were properly valued. And how can disclosure requirements be left behind? Whether all disclosures have been made in respect of such balances which were required to be made in accordance with applicable financial reporting framework? Besides this, analytical procedures also needed to be performed to bring out variations and fluctuations.

Gathering that transactions and balances reflected in financial statements convey so many things, both stated and understood, he found such a framework quite logical. In this context, requirements of applicable financial reporting framework become too important to be taken lightly. Schedule III of Companies Act, 2013 came to his mind instantaneously in context of their talks pertaining to a manufacturing company.

Performing audit procedures to verify such assertions provides evidence to auditor which is evaluated in light of overall circumstances. Such procedures are indeed bedrock which help auditor to crystallize his opinion in form of audit report. Wanting to learn comprehensively about such procedures particularly in context of companies, he scrolled mouse to next page.

***Notes to Add***

## INTRODUCTION

Explicit    Implicit

Assertion→Representation→By Mgt.→used by Auditor

↓ Embodied in F.S.

↓ To consider difference types of MM

↓ That May Occur

Auditor→To draw→Audit Programme

↓

To VERIFY assertions made by Mgt.

↓

by obtaining Suff. + Appro. A.E. → for claims
- CoT
- A/c. Bal.
- Disclosures

***Notes to Add***

Companies prepare their financial statements in accordance with the framework of generally accepted accounting principles (Indian GAAP ), also commonly referred to as accounting standards (AS).

A financial statement audit comprises the examination of an entity's financial statements and accompanying disclosures by an independent auditor. The result of this examination is a report by the auditor, attesting the truth and fairness of preparation and presentation of the financial statements and related disclosures. The preparation and presentation of the financial statements is the responsibility of the management.

Further, every financial statement contains an overall representation in addition to various specific assertions. Each financial statement purports to present something as a whole in addition to its component details. For example, an income statement purports to present "the results of operations" a balance sheet purports to present "financial position". The auditor's opinion is typically directed to these overall representations. But to formulate and offer an opinion on the overall truth of these statements he has first to inquire into the truth of many specific assertions that makes up each of these statements. Out of his individual judgements of these specific assertions he arrives at a judgement on the financial statement as a whole. In this chapter, we will be discussing in detail about the various audit procedures that an auditor can perform in order to verify the various assertions appearing in the financial statements. Before discussing about the audit procedures that an auditor can perform to verify the various assertions appearing in the financial statements, let us have a look at the meaning of the term assertion.

**Definition of Assertion:** It refers to the representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

In preparing financial statements, company's management makes various implicit or explicit claims (i.e. assertions) regarding:

- completeness;
- cut-off;
- existence / occurrence;
- valuation/ measurement;
- rights and obligations; and
- presentation and disclosure

of Assets, Liabilities, Equity, Income, Expenses and Disclosures in accordance with the applicable accounting standards.

**Example**

If Company X's balance sheet shows Building with carrying amount of ₹ 50 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 X owns & 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 ₹ 50 lakh (Completeness assertion).

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 MAY BE BROADLY CLASSIFIED INTO THE FOLLOWING TYPES

**Income Statement Captions Comprising Revenue & Expense Balances**

| Assertions | Explanations |
|---|---|
| Occurrence | Transactions — Occurred<br>Transactions — Relates to Entity |
| Completeness | Transactions → Supposed to be Recorded<br>Recognized / Not Omitted |
| Cut-off | Transactions → correct A/c period<br>Separate Assertion → Substantive Procedures<br>↓<br>Different |
| Measurement | Transactions → Recorded — Accurately / Appro. Amt.<br>↓<br>No — Error / Misstatement |
| Presentation & Disclosure | Transactions — Fairly — Presented / Classified<br>Transactions — Appro — Segregated / Dissegregated<br>Transactions — Disclosure — Complete / Accurate |

***Notes to Add***

| Assertions | Explanation | Example: Employee benefit expenses and sales |
|---|---|---|
| Occurrence | Transactions recognized in the financial statements have occurred and relate to the entity. | (i) Employee benefit expense has been incurred during the period in respect of the personnel employed by the entity. Employee benefit expense does not include the cost of any unauthorized personnel.<br>(ii) Recorded Sales represent goods which were ordered by valid customers and were despatched and invoiced in the period. |
| Completeness | All transactions that were supposed to be recorded have been recognized in the financial statements. Transactions have not been omitted. | (i) Employee benefit expenses in respect of all personnel have been fully accounted for.<br>(ii) All genuine Sales have been recorded. |
| Cut-off | Whether all income and expenses are reported in the- correct accounting period. Cut-off is a separate assertion because the substantive procedures to verify it are typically different from those applied to the other components of completeness. | (i) Employee benefit expenses recognized during the period relates to the current accounting period only.<br>(ii) Sales shall include the despatch of goods made at the year end as they belong to the relevant period. |
| Measurement | Transactions have been recorded accurately at their appropriate amounts in the financial statements. There have been no errors while preparing documents or in posting transactions to ledger. The figures and explanations are not misstated. | (i) Employee benefit expense has been measured/calculated accurately.<br>Any adjustments such as tax deduction at source have been correctly reconciled and accounted for.<br>(ii) Sales are recorded correctly in the books based on the invoices. Discounts have been properly adjusted or accounted for. |
| Presentation and Disclosure | Transactions have been classified and presented fairly in the financial statements.<br>Transactions and events are appropriately segregated or disaggregated.<br>Presentation and disclosure assertions are considered during the course of the audit to determine that the disclosures are complete and accurate.<br>The disclosures that are most susceptible to material misstatement are those that require significant judgement and qualitative assessments. Audit teams assess the completeness and accuracy of disclosures by determining that the disclosures provide information in a manner that does not materially omit, distort or mislead the user. The description and disclosure of transactions are relevant and easy to understand. | (1) A Company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items:—<br>Employee Benefits Expense [showing separately<br>(*i*) salaries and wages,<br>(*ii*) contribution to provident and other funds,<br>(*iii*) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP),<br>(*iv*) staff welfare expenses.<br>(2) In respect of a company other than a finance company revenue from operations shall disclose separately in the notes revenue from—<br>(*a*) Sale of products;<br>(*b*) Sale of services;<br>(*ba*) Grants or donations received (relevant in case of section 8 companies only),<br>(*c*) Other operating revenues;<br>Less:<br>(*d*) Excise duty |

## BALANCE SHEET CAPTIONS COMPRISING ASSETS, LIABILITIES AND EQUITY BALANCES

| **Assertions** | **Explanations** |
|---|---|
| Existence | Balances $\rightarrow$ EXISTS |
| Completeness | Transactions $\rightarrow$ supposed to be Recorded<br>– Recognized<br>– Not Omitted |
| Cut-off | Balances $\rightarrow$ Correct A/c. Period |
| Valuation | Balances $\rightarrow$ Appro. Valued<br>$\downarrow$<br>No – Overstatement<br>No – Understatement |
| Rights & Obligation | Assets $\rightarrow$ Rights – Ownership<br>Assets $\rightarrow$ Rights – Legal Title<br>Liabilities $\rightarrow$ Entity's Obligations |
| Presentation & Disclosure | Balances<br>– Fairly – Presented<br>– Fairly – Classified<br>– Appro – Segregated<br>– Appro – Disegregated<br>– Disclosure – Complete<br>– Disclosure – Accurate |

***Notes to Add***

| Assertions | Explanation | Example: Inventory balance |
|---|---|---|
| Existence | Assets, liabilities and equity balances exist as at the period end. | Inventory recognized in the balance sheet actually existed as at the period end. |
| Completeness | All assets, liabilities and Equity balances that were Supposed to be recorded have been recognized in the financial statements. | All inventory units held by the entity that should have been recorded, have been recognized appropriately in the financial statements. 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 (on behalf of third party i.e. Consignor) shall be excluded. |
| Cut-off | Whether all assets and liabilities are reported in the appropriate period. | Inventory balance as at the year- end does not include any element of next financial year. All items of inventory pertaining to the relevant year shall be included regardless of the location. |
| Valuation | Assets, liabilities and equity balances have been valued appropriately i.e. the amounts at which they are recorded are appropriate. There has been no overstatement or understatement. | Inventory has been recognized at the lower of<br>❑ cost and<br>❑ net realizable value 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. |
| Rights & Obligations | Entity has the right to assets i.e. (whether the entity has ownership and legal title to assets) and the liabilities recognized in the financial statements represent all the entity's obligations to repayment as at a given date. | The entity owns or controls the inventory recorded in the financial statements i.e. the purchase invoices have been made in the name of client.<br>Any inventory held by the entity on behalf of another entity has not been recognized as part of inventory of the entity. (Eg: Consignment agreements can be checked). |

| | | |
|---|---|---|
| Presentation and Disclosure | Whether particular items in the financial statements are properly classified, described and disclosed.<br>Presentation and disclosure assertions are considered during the course of the audit to determine that disclosures are complete and accurate.<br>The disclosures that are most susceptible to material misstatement are those that require significant judgement and qualitative assessments.<br>Audit teams assess the completeness and accuracy of disclosures by determining that the disclosures provide<br>Information in a manner that does not materially omit, distort or mislead the user. The balances have been appropriately segregated or disaggregated. The related disclosures are understandable in accordance with applicable Financial Reporting framework. | Example 1<br>Inventories<br>(i) Inventories shall be classified as:<br>(*a*) Raw materials;<br>(*b*) Work-in-progress;<br>(*c*) Finished goods;<br>(*d*) Stock-in-trade (in respect of goods acquired for trading);<br>(*e*) Stores and spares;<br>(*f*) Loose tools;<br>(*g*) Others (specify nature).<br>(ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.<br>(iii) Mode of valuation shall be stated.<br>Shares outstanding at the beginning and at the end of the reporting period is required to be disclosed in the notes to accounts of the company. |

## QUESTIONS

### Correct/Incorrect

**State with reasons (in short) whether the following statements are correct or incorrect:**

**1.** If Company X's balance sheet shows building with carrying amount of Rs 100 lakh, the auditor shall assume only one point that the management has only asserted that the building recognized in the balance sheet exists as at the period-end.

**Ans. Incorrect:** If Company X's balance sheet shows building with carrying amount of Rs 100 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 X 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 ₹100 lakh (Completeness assertion).

### Multiple Choice Questions (MCQ)

**1.** Which of the following statement is most appropriate as regards to disclosure of goods in transit in financial statements of a company?

(*a*) No separate disclosure of goods in transit is required

(*b*) Disclosure of total goods in transit under head of inventories is required

(*c*) Disclosure of goods in transit under each sub-head of inventories is required

(*d*) Disclosure of goods in transit for raw material and finished goods is required

**Ans.** (*c*)

**Test Your Understanding 1**

A company is engaged in manufacturing of fabrics from yarn purchased from different suppliers. Occasionally, it also manufactures fabrics tailor made in accordance with requirements of certain mills from yarn received from these mills. The company raises bill of its labour charges only on mills for converting yarn into fabrics. The auditor of company tries to ensure that stocks of the company as at year end do not include stocks pertaining to these mills. Which assertion auditor tries to verify in above situation? How he can ensure that?


Following section defines the various procedures an auditor should design to perform around certain Balance Sheet captions:

**Ans.** The auditor is trying to verify assertion relating to "Rights and Obligations". He is verifying that the company owns or controls the inventory recorded in the financial statements. Any inventory held by the company on behalf of another entity has not been recognized as part of inventory of the company.

This can be achieved by verifying stock records pertaining to goods received from mills and sent back to mills after carrying out necessary operations. Besides, agreements with such mills may also be verified.

***Notes to Add***

## BALANCE SHEET CAPTIONS

Share Capital → Existence + Completeness + Valuation

(1) Tally → Period end Balance

(2) △ → Yes → Verify → Limits → Authorised Capital → MoA

(3) △ → No → Obtain W.R. ← Company Secretary

(4) Obtain → Copies of Resolution

(5) Compliance
- The Companies Act, 2013
- SEBI Regulations
- MCA Guidelines

***Notes to Add***

## SHARE CAPITAL

Every company's lifecycle starts with raising of capital. Other than a private company, every other company issues a prospectus, which may be in the abridged form, or a Statement in lieu of Prospectus, before it proceeds towards allotment of share capital.

The Prospectus defines the conditions on which allotment will be made (like minimum subscription), the projects on which the amount raised shall be spent (when these have been decided upon in advance) and to specify limits on certain expenses incidental to raising of capital. The receipt of applications for shares and allotment of shares in pursuance thereto are two important aspects of every issue of capital in the matter of purchase of shares. These, therefore, should receive a careful attention of the auditor. He must verify that each party, has performed his part of the contract, within the allotted time. For issue of shares, the companies also enter into certain underwriting contracts which become an important part of verification by the auditor.

The below table summarises the audit procedures generally required to be undertaken while auditing share capital:

| Brief description | Audit procedures |
|---|---|
| To establish the EXISTENCE of share capital as at the period- end<br>Equity balances that were supposed to be Recorded have been Recognized in the financial statements. (COMPLETENESS)<br>Equity balances have been VALUED appropriately. | **Audit procedures**<br>❑ Tally the period-end share capital balance- authorised, issued and paid up, to the previous year audited financial statements.<br>❑ In case there in no change during the year, obtain a written confirmation/ representation from the Company Secretary that there were no changes to entity's capital structure during the year.<br>❑ In case there is any change, verify whether the paid up capital as at the period-end is within the limits of authorised capital. Authorized capital should be verified by examining MOA. |

| Brief description | Audit procedures |
|---|---|
| | ❑ Obtain the certified copies of relevant resolutions passed at the meetings of board of directors, shareholders authorising the increase/decrease in authorised share capital, if required, or paid up share capital.<br>❑ In case of 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.<br>❑ No shares have been issued at Discount (Sec. 53 of Companies Act)<br>❑ Check if Shares are issued for cash or for Consideration other than cash. (Eg: To promoters for their services, underwriters for commission payable to them etc.)<br>❑ Compliance with SEBI regulations and Guidelines.<br>❑ Also, obtain and verify copies of forms filed with Ministry of Corporate Affairs (MCA) (Form SH-7, notice to Registrar of any alteration of share capital, Form PAS 3 company making allotment of shares/ securities required to file a return of allotment to the Registrar) and with Reserve Bank of India (Form FCGPR in case of Foreign Direct Investment (FDI) by a Non-resident shareholder) and verify the number of securities issued along with the issue price.<br>❑ In case there was increase in share capital, verify whether the Company has accurately calculated the required fee and stamp duty payable to MCA. |

***Notes to Add***

***Notes to Add***

## SHARES ISSUED @ PREMIUM

(1) Compliance → Sec.52

(2) Transfer → Amount → Securities Premium A/c.

(3) State → Purpose → Amount to be applied

- Unissued Shares → To Members → Fully Paid Bonus Shares
- Writing off
  - Preliminary Expenses
  - Commission / Discount Paid
- Premium on Redemption
  - Pref. Shares
  - Debentures
- Sec.68 → Buy Back

Auditor Needs to Verify

***Notes to Add***

| Brief description | Audit procedures |
|---|---|
| | **Shares Issued at Premium:**<br><br>In case a company has issued shares at a premium, that is, at amount in excess of the nominal value of the shares, whether for cash or otherwise, 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.<br><br>There is no restriction or conditions prescribed in the Act for issue of shares at premium.<br><br>The provisions of this Act relating to reduction of share capital of a company shall apply as if the securities premium account were the paid-up share capital of the company.<br><br>**Application of securities premium account:** The securities premium account may be applied by the Company for the following purposes:<br>(a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;<br>(b) in writing off the preliminary expenses of the Company;<br>(c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;<br>(d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or<br>(e) for the purchase of its own shares or other securities under Section 68. (Buyback)<br><br>Prescribed Class of Companies are permitted to apply Securities Premium Account:<br><br>Prescribed Class of Companies are permitted to apply Securities Premium Account: |
| | The securities premium account may be applied by such class of companies, as may be prescribed and whose financial statement comply with the accounting standards prescribed for such class of companies under Section 133:<br>(a) in paying up unissued equity shares of the company to be issued to members of the company as fully paid bonus shares; or<br>(b) in writing off the expenses of or the commission paid or discount allowed on any issue of equity shares of the company; or<br>(c) for the purchase of its own shares or other securities under section 68.<br>The auditor needs to verify<br>(i) Whether the premium received on shares, if any, has been transferred to a "securities premium account" and<br>(ii) whether the application of any amount out of the said "securities premium account" is only for the purposes mentioned above. |

## QUESTIONS

**Theory Questions**

**2.** ABC Ltd. has issued shares for cash at a premium of ₹450, that is, at amount in excess of the nominal value of the shares which is ₹10 for cash. Section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account. Advise the means in which the amount in the account can be applied.

**Ans.** Shares Issued at Premium: In case a company has issued shares at a premium, that is, at amount in excess of the nominal value of the shares, whether for cash or otherwise, section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account and state the means in which the amount in the account can be applied.

(*a*) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or

(*b*) for the purchase of its own shares or other securities under section 68.

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.

***Notes to Add***

***Notes to Add***

## SHARES ISSUED @ DISCOUNT

(1) Compliance → Sec.53

(2) Shall Not Issue Shares @ Discount → EXCEPT

- Sec. 54 ↓ Sweat Equity Shares
- Creditors
  - Statutory Resolution
  - Debt. Restructuring

(3) **Co → Fails to Comply** — **Co.** / **Every Official** — **Penalty**

**Amount Raised by issuing shares @ Discount** **←LESSOR OF→** **₹5,00,000**

**+**

**Refund all Money**

**+**

**Interest @ 12% p.a.**

**Auditor to Check**

***Notes to Add***

| Brief description | Audit procedures |
|---|---|
| | **Shares issued at a discount:**<br>According to Section 53 of the Companies Act, 2013,<br>(1) a company shall not issue shares at a discount, except in the case of an issue of sweat equity shares given under Section 54 of the Companies Act, 2013.<br>(2) any share issued by a company at a discounted price shall be void. Notwithstanding anything contained in (2A) sub-sections (1) and (2), 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 the Reserve Bank of India under the Reserve Bank of India Act, 1934 or the Banking (Regulation) Act, 1949.<br>(3) 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 five lakh rupees, whichever is less, and the company shall also be liable to refund all monies received with interest at the rate of twelve per cent. per annum from the date of issue of such shares to the persons to whom such shares have been issued. |
| | **The auditor needs to check**<br>(i) the movement in share capital during the year and wherever there is any issue,<br>(ii) he should verify that the Company has not issued any of its shares at a discount by reading the minutes of meeting of its directors and shareholders authorizing issue of share capital and the issue price.<br>(iii) Further, auditor should also 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 the Reserve Bank of India under the Reserve Bank of India Act, 1934 or the Banking (Regulation) Act, 1949. |

***Notes to Add***

## ISSUE OF SWEAT EQUITY SHARES

Equity Shares → By Co. → To
- Employee
- Director

↓

at
- Discount
- Consideration Other than Cash

For Providing
- Know-how
- IPR
- Value Additions

**→Auditor needs to Verify**

**(1) Compliance → Sec. 54**

**(2) SR → Passed by Co.**

↓

**(3) Specifies**
- **No. of Shares**
- **CMP**
- **Consideration**
- **Class (s)**
  - **Directors**
  - **Employee**

**(4) Regulations**
- **Listed→SEBI**
- **Unlisted→As prescribed**

***Notes to Add***

| Brief description | Audit procedures |
|---|---|
| | **Issue of Sweat Equity Shares:**<br>According to Section 54 of the Companies Act, 2013, the employees may be compensated in the form of 'Sweat Equity Shares".<br>"Sweat Equity Shares" mean equity shares issued by the company to employees or directors at a<br>(i) discount or<br>(ii) for consideration other than cash<br>for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called. |
| | 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):<br>(a) the issue is authorized by a special resolution passed by the company;<br>(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;<br>(c) Omitted<br>(d) where the equity shares of the company are listed on a recognized stock exchange, the sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board in this behalf and if they are not so listed, the sweat equity shares are issued in accordance with such rules as may be prescribed. |
| | Further, 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. |

## QUESTIONS

### Multiple Choice Questions (MCQ)

**2.** Sweat Equity shares are issued by a company at a discount or for consideration other than cash to its:-

(*a*) Directors only (*b*) Clients only

(*c*) Directors or employees (*d*) Auditors only

**Ans.** (*c*)

### Correct/Incorrect

**State with reasons (in short) whether the following statements are correct or incorrect:**

3. "Sweat Equity Shares" means equity shares issued by the company to employees or directors at a premium or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.

**Ans. Incorrect:** "Sweat Equity Shares" means 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 right in the nature of intellectual property rights or value additions, by whatever name called.

**4.** The securities premium account may only be applied by the Company towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares.

**Ans. Incorrect:** The securities premium account may be applied by the Company:

(*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.

**5.** Increase in authorised capital of the company requires special resolution to be passed at the general meeting.

**Ans. Incorrect:** Increase in Authorised capital requires alteration of capital clause of memorandum of Association. Therefore, ordinary resolution is passed for increase in authorised capital of the company as per the Companies Act, 2013.

**6.** A company should disclose in its Annual Report, the shares in the company held by each shareholder holding more than 10 percent shares specifying the number of shares held.

**Ans. Incorrect:** Schedule III to the Companies Act, 2013 requires the company to disclose- "shares in the company held by each shareholder holding more than 5 per cent shares specifying the number of shares held" in notes to accounts.

**Theory Questions**

**7.** S & Co., Chartered Accountants, are appointed as the auditors of ABC Ltd. CA S, the engagement partner, has come across the following while verifying equity share capital of the company:

(*i*) He noticed that some of the equity shares are held by promoters.

(*ii*) Some shares are issued as sweat equity shares to the employees. What is the meaning of sweat equity shares?

What are the disclosure requirements of such promoter's shareholding?

**Ans.** Meaning of Sweat Equity & Disclosure of shares held by Promotors:

Meaning Sweat Equity Shares: 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 right in the nature of intellectual property rights or value additions, by whatever name called.

Disclosure requirements of such promoter's shareholding: 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

### *Notes to Add*

## REDUCTION OF CAPITAL

(1) Compliance → Sec. 66

(2) Meeting of Share Holders — Properly Convened; S. R. Passed

(3) Verify → AoA

(4) No Defaults — Repayment of Deposits; Payment of Interest on Deposits

(5) Examine — Order of Tribunal; MoM — Filed with RoC

(6) RoC Certificate

(7) A/c. Entries

(8) Revaluation of Assets → Properly Disclosed

***Notes to Add***

| Brief description | Audit procedures |
|---|---|
| | **Reduction of Capital**<br><br>As a principle of sound financial management, a company is required to keep its capital intact. At times, however, it may become necessary for the company to bring about a reduction in its capital. Accumulated business losses, assets of reduced or doubtful value like unsound investments proving bad or having paidup capital in excess of the requirements of the company or surplus capital which cannot be employed gainfully, require corrective measures to be taken to keep the financial health of the company in a reasonably well position. Accordingly, the company may find it necessary to reduce its share capital. |
| | **Section 66 deals with the reduction of share capital.**<br><br>For verifying reduction of capital, the auditor needs to examine whether the company has followed the specific requirements as required by Section 66 of the Companies Act, 2013. The auditor shall undertake the following audit procedures:<br>(*i*) Verify that the meeting of the shareholders held to pass the special resolution was properly convened and that the proposal was circularized in advance to all the shareholders;<br>(*ii*) Verify that the Articles of Association authorises reduction of capital;<br>(*iii*) Examine 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.<br>(*iv*) Examine the order of the Tribunal confirming the reduction and verify that a copy of the order and the minutes have been registered and filed with the Registrar of Companies;<br>(*v*) Check the Registrar's Certificate as regards to reduction of capital;<br>(*vi*) 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; also check whether the requirements of Schedule III, Part I, have been complied with in relation to presentation;<br>(*vii*) Confirm whether the revaluation of assets has been properly disclosed in the Balance Sheet; |

| | |
|---|---|
| | (*viii*) The company may reduce the capital by reduction in unpaid capital or cancellation of lost capital or paying off excess paid up capital. 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;<br>(*ix*) 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.<br>(*x*) Check if the company have complied with all the terms and conditions imposed by the tribunal while confirming reduction of share capital.<br>(*xi*) Verify that the Memorandum of Association of the company has been suitably altered.<br>Exemption to Buy-Back: According to Section 66 (6), nothing in this section shall apply to buy- back of its own securities by a company under Section 68.<br>If the Company has made any buyback of securities, ensure compliance of specific requirements as given under section 68 of Companies Act 2013. |

***Notes to Add***

## *Notes to Add*

## SHARE CAPITAL

**Disclosure**

↓

**Schedule III (Part-I) of The Companies Act, 2013**

**Share Capital → Additional Regulatory Info.**

↓

**Sec. 143(3) (j) (d) [Ch.8 → Audit Report]**

↓

**Disclose**

**Date + Amount**

**Fund**

Relevant Provisions

**The FEMA, 1999**

**The Co. Act 2013**

**Advanced**

**Loaned**

**Invested**

**Intermediaries**

**Intermediaries**

↓

**To Other Intermediaries**

**Ultimate Beneficiaries**

***Notes to Add***

| Brief description | Audit procedures | | | |
|---|---|---|---|---|
| Required DISCLOSURE for equity have been appropriately made | Ensure whether the following disclosure requirements of Schedule III (Part I) to Companies Act, 2013 have been complied with:<br>**Share Capital**<br>For each class of share capital (different classes of preference shares to be treated separately):<br>(*a*) the number and amount of shares authorised;<br>(*b*) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;<br>(*c*) par value per share;<br>(*d*) a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;<br>(*e*) the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;<br>(*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 per cent. shares specifying the number of shares held;<br>(*h*) shares reserved for issue under options and contracts / commitments for the sale of shares/disinvestment, including the terms and amounts;<br>(*i*) for the period of five years immediately preceding the date as at which the Balance Sheet is prepared:<br>(*i*) Aggregate number and class of shares allotted as fully paid-up pursuant to contract(*s*) without payment being received in cash.<br>(*ii*) Aggregate number and class of shares allotted as fully paid-up by way of bonus shares.<br>(*iii*) Aggregate number and class of shares bought back.<br>(*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;<br>(*k*) calls unpaid (showing aggregate value of calls unpaid by Directors and officers);<br>(*l*) forfeited shares (amount originally paid-up).<br>(*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 | | | |

| | |
|---|---|
| | * Promoter here means promoter as defined in the Companies Act, 2013.<br>** Details shall be given separately for each class of shares<br>*** percentage 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.<br>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. |

**Notes:**

To be disclosed as Additional Regulatory Information

Utilisation of Borrowed funds and share premium:

(A) 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

(*i*) 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

(*ii*) provide any guarantee, security or the like to or on behalf of the Ultimate Beneficiaries; the company shall disclose the following:-

(I) date and amount of fund advanced or loaned or invested in Intermediaries with complete details of each Intermediary.

(II) 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.

(III) date and amount of guarantee, security or the like provided to or on behalf of the Ultimate Beneficiaries

(IV) declaration that relevant provisions of the Foreign Exchange Management Act, 1999 (42 of 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 (15 of 2003);

(B) 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

(*i*) 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

(*ii*) provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries, the company shall disclose the following:-

(I) date and amount of fund received from Funding parties with complete details of each Funding party.

(II) date and amount of fund further advanced or loaned or invested other intermediaries or Ultimate Beneficiaries along with complete details of the other intermediaries or ultimate beneficiaries.

(III) date and amount of guarantee, security or the like provided to or on behalf of the Ultimate Beneficiaries

(IV) declaration that relevant provisions of the Foreign Exchange Management Act, 1999 (42 of 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 (15 of 2003).

***Notes to Add***

## RESERVES AND SURPLUS

**Amounts→Appropriated→Out** of Profits

↓

**Not Intended to Meet any**

**Liability** | **Contingency** | **Commitment** | **Diminution in Value of Assets**

**Known to Exist → As at the B/S date**

**Reserve and Surplus → Existence**

↓

**Trace**
**Tally** — **Opening Bal.→Previous Yr**

**Profit & Loss → Completeness + Valuation**

↓

**Trace the Movement** — **St. of P/L** / **St. of Δ in Equity**

↓

**Verify Boards Resolution**

**→Disclosure**

↓

**Schedule III (Part I) of The Companies Act, 2013**

***Notes to Add***

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.

Reserves are a vital source of financing by internal means. The company utilizes the reserves according to the nature and type of such reserve. The reserves can be segregated as revenue or capital 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.

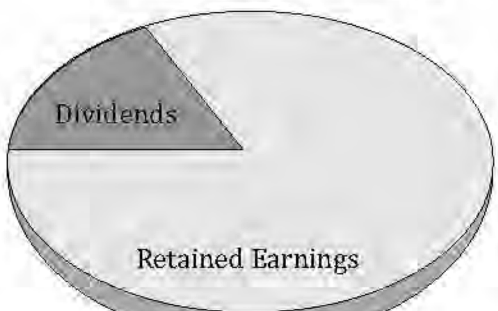
**Capital Reserve** represents a reserve which does not include any amount regarded as free for distribution. They can be utilized only for certain limited purposes.

**Example:**

**Securities premium, capital redemption reserve.**

It may be noted that if a company appropriates revenue profit for being credited to the asset replacement reserve with the objective that these are to be used for a capital purpose, such a reserve shall also be in the nature of a capital reserve.

**Company Earnings**




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 realized.

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.

The below table summarises the audit procedures generally required to be undertaken while auditing reserves and surplus:

| Brief description | Audit procedures |
|---|---|
| To establish the EXISTENCE of reserves and surplus as at the period-end | **Audit procedures**<br>Trace and tally the opening balance of reserves and surplus to the previous year audited financial statements.<br>For addition/utilization in current year, in case of: |
| Reserves and Surplus balances that were supposed to be recorded have been recognized in the financial statements. (COMPLETENESS) | ❑ Profit and Loss balance:<br>❑ Trace the movement to surplus/ deficit as per the Statement of profit and loss for the year under audit.<br>❑ The movement should be traced in the Statement of Changes in Equity. |
| Reserves and Surplus balances have been VALUED appropriately (VALUATION). | ❑ Verify the resolution passed by the board of directors regarding the recommendation of dividend, resolution passed by shareholders declaring the dividend.<br>❑ Students should note that as per AS-4 (Revised) or IND AS 10, if dividends to holders of equity instruments are proposed or declared after the balance sheet date, an entity should not recognize those dividends as a liability as at the balance sheet date. It should, however, disclose the amount of dividends that were proposed or declared after the balance sheet date, but before the financial statements were approved for issue. |
| | ❑ Securities Premium - It needs to be confirmed that the company has issued shares in excess of the nominal value of the shares and for the same, the auditor should obtain and verify the resolution passed by the board of directors.<br>❑ As already discussed under the caption - 'share capital', the utilisation of securities premium account could be done only for limited purposes; auditor needs to ensure the same. (Sec 52 of Companies Act 2013) |
| Required DISCLOSURES for reserves and surplus have been appropriately made | Ensure whether the following disclosure requirements of Schedule III (Part I) to Companies Act, 2013 have been complied with: |

| | |
|---|---|
| | (i) Reserves and Surplus shall be classified as:<br>(*a*) Capital Reserves;<br>(*b*) Capital Redemption Reserve;<br>(*c*) Securities Premium 8 [Omitted];<br>(*d*) Debenture Redemption Reserve;<br>(*e*) Revaluation Reserve;<br>(*f*) Share Options Outstanding Account;<br>(*g*) Other Reserves– (specify the nature and purpose of each reserve and the amount in respect thereof);<br>(*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);<br>(ii) A reserve specifically represented by earmarked investments shall be termed as a "fund".<br>(iii) 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 negative balance of surplus, if any, shall be shown under the head "Reserves and Surplus" even if the resulting figure is in the negative. |

## QUESTIONS

**Correct/Incorrect**

**State with reasons (in short) whether the following statements are correct or incorrect:**

**8.** Capital reserves represent profits that are available for distribution to shareholders held for the time being or any one or more purpose.

**Ans. Incorrect**: Revenue reserves represent profits that are available for distribution to shareholders.

**9.** 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.

**Ans. Correct:** 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 share premium or capital redemption reserve account can be utilised only for the purpose specified in Sections 52 and 55 respectively of the Companies Act, 2013.

**10.** Capital redemption reserve can be used for distribution of dividends.

**Ans. Incorrect:** Capital Redemption reserve is not a free reserve. It is a restrictive reserve and can be used only for purposes given in the Act. Since it is not a free reserve, it cannot be utilised for payment of dividends. CRR can be used only for the purpose of issuing fully paid up bonus shares.

## BORROWINGS

Existence → (1) Review → Board MoM → Agreement ↓ Authorised

(2) Agree → Details
- Interest Rate
- Nature
- Repayment Terms
- Limits
- H.P
- Leasing

(3) Bal. Confirmation
- SA 505
- SA 580

(4) In Case of Debenture → Deb. Trust Deed

Completeness → (1) Sch. of (Short Term / Long Term) Borrowings

(2) Additional Debt.
- Board MoM
- Contracts
- Confirmations
- Disbursements

(3) Trace → Cl. Bal.
(4) Unrecorded?
(5) Correct Period?

* Direct Confirmation Procedure
(1) Ascertain → Confirmation ask
(2) Reminders → Non-Replies
(3) Compare Bal. → Books → Confirmations

Valuation → (1) Determine
- A/c. Policies
- Methods

(2) Agree Loan (Bal. / Payable) to → Agreement

(3) Recompute
- Interest
- Discount

(4) Computation → Amortisation of
- Premium
- Discount

(5) AS-11; AS-18
(6) Examine → Due Dates
(7) AOA & MOA
(8) Sec. 185 & 186
(9) Purpose

Liabilities are the financial obligations of an enterprise other than owners' funds. Liabilities include borrowings, trade payables and other current liabilities, deferred payment credits and provisions.

Verification of liabilities is as important as that of assets, for, if any liability is omitted or understated or overstated, the financial statements would not show a true and fair view of the state of affairs of the company.

Borrowings are monies made available using external sources like bank loans, debentures, public fixed deposits etc.

The below table summarises the audit procedures generally required to be undertaken while auditing borrowings:

| Brief description | Audit procedures |
|---|---|
| All borrowings on the balance sheet represent valid claims by banks or other third parties. (EXISTENCE) | ❑ Review board minutes for approval of new lending agreements. During review, ensure that new loan agreements or bond issuances were authorized. Ensure that significant debt commitments were approved by the board of directors.<br>❑ Agree details of loans recorded (interest rate, nature and repayment terms) to the loan agreement. Verify that borrowing limits, if any, imposed by agreements are not exceeded.<br>❑ Roll out and obtain independent balance confirmations (SA 505) in respect of all the borrowings from the lender (banks/ financial institutions etc.).<br>❑ Agree details of leases and hire purchase creditors recorded to underlying contracts/agreements.<br>❑ In case of Debentures, examine trust deed for terms and dates of redemption, borrowing restrictions and compliance with covenants.<br>❑ When debt is retired, ensure that a discharge is received on assets securing the debt.<br>❑ Obtain Written Representation that all the liabilities which have been recorded represent a valid claim by the lenders. |
| That all borrowings have been accounted for in the books of the company on a timely basis. (COMPLETENESS) | ❑ 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:<br>(*a*) 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.<br>(*b*) Trace the closing balances as per the schedules to the general ledger.<br>❑ 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) |

| | |
|---|---|
| | **Direct confirmation procedures**<br>❑ Roll out and obtain independent balance confirmations in respect of all the borrowings from the lender (banks/ financial institutions etc.) and perform the following:<br>(*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).<br>(*b*) Send reminders for non-replies.<br>(*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. |
| That liability is recorded at the correct amount. (VALUATION) | ❑ Determine that the accounting policies and methods of recording debt are appropriate and applied consistently.<br>❑ Agree loan balance and loan payables to the loan agreement.<br>❑ Recompute the interest and discount or premium on redemption, if any.<br>❑ Check computation of the amortization of premium or discount, if any.<br>❑ 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:<br>(*a*) Test that the entity is in compliance with loan covenants and other significant provisions of the agreements.<br>(*b*) 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.<br>❑ 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.<br>❑ 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.<br>❑ 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.<br>❑ 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.<br>❑ He should carefully review the borrowings from related parties and ensure compliance with AS 18 or IND AS 24.<br>❑ Verify whether liabilities towards bank in respect of bills discounted, bills negotiated, cheques discounted, etc. are correctly reflected and disclosed in the financial statements.<br>❑ 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.<br>❑ Verify that the company has not contravened the restrictions laid down by Section 180 (related to Restrictions on Powers of Board) of the Companies Act, in respect of the borrowings of the company. Also, check compliance of Sections 185 (related to Loans to Directors, etc.) and 186 (related to Loan and Investment by company) of the Companies Act, 2013.<br>❑ Examine the purpose for which the amount is borrowed and ensure that the amount is not used against the interest of the company.<br>❑ 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. |

| | |
|---|---|
| That borrowings have been presented, classified and DISCLOSED in the financial statements in accordance with the requirements of applicable financial reporting framework i.e. Companies Act, 2013 and applicable Indian GAAP | Ensure whether the following disclosures as required under Schedule III (Part I) to Companies Act, 2013 are made for each amount disclosed under each of the following headings:<br>Long- Term Borrowings<br>(i) Long-term borrowings shall be classified as:<br>(*a*) Bonds/debentures;<br>(*b*) Term loans:<br>(A) from banks.<br>(B) from other parties. |
| That borrowings have been presented, classified and DISCLOSED in the financial statements in accordance with the requirements of applicable financial reporting framework i.e. Companies Act, 2013 and applicable Indian GAAP | (*c*) Deferred payment liabilities;<br>(*d*) Deposits;<br>(*e*) Loans and advances from related parties;<br>(*f*) Long term maturities of finance lease obligations;<br>(*g*) Other loans and advances (specify nature).<br>(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.<br>(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.<br>(iv) Bonds/debentures (along with the rate of interest and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where bonds/debentures are redeemable by instalments, the date of maturity for this purpose must be reckoned as the date on which the first instalment becomes due.<br>(v) Particulars of any redeemed bonds/debentures which the company has power to reissue shall be disclosed.<br>(vi) Terms of repayment of term loans and other loans shall be stated.<br>(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.<br>**Other Long term Liabilities**<br>**Other Long term Liabilities shall be classified as:**<br>(a) Trade Payables;<br>(b) Others |

| | |
|---|---|
| That borrowings have been presented, classified and DISCLOSED in the financial statements in accordance with the requirements of applicable financial reporting framework i.e. Companies Act, 2013 and applicable Indian GAAP | **Short Term Borrowings**<br>(i) Short-term borrowings shall be classified as:<br>(*a*) Loans repayable on demand;<br>(A) from banks.<br>(B) from other parties.<br>(*b*) Loans and advances from related parties;<br>(*c*) Deposits;<br>(*d*) Other loans and advances (specify nature).<br>(ii) Borrowings shall further be sub- classified as secured and unsecured. Nature of security shall be specified separately in each case.<br>(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.<br>(v) current maturities of Long term borrowings shall be disclosed separately.<br>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. |

***Notes to Add***

## ADDITIONAL REGULATORY INFO. DISCLOSURE

(1) Borrowing — Banks / F.I. — Basis of Current Assets
- ↓ Quarterly — Returns / Statements
- ↓ Agreement with Books
- ↓ If Not — Summary of Reconciliation / Reasons for Material Discrepancies

(2) Willful Defaulter → Declared by — Bank / FI / Other Lender
- Willful Defaulter ↓ As per guidelines issued by RBI
- Declared by ↓ Disclose
  - Date of Declaration
  - Details of Default
    - Nature
    - Amt.

(3) Charges / Satisfaction → Registration → Pending
- Registration ↓ RoC ↓ Disclose — Details / Reasons
- Pending ↓ Beyond Statutory pd.

**(4) Utilisation of — Borrowed funds / Securities Premium**

**↓ Sec. 143 (3) (j) (d) [Ch. 8 → Audit Report]**

**↓ Disclose**
- **Date + Amount**
  - **Fund**
    - **Advanced** / **Loaned** / **Invested**
      - **Intermediaries**
      - **Intermediaries ↓ To Other Intermediaries**
      - **Ultimate Beneficiaries**
- **Relevant Provisions**
  - **The FEMA, 1999**
  - **The Co. Act 2013**

***Notes to Add***

To be disclosed as Additional Regulatory Information

(1) Where the Company has borrowings from banks or financial institutions on the basis of security of current assets, it shall disclose the following:-

(*a*) 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.

(*b*) if not, summary of reconciliation and reasons of material discrepancies, if any to be adequately disclosed.

(2) Wilful Defaulter*

Where a company is a declared wilful defaulter by any bank or financial institution or other lender, following details shall be given:

(*a*) Date of declaration as wilful defaulter,

(*b*) Details of defaults (amount and nature of defaults),

* wilful defaulter" here means a person or an issuer who or which is categorized as a wilful defaulter by any bank or financial institution (as defined under the Act) or consortium thereof, in accordance with the guidelines on wilful defaulters issued by the Reserve Bank of India.

(3) 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.

(4) Utilisation of Borrowed funds and share premium:

(*a*) 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

(*i*) 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

(*ii*) provide any guarantee, security or the like to or on behalf of the Ultimate Beneficiaries; the company shall disclose the following:-

(I) date and amount of fund advanced or loaned or invested in Intermediaries with complete details of each Intermediary.

(II) date and amount of fund further advanced or loaned or invested by such Intermediaries to other intermediaries or Ultimate Beneficiaries alongwith complete details of the ultimate beneficiaries.

(III) date and amount of guarantee, security or the like provided to or on behalf of the Ultimate Beneficiaries

(IV) declaration that relevant provisions of the Foreign Exchange Management Act, 1999 (42 of 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 (15 of 2003).;

(*b*) 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:

(*i*) 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

(*ii*) provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries, the company shall disclose the following:-

(I) date and amount of fund received from Funding parties with complete details of each Funding party.

(II) date and amount of fund further advanced or loaned or invested other intermediaries or Ultimate Beneficiaries alongwith complete details of the other intermediaries' or ultimate beneficiaries.

(III) date and amount of guarantee, security or the like provided to or on behalf of the Ultimate Beneficiaries

(IV) declaration that relevant provisions of the Foreign Exchange Management Act, 1999 (42 of 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 (15 of 2003).

**Test Your Understanding 2**

A company has availed cash credit facility of ₹2 crore (O/s balance ₹2 crore as at year end) from a bank for meeting its working capital requirements against security of stocks and debtors and guaranteed by directors of the company. Discuss, how the above cash credit facility, would be classified and disclosed in financial statements of company.

**Ans.** It shall be shown under the head "Borrowings" and classified as Short-term secured borrowings specifying nature of security. The above said outstanding amount shall be further sub-classified under heading "Loans repayable on Demand" from Banks. As per requirements of Schedule III of Companies Act, 2013, where loans have been guaranteed by directors or others, aggregate amount of such loans under each head shall be disclosed.

***Notes to Add***

### *Notes to Add*

## ■ TRADE RECEIVABLES

Existence → (1) Check Controls — Invoices not recorded twice / Receivables Bal. → Automatically Recorded

(2) A/c. Receivable Ageing Report
(3) Realisation → Invoice wise?
(4) Reason / Justification — Overdue → Large Bal.

* Direct Confirmation Procedure
(1) With the consent of the Entity
(2) Form of Requesting Confirmation — With / Without — Bal.
(3) Method of Selection
(4) Discrepancies → Revealed by the Confirmation
(5) No Reply Received → Perform Alternate Procedure
- Agreeing Bal. to Cash Received
- Preparing Detailed Analysis of Bal.

(6) Related Party Receivables

* Completeness
(1) Invoices Issued → Last few days
(2) All Dispatched Goods → Invoiced
(3) Match Invoices → Shipping / Dispatch Log
(4) Review Process — Discount / Incentives
(5) Review → Credit Memos

***Notes to Add***

Trade receivable are an essential part of any organisation's balance sheet, often referred to as debtors. Typically, an invoice is raised and issued to the customer with the invoice amount being recorded as a debtor balance. Until the invoice is paid, the invoice amount is recorded in the organization's balance sheet as accounts receivable. If these balances are not recoverable later on, then these amounts need to be written off as bad and charged in the statement of profit and loss.

It is important to carry out Test of Controls for checking the effectiveness of internal control over sales as a part of the debtors' audit procedure. Following points need to be considered in respect of trade receivables:

- Only bona fide sales lead to trade receivables.
- All such sales are made to approved customers.
- All such sales are properly recorded in the books of accounts.
- Once recorded, the debtors can be settled only by receipt of cash or on the
- authority of a responsible official.
- Segregation of duties at every point in sales transaction. (accounting for debtors, collecting the payments, sending reminders etc.)
- Debtors are collected on time.
- In case debtors are not collected in time, sending reminders and taking legal actions if required.
- Balances are regularly reviewed.
- A proper system of follow up exists and if necessary, adequate provision for bad debt should be made by preparing adequate ageing schedule of the debtors.


After performing Test of Controls over sales, the auditor will decide upon the audit procedure to be applied to verify debtors balance.

The below table summarises the audit procedures generally required to be undertaken while auditing trade receivables:

| Brief description | Audit procedures |
|---|---|
| To establish the EXISTENCE of trade receivables as at the period- end | ❑ 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.<br>❑ Ask for a period-end accounts receivable ageing report and trace the balance as per the report to the general ledger.<br>❑ 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. If realization is made on account, verify whether the Company has obtained confirmations from debtors in respect of the same.<br>❑ To establish the EXISTENCE of trade receivables as at the period- end<br>❑ If any large balance is due for a long time, auditor should ask for reasons and justification for the same. |

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| | **Direct confirmation procedures**<br>❑ A significant and important audit activity is to contact customers directly and ask them to confirm the amounts of unpaid accounts receivable as of the end of the reporting period under audit. This should necessarily be done for all significant account balances as at the period- end while certain random customers having smaller outstanding invoices should also be selected. |
| | ❑ 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 receivables. In such cases, the auditor should consider whether there are valid grounds for such a request. In appropriate cases, the auditor may also need to reconsider the nature, timing & extent of his audit procedures including the degree of planned reliance on management's representations.<br>❑ The trade receivables may be requested to confirm the balances either (a) as at the date of the balance sheet, or (b) 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.<br>❑ The form of requesting confirmation from the trade receivables may be either (a) the form with balance outstanding amount as per the company, wherein the trade receivable is requested to respond whether or not he is in agreement with the balance shown, or (b) the form without any balance mentioned therein, wherein the trade receivable is requested to respond with the balance outstanding as per his records. The use of the form without any balance is preferable.<br>❑ The method of selection of the trade receivables to be circularised should not be revealed to the Company until the trial balance of the trade receivables' ledger is handed over to the auditor. 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. The auditor should maintain strict control to ensure the correctness and proper despatch 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.<br>❑ 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. The Company should be asked to investigate and reconcile the discrepancies, if any. |

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| | ❑ Where no reply is received, the auditor should perform alternate procedures regarding the balances. This could include:<br>❍ Agreeing the balance to cash received subsequently;<br>❍ Preparing a detailed analysis of the balance, ensuring it consists of identifiable transactions and confirming that these revenue transactions actually occurred. (examination in depth for those balances) |
| To establish the EXISTENCE of trade receivables as at the period- end | ❑ 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.<br>❑ Check that the receivables for other than sales or services are not included in the list.<br>❑ 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. This will enable the auditor to check the reasonableness of balances. Also, measure the average collection period. 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.<br>**(COMPLETENESS)** | ❑ 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:<br>❍ For the invoices issued during the last few days (last 5 days of the reporting year) i.e. cut-off date and which have been included in the debtors; check that the goods should have been dispatched and not lying with the Company;<br>❍ Ensure that all goods dispatched prior to the period/ year-end have been invoiced and included in debtors on a test check basis;<br>❍ Ensure that no goods dispatched after the year- end have been invoiced and included in debtors for the period under audit.<br>❑ Test invoices listed in receivable report. Select 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.<br>❑ 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. |

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|---|---|
| | ❑ Assess bill 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. |
| All Trade receivable balances that were supposed to be recorded have been recognized in the financial statements.<br><br>**(COMPLETENESS)** | ❑ Review the receiving log to see 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;<br>❑ Review the process of giving discounts/ incentives and check whether the same were given as per the Company's policy/ general industry trends.<br>❑ Review credit memos, on a sample basis, issued during the audit period to see if they were properly authorized and whether they were issued in the correct period. Also, review credit memos issued after the period end to see if they relate to transactions belonging to the period under audit. Where any deduction has been made against a bill, check the reason and correspondence for the same. |
| Trade receivable balances have been **VALUED** appropriately. | ❑ Review the process followed by the Company to derive an allowance for doubtful accounts. 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.<br>❑ Obtain the ageing report of accounts receivable (both Dr/ Cr balance).<br>❑ Also, obtain the list of debtors under litigation and compare with previous year.<br>❑ Scrutinize the analysis and 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.<br>❑ He should check if provisions are made at appropriate rates considering the recoverability of amounts due.<br>❑ Prepare schedule of movements of bad debts – Provision accounts and debts written off and compare the proportion of bad debt expense to sales for the current year in comparison to prior years to see if the current expense appears reasonable.<br>❑ 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. |

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| Required **DISCLOSURE** for trade receivables have been appropriately made | ❑ Check that the restatement of foreign currency trade receivables has been done properly in accordance with AS 11.<br>❑ Proper disclosure of Related Party Transactions regarding receivables have been made as per AS 18 or IND AS 24.<br>❑ Ensure that the transactions with parties covered under Section 189 (Register of Contracts or Arrangements in which Directors are interested) of the Companies Act, 2013 are reported properly in Companies Auditors' Report Order (CARO), 2020.<br>Ensure whether the following disclosures as required under Schedule III (Part I) to Companies Act, 2013 are made for each amount disclosed under the heading "Trade Receivables"<br>(i) Trade Receivables ageing schedule |

| | | | | | | (Amount in ₹) |
|---|---|---|---|---|---|---|
| Particulars | Outstanding for following periods from due date of payment# | | | | | |
| | Less than 6 months | 6 months-1 year | 1-2 years | 2-3 years | More than 3 years | Total |
| (i) Undisputed Trade receivables– considered good | | | | | | |
| (ii) Undisputed Trade Receivable- considered doubtful | | | | | | |
| (iii) Disputed Trade Receivables considered good | | | | | | |
| (iv) Disputed Trade Receivables considered doubtful | | | | | | |

| | |
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| | # 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.<br>Unbilled dues shall be disclosed separately.<br>(ii) Trade receivables shall be sub-classified as:<br>(*a*) Secured, considered good;<br>(*b*) Unsecured, considered good;<br>(*c*) Doubtful.<br>(iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.<br>(iv) Debts due by<br>❍ directors or other officers of the company or any of them either severally or jointly with any other person or<br>❍ firms or private companies respectively in which any director is a partner or a director or a member should be separately stated. |

## QUESTIONS

### Correct/Incorrect

**State with reasons (in short) whether the following statements are correct or incorrect:**

**11.** In verifying Trade Receivables balance, Direct Confirmation Procedure is one of the important audit activity.

**Ans. Correct:** While auditing trade receivable balance, direct confirmations as per SA 505, is considered to be the most important audit activity. Direct confirmation can be sought from the debtors directly confirming their balance due.

The replies to the confirmation can be then matched with the records maintained by the client. Any discrepancies so revealed, can be investigated and checked in detail for possibility of any risk of material misstatement. Auditor selects few debtors' balances and ask the client to prepare the confirmations properly addressed to the debtors. Auditor maintains strict control over this process.

### Theory Questions

**12.** While auditing books of accounts of SOLAR Ltd., you observed that an amount due from a debtor for invoice issued on 31.03.2022 has not been recognized in the books ofaccounts. As an auditor, you want to ensure that all trade receivable balances that are supposed to be recorded have been recognized in the financial statements. How will you achieve the stated objective?

**Ans.** Audit of Trade Receivable:

All Trade receivable balances that were supposed to be recorded have been recognized in the financial statements.

(COMPLETENESS): 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*) For the invoices issued during the last few days (last 5 days of the reporting year) i.e. cut-off date and which have been included in the debtors; check that the goods should have been dispatched and not lying with the Company;

(*b*) Ensure that all goods dispatched prior to the period/ year-end have been invoiced and included in debtors on a test check basis;

(*c*) Ensure that no goods dispatched after the year- end have been invoiced and included in debtors for the period under audit.

**13.** Write the audit Procedure for verification of existence of Trade Receivables.

**Ans.** For Verification of Existence of Trade Receivables, the auditor should check the following :

(*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*) 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.

(*v*) 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.

(*vi*) 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.

(*vii*) Where no reply is received, the auditor should perform alternate procedures regarding the balances.

(*viii*) Agreeing the balance to cash received subsequently;

(*ix*) Preparing a detailed analysis of the balance, ensuring it consists of identifiable transactions and confirming that these revenue transactions actually occurred. (examination in depth for those balances)

(*x*) 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.

(*xi*) Check that receivables for other than sales or services are not included in the list.

(*xii*) 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

***Notes to Add***

## CASH AND CASH EQUIVALENTS

Existence + Completeness

(1) Checked by Surprise → Last Day of the year

+

Again after few days

(2) Desirable for the cashier to be present

↓

Made to Sign

(3) Any — Slip / Chit / I.O.U.

(4) Perform → Cash Sensitivity Analysis

(5) B.R.S → For all bank A/c.

- Tally the Bal. as per Bank Book
- Cheques issued but not presented for payments
- Checking of all materials Reconciling Items

*** Direct Confirmation Procedure**

(1) Contact — Bank / F.I. — Confirm → Amounts

- Current A/c.
- Deposit A/c.
- Exchange Earners Foreign Currency (EEFC) A/c.
- CC A/c.
- Restrictive use A/c.
  - Dividend A/c.
  - Escrow A/c.

**(2) Investigate / Reconcile — Discrepancies + Seek W.R.**

**(3) Emphasis on → 100% Bank A/c. <u>Bal. Confirmation</u>**

**↓**

**No REPLY RECEIVED**

**↓**

**Additional Procedures**

- **Agree the Bal. ↓ Bank St.**
- **Interest / Online Login ↓ Auditor's Personal Presence**
- **Sending Audit team Member + Entity Personnel ↓ Bank Branch**

Valuation → Bank A/c. → Holding F.C. → Cl. Exchange Rates

Disclosure

↓

Schedule III (Part I) of The Companies Act, 2013

Cash and cash equivalents in the form of cash in hand, stamps in hand, balances held with bank in current accounts/ margin money accounts, cash credit accounts (debit balance), fixed deposits, cheques in hand etc. represent the most liquid assets of an enterprise i.e. readily convertible into cash and subject to insignificant value risk. Utmost professional skepticism needs to be exercised while auditing such balances as they are prone to misappropriation.

The below table summarises the audit procedures generally required to be undertaken while auditing cash and cash equivalents:

| Brief description | Audit procedures |
|---|---|
| To establish the Existence of cash and cash equivalent balances as at the period- end.<br><br>Cash and cash equivalent balances that were supposed to be recorded have been recorded in the financial statements. **(COMPLETENESS)** | ❑ Special care is necessary in regard to verification of cash balances. Unless they are checked by surprise, there can be no certainty that the cash produced for inspection was in fact held by the custodian. For this reason, 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)<br>❑ 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, as far as practicable so that the shortage in one balance is not made good by transfer of amount from the others.<br>❑ 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. If he is absent at the time the cash is being verified, he may hold the auditor responsible for the shortage, if any, in cash.<br>❑ 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.<br>❑ 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.<br>❑ 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.<br>❑ 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.<br><br>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. |

- Verification of BRS shall entail the following:
  - Tallying the balance as per bank book
  - to the bank confirmation/ statement.
  - 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. In addition, the auditor should request for bank statements of subsequent period and should verify if the cheques issued have subsequently been cleared by the bank. 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.
  - 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. For any instances related to cheques not cleared beyond reasonable time, the auditor should seek brief descriptions from the management and in case such explanations are found to be unsatisfactory, the auditor should verify the revenue recognition related to such parties was in order and as per the Company's revenue recognition policy.
  - 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**

- 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, EEFC account, cash credit accounts, restrictive use accounts like dividend, escrow accounts as of the end of the reporting period under audit. This should necessarily be done for all account balances as at the period-end.
- 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.

| | |
|---|---|
| | ❑ 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:<br>❍ Agreeing the balance to bank statement received by the Company or internet/ online login to account in auditor's personal presence;<br>❍ 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 Financial Reporting Framework. |
| Required **DISCLOSURES** for cash and cash equivalents have been appropriately made | Ensure whether the following disclosures as required under Schedule III (Part I) to Companies Act, 2013 have been made:<br>**Cash and cash equivalents**<br>(i) Cash and cash equivalents shall be classified as:<br>(*a*) Balances with banks;<br>(*b*) Cheques, drafts on hand;<br>(*c*) Cash on hand;<br>(*d*) Others (specify nature)<br>(ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.<br>(iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.<br>(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.<br>(v) Bank deposits with more than 12 months' maturity shall be disclosed separately. |

## QUESTIONS

### Multiple Choice Questions (MCQ)

3. Which of the classification is not required by a company in respect of its "Cash and cash equivalents?"

(*a*) Balance with Banks (*b*) Balance with scheduled banks
(*c*) Cash on hand (*d*) Cheques on hand

**Ans.** (*b*)

**Theory Questions**

**14.** How is "Cash and cash equivalents" disclosed in the Financial Statements as required under Schedule III (part I) to Companies Act, 2013?

**Ans.** Disclosure of Cash & Cash Equivalent in the Financial Statements: Regarding Cash and cash equivalents- Ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made:

(*i*) 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)

(*ii*) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

(*iii*) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(*iv*) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(*v*) Bank deposits with more than 12 months' maturity shall be disclosed separately.

***Notes to Add***

***Notes to Add***

## INVENTORIES

- Held for Sale → Ordinary Course of Business
- Process of Production → of Such Sale
- Form of
  - Materials
  - Supplies
  - To be Consumed

Existence→(1) Review→Entity's Plan→Inventory Count
+
Participate

(2) Ensure → Consigned Goods → Segregated

(3) Test Count → Inventory

- Observe Employees → Adhering to Agreed Plan
- Assuring → Appro. Supervision
- All items → Properly tagged
- Proper Amts. → On Tags.

Completeness→(1) Perform→Analytical Procedure

- Inventory T/O Ratio
- Vertical Analysis
- Budgetary Expatation ↕ Actuals

(2) Examine → Non Financial Info.

(3) Purchase, Sale — Cut-off test

(4) Clerical, Arithmetical — Accuracy

(5) Reconciliation

**Rights**

(1) Documentation

(2) Client Correspondence

(3) Collateral Agreements

(4) External Confirmation

Valuation → Raw Materials

- Ascertain → Elements of Cost
- Compare → Standard → Actual
- Test Check → Cost Price ← Purchase Invoice
- Valuation
  - Damaged
  - Obsolete
  - Inventories

**Inventories are assets:**

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

As per AS 2 – "Valuation of Inventories", Inventory is valued at lower of cost and net realisable value. The basis for valuation shall be applied consistently year on year. Any change in accounting policy shall have adequate disclosures in financial statements.

The below table summarises the audit procedures generally required to be undertaken while auditing inventories:

| Brief description | Audit procedures |
|---|---|
| To establish the **EXISTENCE** of Inventories as at the period- end. | ❑ Review entity's plan for performing inventory count.<br>❑ Ensure that consigned goods have been segregated.<br>❑ Auditor should participate in the inventory count with the management.<br>❑ Test counts of inventory by auditor should include:<br>○ observing employees are adhering to the agreed plan.<br>○ assuring that there is appropriate supervision on the count procedure.<br>○ assuring that all items are properly tagged.<br>○ observing that proper amounts are shown on tags.<br>○ determining that tags and summary sheets are controlled and reconciled.<br>○ reconciliation of test counts with tags and summary sheets and discrepancies noted, if any, are summarized and agreed with client personnel.<br>○ staying alert at all times and specifically being cautious about empty boxes, etc. and obsolete items.<br>○ performing cut-off testing by documenting last 5-10 receiving reports and shipping documents as of the period end.<br>○ ensuring exclusion of third party stock and damaged or obsolete stock.<br>○ ensuring the accounting of all stock sheets.<br>○ investigating any significant differences between the physical stock take and the stock records as per books. Further, 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.<br>❑ When the entity uses periodic system for inventory count, it should be undertaken at the end of the period. If the entity uses perpetual system with proper and adequate records, inventory may be counted at interim dates.<br>❑ 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 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<br><br>**(COMPLETENESS)** | ❑ Perform analytical procedures (comparison tests with industry averages, budgets, prior years, trend analysis, etc.).<br>❍ Compute inventory turnover ratio (COGS/ average inventory)<br>❍ Perform vertical analysis (inventory/ total assets)<br>❍ Compare budgetary expectations vis-à-vis actuals<br>❑ Examine non-financial information related to inventory, such as weights and other measurements.<br>❑ Perform purchase and sales cut-off tests. Trace shipping documents (bills of lading and receiving reports, warehouse records, and inventory records) to accounting records immediately before and after year-end.<br>❑ With respect to tagged inventory, perform tests for omitted transactions and tests for invalid transactions.<br>❑ Verify the clerical and arithmetical accuracy of inventory listings.<br>❑ Reconcile physical inventory amounts with perpetual records.<br>❑ Reconcile physical counts with general ledger control totals.<br>❑ Reconcile inventories which belong to client but are held with third parties like transporters, warehouses, port authorities etc.<br>❑ Goods received on consignment basis have been properly segregated from other items of inventory. |
| The entity has valid legal ownership **rights**<br><br>over the inventories claimed to be held by the entity and recorded in the financial statements | ❑ Vouch recorded purchases to underlying documentation (purchase requisition, purchase order, receiving report, vendor invoice and cancelled cheque or payment file).<br>❑ Evaluate the consigned goods.<br>❑ Examine client correspondence, sales and receivables records, purchase documents.<br>❑ Determine existence of collateral agreements.<br>❑ Review consignment agreements.<br>❑ Review material purchase commitment agreements.<br>❑ Examine invoices for evidence of ownership i.e. the invoices shall be in the name of the client.<br>❑ Auditor shall obtain confirmation for significant items of inventory. |
| Inventories have Been **VALUED** appropriately and as per generally accepted accounting policies and practices | ❑ 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.<br>❑ For Raw materials and consumables<br>❍ Ascertain what elements of cost are included e.g. carriage inward, non-refundable duties etc.<br>❍ If standard costs are used, enquire into basis of standards; how these are compared with actual costs and how variances are analyzed and accounted for/ treated in accounting records.<br>❍ Test check cost prices used with purchase invoices received in the month(s) prior to counting. |

| | |
|---|---|
| Inventories have Been **VALUED** appropriately and as per generally accepted accounting policies and practices | ❑ Follow up valuation of all damaged or obsolete inventories noted during observance of physical counting with a view to establishing a realistic net realizable value.<br>**For Work in progress**<br>❑ Ascertain how the various stages of production/ value additions are measured and in case estimates are made, understand the basis for such estimates.<br>❑ 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. |
| Inventories have Been **VALUED** appropriately and as per generally accepted accounting policies and practices | ❑ Ensure that material costs exclude any abnormal wastage factors.<br>**For Finished goods and goods for resale**<br>❑ 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.<br>❑ Ensure that inventories are valued at net realizable value if they are likely to fetch a value lower than their cost. For any such items, also verify if the relevant semi/partly processed inventories (work in progress) and raw materials have also been written down. |
| | Follow up for items that are obsolete, damaged, slow moving and ascertain the possible realizable value of such items. Carefully examine the valuation of obsolete and damaged inventory. For the purpose, request the client to provide inventory ageing split and follow up for any inventories which at time of observance of physical counting were noted as being damaged or obsolete.<br>❑ Compare recorded costs with replacement costs.<br>❑ Examine vendor price lists to determine if recorded cost is less than current prices.<br>❑ Calculate inventory turnover ratio. Obsolete inventory may be revealed if ratio is significantly lower.<br>❑ In manufacturing environments, test overhead allocation rates and ensure that only direct labor, direct material and overhead have been included.<br>❑ Verify the correct application of lower-of-cost-or-net realizable value principles. |
| Required **DISCLOSURES** for inventories have been appropriately made | Ensure whether the following disclosures as required under Schedule III (Part I) to the Companies Act, 2013 have been made:<br>❑ Whether inventory has been classified as:<br>❍ Raw materials<br>❍ Work-in-progress<br>❍ Finished goods<br>❍ Stock-in-trade (goods acquired for trading)<br>❍ Stores and spares<br>❍ Loose tools<br>❍ Others (specify nature). |
| Required **DISCLOSURES** for inventories have been appropriately made | ❑ Whether goods-in-transit have been disclosed separately under each sub-head of inventories.<br>❑ Mode of valuation shall be stated. |

Work in Progress

- Ascertain → Stages of Production
- Ascertain → Element of Cost
- Material Cost → Exclude → Abnormal Wastage Factor

**→ Finished Goods → Ensure**

- **Included Costs → Reasonable**
- **Valued @ N.R.V.**

**Disclosure**

**↓**

**Schedule III (Part I) of The Companies Act, 2013.**

*Notes to Add*

## LAND, BUILDING, PLANT & EQUIPMENT, FURNITURE & FIXTURES, VEHICLES, OFFICE EQUIPMENT, COMPUTERS ETC. REFERRED TO AS "PROPERTY, PLANT & EQUIPMENT" ("PPE")

Recognition Criteria — Revenue / Capital — Nature Expenditure

- Probability of future Economic Benefits
- Cost → Measurement ↓ Reliable

Existence → (1) Review → Entity's Plan → Physical Ver.

- Own Staff
- 3rd Party
- Annual
- 2/3 Years

(2) Evidence → Appro. Supervision
(3) Verification Report + Working Sheet

- Properly Tagged
- Reconciliation
- Discrepancies

Completeness → (1) Movement in PPE Schedule

Op. Bal. + Addition – Deletion = Cl. Bal.
(2) Arithmetical Accuracy
(3) As per AS 10
(4) Rationale → For Deletion

Valuation → (1) Depreciation (Unless Non-Depreciable)
↓
(2) Method
(3) Impairment → AS 28

Rights & Obligation →
(1) Land / Bldg. → Conveyance / Sale Deed
(2) Original Title Deed
(3) Register of Charges

Disclosure
↓
Schedule III (Part-I) of The companies Act, 2013

**Additional Regulatory Info.**
**(1) Title Deed → Not In The Name of Co.**

- **Relevant Line item in B/S**
- **Description**
- **Gross Carrying Value**
- **Title Deed in the name of**
- **Holder ↓ Promoter ↓ Director ↓ Relative**
- **Held Since**
- **Reason**

The Valuation of PPE becomes a very important aspect of consideration by the auditor in the course of his audit. The auditor should analyze the expenditure incurred on PPE, whether they are of Revenue or Capital in nature.

**Recognition Criteria for PPE**

The cost of an item of PPE should be recognised as an asset if, and only 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 enterprise evaluates under this recognition principle all its costs on property, plant and equipment at the time they are incurred. These costs include costs incurred:

(a) initially to acquire or construct an item of property, plant and equipment; and
(b) subsequently to add to, replace part of, or service it.

**Measurement at Recognition**

An item of property, plant and equipment that qualifies for recognition as an asset should be measured at its cost.

**Elements of Cost**

The cost of an item of property, plant and equipment 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 necessary for it to be capable of operating in the manner intended by management.
(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', the obligation for which an enterprise incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

**Examples of directly attributable costs are:**

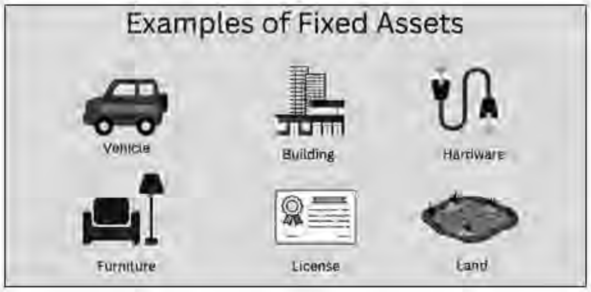
(a) costs of employee benefits (as defined in AS 15, Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment;
(b) costs of site preparation;
(c) initial delivery and handling costs;
(d) installation and assembly costs;
(e) costs of testing 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 (such as samples produced when testing equipment); and
(f) professional fees.

**Examples of costs that are not costs of an item of property, plant and equipment are:**

(a) costs of opening a new facility or business, such as, inauguration costs;
(b) costs of introducing a new product or service (including costs of advertising and promotional activities);
(c) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and
(d) administration and other general overhead costs.

The expenses have to be analysed and properly classified. The revenue expense like regular repairs on assets have to be charged off to the Statement of Profit and Loss.

The below table summarises the audit procedures generally required to be undertaken while auditing tangible fixed assets:




| Brief description | Audit procedures |
|---|---|
| To establish the **EXISTENCE** of PPE as at the period-end | ❑ Review entity's plan for performing physical verification of PPE i.e. whether performed by own staff or by a third party and the policy regarding periodicity i.e. whether physical verification shall be done on annual basis or once in two years/ three years.<br>❑ Evidence of appropriate supervision of those performing physical verification of PPE should be examined.<br>❑ Obtain PPE physical verification report backed by the working sheets from the entity and perform the following procedures:<br>❍ Assess if all items of PPE are properly tagged and carry identification marks/ numbers and physical verification work papers do capture the asset identification numbers for assets physically verified.<br>❍ Reconciliation of items of PPE as physically verified with the fixed asset register maintained by the entity as at the date/ period of undertaking physical verification. Specifically verify if the PPE additions up to the date of physical verification have been updated in 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. For example, any identified shortages/ assets not in working condition and/or active use should be accounted for as deletions in the books of account post approvals by the entity's management and depreciation should have ceased to be charged after the date of deletion. |
| Additions to PPE during the period under audit have been recorded in the financial statements and do not include any PPE that belong to third parties but does include PPE owned and controlled by the entity although lying with a third party. (COMPLETENESS) | ❑ Verify the movement in the PPE schedule (asset class-wise like building, Plant & machinery etc.) 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.<br>❑ 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:<br>❍ For all material additions, verify if such expenditure meets the criteria of PPE as per AS 10 (Revised). |

| | |
|---|---|
| | These costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service it.<br>Verify that the cost of an item of property, plant and equipment is as per AS 10 (Revised).<br>❑ Items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with AS 10 (Revised) when they meet the definition of property, plant and equipment. Otherwise, such items are<br>❑ classified as inventory. 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.<br>❑ 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.<br>❑ Verify whether the PPE additions have been approved by authorized personnel.<br>❑ 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 (example could be new purchase of similar asset once the old asset was no longer fit to be used in production process) and the manner of disposal. Obtain the management approval and discard note authoring disposal of the asset from its active use. Verify the process followed for sale of discarded PPE, for example - inviting competitive quotes, tenders and the basis of calculation of sales proceeds. Verify that the management has accurately recorded the deletion of PPE (original cost and accumulated depreciation up to the date of disposal) and the resultant gain/ loss on disposal of PPE item in the entity's books of account. |
| PPE have been **VALUED** appropriately and as per generally accepted accounting policies and practices | It is a common understanding that the value of fixed assets/ PPE depreciates due to efflux of time, use and obsolescence. The diminution of the value represents an item of cost to the entity for earning revenue during a given period. Unless this cost in the form of depreciation is charged to the accounts, the profit or loss would not be correctly ascertained and the values of PPE would be shown at higher amounts. The auditor should:<br>❑ Verify that the entity has charged depreciation on all items of PPE unless any item of PPE is non-depreciable like freehold land;<br>❑ 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. It could be Straight line method, diminishing value method, unit of production method, as applicable.<br>❑ The auditor should also verify whether the management has done an impairment assessment to determine whether an item of property, plant and equipment is impaired as per the requirements of AS 28 - Impairment of Assets. |

| | |
|---|---|
| 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)** | ❑ In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, the auditor while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity.<br>❑ 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.<br>❑ 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)<br>❑ The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date. |
| | ❑ In case the entity has given such immoveable property 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 immoveable property as security.<br>❑ In addition, the auditor should also verify the register of charges, available with the entity to assess that any charge has been created against the PPE. |
| Required **DISCLOSURES** for PPE have been appropriately made | Ensure whether the following disclosures as required under Schedule III (Part I) to Companies Act, 2013 have been made under the heading "Property, Plant and Equipment":<br>(i) Classification shall be given as:<br>(*a*) Land;<br>(*b*) Buildings;<br>(*c*) Plant and Equipment;<br>(*d*) Furniture and Fixtures;<br>(*e*) Vehicles;<br>(*f*) Office equipment;<br>(*g*) Others (specify nature).<br>(ii) Assets under lease shall be separately specified under each class of asset.<br>(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.<br>(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. |

## NOTES

To be disclosed as Additional Regulatory Information

(i) 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 companys 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/ director | Property held since which date | Reason for not being held in the name of the company** |
|---|---|---|---|---|---|---|
| PPE - | Land<br>Building | - | - | - | - | **also indicate if in dispute |
| Investment property | Land<br>Building | | | | | |
| PPE retired from active use and held for disposal- | Land<br>Building | | | | | |
| Others | | | | | | |

#Relative here means relative as defined in the Companies Act, 2013.

*Promoter here means promoter as defined in the Companies Act, 2013.

(ii) Where the Company has revalued its Property, Plant and Equipment, the 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.

(iii) Capital-Work-in Progress (CWIP)

(*a*) For Capital-work-in progress, following ageing schedule shall be given: CWIP ageing schedule

| | | | | | (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.

## QUESTIONS

### Multiple Choice Questions (MCQ)

**4.** Which of the following is not an element of cost of an item of machinery included under head "Property, Plant and Equipment"?

(*a*) Installation costs

(*b*) Freight cost of bringing the item to its location

(*c*) Inaugural costs

(*d*) Employee benefit cost for making such an item suitable for production

**Ans.** (*c*)

### Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

**15.** Material and wages are considered to be revenue expenditure when incurred for construction of building.

**Ans. Incorrect:** Material and Wages incurred on construction of building qualify to be capital expenditure as per AS 10 "Plant, Property and Equitment". Therefore, these have to be added to the cost of the asset i.e building and shall not be expensed off to Statement of Profit and Loss.

### Theory Queston

**16.** CAR is the statutory auditor of QRS Ltd. While performing testing of additions during the year, he wanted to verify that:

(*i*) All PPE (property, plant and equipment) are in the name of the entity he is auditing.

(ii) For all additions to land and building in particular, the auditor desires to have concrete about the ownership.

(iii) The auditor wants to know whether the entity has valid legal ownership rights over the PPE, where it is kept as security for any borrowings. Advise the auditor on the audit procedure to be undertaken by him to establishthe Rights and Obligations of the entity over the PPE.

**Ans.** Audit procedure to establish Rights and Obligations of the entity over PPE:

(i) In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, CA R, the statutory auditor of B Ltd, while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity. Verify whether the PPE additions have been approved by authorized personnel.

(ii) For all additions to land, building in particular, CA R, the statutory auditor of B Ltd, should obtain copies of conveyance deed/ sale deed to establish whether the entity is mentioned to be the legal and valid owner.

(iii) The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date.

(iv) In case the entity has given such immoveable property as security for any borrowings and the original title deeds are not available with the entity, CA R, the statutory auditor of B Ltd should request the entity's management for obtaining a confirmation from the respective lenders that they are holding the original title deeds of immoveable property as security.

(v) In addition, the auditor should also verify the register of charges, available with the entity to assess that any charge has been created against the PPE.

**17.** The auditor A of ABC & Co.- firm of auditors is conducting the audit of XYZ Ltd and while performing testing of additions wanted to verify that all PPE (Property Pland and Equipment) purchase invoices are in the name of the entity he is auditing. For all additions to land, building in particular, the auditor desires to have concrete evidence about ownership. The auditor is worried about whether the entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements. Advise the auditor.

**Ans.** In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, the auditor while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity. For all additions to land, building in particular, the auditor should obtain copies of conveyance deed/ sale deed to establish whether the entity is mentioned to be the legal and valid owner.

The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date. In case the entity has given such immoveable property 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 immoveable property as security. In addition, the auditor should also verify the register of charges, available with the entity to assess that any charge has been created against the PPE.

***Notes to Add***

## INTANGIBLE ASSETS (COMPRISING GOODWILL, BRAND / TRADEMARKS, COMPUTER SOFTWARE ETC.).

Identifiable → Non-Monetary Asset

↓

Without → Physical Substance

↓

Use in → Production → G & S

→ Rental → to others

→ Administrative Purpose

Existence → (1) Verify → Active in use

- Yes
- No
  - Deletion Recorded? ↓ Post Approval
  - Amortization Charges ↓ Stopped

**Completeness → (1) Verify → Movement**

**Op. Bal. + Add – Deletion = Cl. Bal.**

**(2) Check →Arithmetical Accuracy**

**(3) For Addition**

- **AS 26 Criteria**
- **Approved** ↓ **Appro. Personnel**
- **Internal Process**
  - **Quotations**
  - **Tenders**

(4) For Deletion

- Mgt.
  - Reason
  - Rationale
- Manner of Disposal
- Mgt. Approval
- Disposal Note

***Notes to Add***

### *Notes to Add*

Valuation $\rightarrow$

(1) Charged Amortization

$\downarrow$

(2) Method

(3) Impairment $\rightarrow$ AS 28

Rights & Obligation $\rightarrow$ Legal Title of Ownership $\rightarrow$ Entity

Disclosure

$\downarrow$

Schedule III (Part I) of The Companies Act, 2013

$\rightarrow$ Additional Regulatory Info.

(1) Ageing Schedule

| | | | |
|---|---|---|---|
| < 1 years | 1 – 2 Years | 2 – 3 Years | > 3 years |


***Notes to Add***

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.

Enterprises frequently spend resources on the acquisition, development, maintenance or enhancement of intangible assets such as scientific or technical knowledge, design and implementation of new processes or systems, licenses, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licenses, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights. Goodwill is another example of an item of intangible nature which either arises on acquisition or may be internally generated.

Not all the items described in above paragraph will meet the definition of an intangible asset, that is, identifiability, control over a resource and expectation of future economic benefits flowing to the enterprise. If an item covered by this Standard does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred.

As per AS 26 – Intangible Assets, internally generated goodwill should not be recognized as an asset.

Some intangible assets may be contained in or on a physical substance such as a compact disk (in the case of computer software), legal documentation (in the case of a licence or patent) or film (in the case of motion pictures). The cost of the physical substance containing the intangible assets is usually not significant. Accordingly, the physical substance containing an intangible asset, though tangible in nature, is commonly treated as a part of the intangible asset contained in or on it.

In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. Judgement is required to assess as to which element is predominant. For example, computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. The same applies to the operating system of a computer. Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

The below table summarises the audit procedures generally required to be undertaken while auditing intangible fixed assets:

| Brief description | Audit procedures |
|---|---|
| To establish the **EXISTENCE** of intangible fixed assets as at the period- end | ❑ Since an intangible asset is an identifiable non-monetary asset, without physical substance, for establishing the existence of such assets, the auditor should verify whether such intangible asset is in active use in the production or supply of goods or services, for rental to others or for administrative purposes.<br>**Example-** 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.<br>**Example-** 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. |

| | |
|---|---|
| All additions to Intangible assets during the period under audit have been recorded appropriately in the financial statements.<br><br>**(COMPLETENESS)** | ❑ Verify the movement in the intangible assets schedule (asset class wise like software, designs/ drawings, goodwill etc.) compiled by the management i.e. Opening balances + Additions – Deletions = Closing balances. Tally the closing balances to the entity's books of account.<br>❑ Check the arithmetical accuracy of the movement in intangible assets schedule.<br><br>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.<br>❑ Ensure that no intangible asset arising from research (or from the research phase of an internal project) should be recognised. Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred. 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 under audit.<br>❑ Verify whether the additions (acquisitions) have been approved by appropriate entity's personnel.<br>❑ 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.<br>❑ 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.<br>❑ 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 | The value of intangible assets may diminish due to efflux of time, use and/ or obsolescence. The diminution of the value represents cost to the entity for earning revenue during a given period. Unless this cost in the form of amortization is charged to the accounts, the profit or loss would not be correctly ascertained and the values of intangible asset would be shown at higher amounts. The auditor should:<br>❑ Verify that the entity has charged amortization on all intangible assets;<br>❑ 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 for determining the manner of reviewing the carrying amount of its intangible asset, determining the recoverable amount of the asset to determine impairment loss, if any. |
| 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)** | ❑ In addition to the procedures for verifying completeness of additions to intangible assets during the period under audit, 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 | Ensure that the following disclosures as required under Schedule III (Part I) to Companies Act, 2013 have been made under the heading "Intangible Assets":<br>(i) Classification shall be given as:<br>(*a*) Goodwill;<br>(*b*) Brands /trademarks;<br>(*c*) Computer software;<br>(*d*) Mastheads and publishing titles;<br>(*e*) Mining rights;<br>(*f*) Copyrights, and patents and other intellectual property rights, services and operating rights;<br>(*g*) Recipes, formulae, models, designs and prototypes;<br>(*h*) Licences and franchise;<br>(*i*) Others (specify nature).<br>(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.<br>(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. |

**Intangible assets under development:**

To be disclosed as Additional Regulatory Information.

(a) For Intangible assets under development, following ageing schedule shall be given:
Intangible assets under development ageing schedule

| (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 | |
| Intangible asset under development | | | | | |
| Projects in Progress | | | | | |
| Projects temporarily suspended | | | | | |

* Total shall tally with the amount of Intangible assets under development in the balance sheet.

(b) For Intangible assets under development, whose completion is overdue or has exceeded its cost compared to its original plan, following Intangible assets under development completion schedule shall be given**:

| (Amount in ₹) | | | | |
|---|---|---|---|---|
| | To be completed in | | | |
| Intangible asset under development | 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.

***Notes to Add***

*Notes to Add*

## TRADE PAYABLES & OTHER CURRENT LIABILITIES

Existence → (1) Controls → To Ensure

- Purchase / Expense ↓ Not Recorded more than once
- Payable Bal. ↓ Automatically Recorded ↓ General Ledger

(2) Obtain → Ageing Report

(3) Related Party Payables

* **Direct Confirmation Procedure**

**(1) Contact Vendors**
- **Directly**
- **Independently**

**(2) For → All Significant Account**

**(3) Consent of the Entity**

**(4) Creditors → Confinm Bal.**
- **Date of B/S**
- **Any other Reasonably Close Date** ↓ **Decided by Auditor ↔ Consultation with Co.**

**(5) Method of Selection**

**(6) Investigate → Discrepancies**

(7) No Reply Received
- Testing ↓ Subsequent Payments
- Agreeing ↓ Balances ↓ Invoices
- Detailed Analysis

Completeness

(1) Last 5 Invoices

(2) Prior pd. Goods → Received → Booked

(3) Sample Basis

(4) Purchase Date ← MATCH → Gate Entry Date

(5) Statutory Dues
- GST
- TDS
- PF
- ESI

Valuation

(1) Old Creditor → Written Back → Process

(2) Ageing of Payable

(3) Write Back → Approved → CEO / MD

(4) Foreign Currency → AS 11

Disclosure

Schedule III (Part I) of The Companies Act. 2013

Liabilities in addition to borrowings (discussed above), include trade payables and other current liabilities, deferred payment credits and provisions. A liability is considered to be current if it is due to be paid within twelve months and held primarily for the purpose of being traded in the entity's normal operating cycle.

E.g. Short term debt, dividends etc. Verification of liabilities is as important as that of assets, considering if any liability is omitted or understated or overstated, the financial statements would not show a true and fair view of the state of affairs of the entity.

The below table summarises the audit procedures generally required to be undertaken while auditing trade payables and other current liabilities:


| Brief description | Audit procedures |
|---|---|
| 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.<br>❑ 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**<br>An important audit activity is to contact vendors directly / independently and ask them to confirm the amounts of accounts payable as of the end of the reporting period under audit. 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.<br>❑ 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. |

| | |
|---|---|
| | ❑ In appropriate cases, the auditor may also need to reconsider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations.<br>❑ The trade creditors may be requested to confirm the balances either (a) as at the date of the balance sheet, or (b) 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.<br>❑ The form of requesting confirmation from the trade creditor may be either (a) 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 (b) the form with no balance wherein the trade creditor is requested to respond the balance as per his records. The use of the form with no balance is preferable. |
| | ❑ The method of selection of the trade creditors to be circularised should not be revealed to the Company until the trial balance of the trade payables' ledger is handed over to the auditor. 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.<br>The auditor should maintain strict control to ensure the correctness and proper dispatch of request letters. 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. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.<br>❑ 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. The entity should be asked to investigate and reconcile the discrepancies.<br>In addition, the auditor should also consider what further tests he can carry out in order to satisfy himself as to the correctness of the amount of trade payables taken as a whole. |
| | ❑ Where no reply is received, the auditor should perform additional testing regarding the balances. This testing could include:<br>❍ Testing of subsequent payments in respect of the trade payables to whom confirmations were rolled out but no replies received;<br>❍ Agreeing the details of the respective balance to the underlying vendor invoices;<br>❍ 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)<br>❑ 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. |

<table>
<tr><td></td><td>❑ 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.</td></tr>
<tr><td>Trade payables and liability balances that were supposed to be recorded have been recognized in the financial statements. (COMPLETENESS)</td><td>❑ The auditor needs to perform the following cut off procedures:<br>❍ 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 goods should have been received/ risk and rewards of ownership in goods should have been transferred in favour of the entity;<br>❍ All goods received prior to the period/year- end should have been booked in the form of purchases and included in trade creditors.<br>❑ 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.<br>❑ 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.<br>❑ 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.<br>❑ For advance received from customers/ revenue received in advance, obtain the customer wise listing along with its ageing and the nature. Enquire from the entity's management if there has been any dispute with the customer and if there is any additional liability to be recorded. For all such advances, the auditor should verify the underlying documentation based on which the entity had received the advance.<br>❑ 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 with respect to sales/ purchases/ employee benefit expenses.<br>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.<br>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.</td></tr>
</table>

| | |
|---|---|
| | 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.<br>❑ 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. | ❑ 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.<br>❑ Obtain the ageing of payable balances, and the list of vendors with whom the Company has disputes and any claims from customers, under litigation and compare with previous year.<br>❑ Check that write backs in the liability balances assessed as no longer payable have been approved by an appropriate and authorized member of senior management, for example – CEO/MD.<br>❑ Check that the restatement of foreign currency trade payables has been done properly in accordance with AS 11.<br>Understand management's process to identify the principal amount and the interest due thereon (if any) remaining unpaid to any Micro, Small and Medium Sized Enterprises 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 I) to Companies Act, 2013 have been made:<br>❑ Whether the Company has disclosed the following details relating to micro and small enterprises in the notes:<br>○ the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year.<br>○ the 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.<br>○ the 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 the Micro, Small and Medium Enterprises Development Act, 2006.<br>○ the amount of interest accrued and remaining unpaid at the end of each accounting year. |

- the 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 Micro, Small and Medium Enterprises Development Act, 2006.

- Trade payables due for payment

  The following ageing schedule shall be given for Trade payables due for payment:-

Trade Payables ageing schedule

| (Amount in ₹) | | | | | |
|---|---|---|---|---|---|
| **Particulars** | **Outstanding for following periods from due date of payment#** | | | | |
| | 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

- Whether the amount disclosed under other current liabilities are classified as below:
  - 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";<br>❑ Unpaid matured deposits/debentures and interest accrued thereon<br>❑ Unpaid matured debentures and interest accrued thereon<br>❑ Others (specify nature). |

## QUESTIONS

### Multiple Choice Questions (MCQ)

**5.** An auditor is verifying purchases to ensure their genuineness. Consequently, he is also trying to verify that no fake "trade payables" are present in financial statements. Which assertions concerning purchase transactions and trade payables respectively are being verified by auditor?

(*a*) Occurrence; Existence (*b*) Occurrence; Completeness

(*c*) Existence; Occurrence (*d*) Completeness; Occurrence

**Ans.** (*a*)

### Theory Questions

**18.** Proceedings have been initiated against False Limited for holding benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and the rules made thereunder, but such property is not recorded in books of accounts. As a consultant to the company, what will you advice to the company as far as disclosure requirements are concerned in relation to said proceedings?

**Ans.** Disclosure in case of Benami Properties held by the Company:

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 not in the books, then the fact shall be stated with reasons,

(*e*) Where there are proceedings against the company under this law as an a better of the transaction or as the transferor, then the details shall be provided,

(*f*) Nature of proceedings, status of same and company's view on same.

*Notes to Add*

## LOANS & ADVANCES & OTHER CURRENT ASSETS

**Existence**

(1) Direct Confirmation Procedures

**Completeness**

(1) List of Advances

(2) Verify → Loan Agreement

(3) Authorized → MoA; → AoA

(4) Inspect → Board's MoM

(5) Related Party Loans

(6) Balance with Statutory Authorities

(7) Statutory Returns → Filed?

**Valuation**

(1) Allowance for Doubtful A/c.

(2) Ageing Report

(3) Identify / Analyse ← A/c. → Appear doubtful

(4) Write - offs

(5) Schedule of Movement

(6) Foreign Currency Loans → AS 11

Disclosure

↓

Schedule III (Part – I) of The companies Act, 2013

→ Additional Regulatory Info.

(1) Loans / Advances — Promoter / Director / KMP / Related Party — Repayable on Demand / Without Specifying — Terms / Period — Repayment

*Notes to Add*

Loans and advances include loans and advances to related parties, security deposits, capital advances, amounts recoverable in cash or in kind or for value to be received, e.g., rates, taxes and insurance paid in advance/ prepaid.

Other current assets primarily include balances with statutory/ government authorities etc.

The below table summarises the audit procedures generally required to be undertaken while auditing loans and advances and other current assets:

| Brief description | Audit procedures |
|---|---|
| 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, similar to those performed for Accounts receivable balances are should be performed with the only difference that while performing circularization of direct confirmations, in addition to 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 & advances & other current asset balances that were supposed to be recorded have been recognized in the financial statements **(COMPLETENESS)** | ❑ Obtain a list of all advances and other current assets and compare them with balances in the ledger.<br>❑ Verify loan agreements and acknowledgements of parties in respect of outstanding loans. A loan or an advance, if material, is granted only if authorised by the Memorandum and<br>❑ 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.<br>❑ 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.<br>❑ Further, the auditor should 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. | ❑ Assess the allowance for doubtful accounts. Review the process followed by the Company to derive an allowance for doubtful accounts. 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.<br>❑ Obtain the ageing report of loans and advances. Also, obtain the list of loans and advances under litigation and compare with previous year.<br>❑ Scrutinize the analysis and 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.<br>❑ Assess bad loans/ advances write-offs. Prepare schedule of movements on Bad loans/ advances –Provision Accounts and loans/ advances written off. |

| | |
|---|---|
| | ❑ Check that write-offs or other reductions in the recoverable balances have been approved by the authorsied and appropriate senior authority<br>❑ 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 I) to Companies Act, 2013 have been made:<br>**Long Term loans & Advances**<br>(i) Long-term loans and advances shall be classified as:<br>❍ Capital Advances;<br>❍ Loans and advances to related parties (giving details thereof);<br>❍ Other loans and advances (specify nature).<br>(ii) The above shall also be separately sub- classified as:<br>(*a*) Secured, considered good;<br>(*b*) Unsecured, considered good;<br>(*c*) Doubtful.<br>(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.<br>(iv) Loans and advances due by<br>❍ Directors or other officers of the company or any of them either severally or jointly with any other persons or<br>❍ 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.<br>**Short-term loans and advances**<br>(i) Short-term loans and advances shall be classified as:<br>(*a*) Loans and advances to related parties (giving details thereof);<br>(*b*) Others (specify nature).<br>(ii) The above shall also be sub-classified as:<br>(*a*) Secured, considered good;<br>(*b*) Unsecured, considered good;<br>(*c*) Doubtful.<br>(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.<br>(iv) Loans and advances due by<br>❍ Directors or other officers of the company or any of them either severally or jointly with any other person or<br>❍ 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. |

## NOTES

**To be disclosed as Additional Regulatory Information**

(i) 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 | | |

***Notes to Add***

## PROVISIONS AND CONTINGENT LIABILITIES

* Measured → Substantial degree of estimation
* Recognized

Present Obligation
↓
Result
↑
Past event

Probable Outflow of resources
↓
Settle the obligation

Reliable estimate
↓
Amount of obligation

**Contingent Liabilities**

Possible Obligation → Past Event

Existence will be confirmed

Occurrence | Non-Occurrence

Uncertain Future Events
↓
Not in Control of Entity

But not recognised

Not probable
↓
Outflow of Resources
↓
To Settle Obligation

Amount
↓
Cannot be measured
↓
Suff. Reliability

Existence →

(1) Obtain → List of all provision
↓
Compare → Ledger Balances

(2) Inspect → Underlying Agreement

Warranty Commitments | Legal / Other Claims

**Valuation →**

**(1) Working + Basis → Provisions made**

**(2) Expert Report → Required**

Evaluate

Competence | Capabilities | Objectivity

Expert

Understanding
+
Appropriateness
↓
Work of Expert

**(3) Obtain → W.R. → Mgt. → Made → All provisions which were required to be made**

**Disclosure**

↓

**Schedule III (Part I) of The Companies Act, 2013**

→ **Additional Regulatory Info**

**(1) Details of Benami Property held**

↓

**Disclose**

- Details of Property
- Year of Acquisition
- Amount
- Details of Beneficiaries
- Proceedings
  - Nature
  - Status
  - Co.'s view

**(2) Relation with struck-off Companies**

↓

**Disclose**

- Name of Struck off Co.
- Nature of Transaction with struck off Co.
- Bal. O/S
- Relationship with struck off Co.

***Notes to Add***

## PROVISIONS AND CONTINGENT LIABILITIES

A provision is a liability which can be measured only by using a substantial degree of estimation.

A provision is recognised when:

(i) an entity has a present obligation (legal or constructive) as a result of a past event;

(ii) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(iii) a reliable estimate can be made of the amount of the obligation. If the above conditions are not met, no provision is recognised.

**Example:** Provision may include provision for litigation, provision for warranties etc.

A contingent liability is:

(i) 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

(ii) 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.

The below table summarises the audit procedures generally required to be undertaken while auditing provisions and contingent liabilities:

| Brief description | Audit procedures |
|---|---|
| To establish the **EXISTENCE** of provisions as at the period- end Provisions that were supposed to be recorded have been recognized in the financial statements. **(COMPLETENESS)** | ❑ Obtain a list of all provisions and compare them with balances in the ledger.<br>❑ Inspect the underlying agreements like agreement with customers to assess warranty commitments, any legal and other claims on the entity i.e. litigations. |
| Provision balances have been valued appropriately. **(VALUATION)** | ❑ 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.<br>❑ 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 and in case of any matter under legal dispute, the auditor should request for assessment made by a legal expert in relation to likelihood of a liability devolving on the entity i.e. whether probable or possible or remote as defined above. 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:<br>❍ Evaluate the competence, capabilities and objectivity of that expert:<br>➢ Whether the expert is employed by the entity or is an outside party.<br>➢ Whether the expert is independent in respect of the entity.<br>➢ Auditor's previous<br>➢ experience of the work of the expert.<br>➢ Knowledge of the expert, his qualification, membership of a professional body or industry association, etc.<br>❍ Obtain an understanding of the work of that expert: |
| Required **DISCLOSURE** for provisions have been appropriately made | Ensure whether the following disclosures as required under Schedule III (Part-I) to Companies Act, 2013 have been made:<br>**Long-term provisions**<br>The amounts shall be classified as:<br>(a) Provision for employee benefits;<br>(b) Others (specify nature).<br>**Short-term provisions**<br>The amounts shall be classified as:<br>(a) Provision for employee benefits.<br>(b) Others (specify nature).<br>**Contingent liabilities and commitments (to the extent not provided for)**<br>(i) Contingent liabilities shall be classified as:<br>(*a*) Claims against the company not acknowledged as debt;<br>(*b*) Guarantees; Other money for which the company is contingently liable.<br>(ii) Commitments shall be classified as:<br>(*a*) Estimated amount of contracts remaining to be executed on capital account and not provided for;<br>(*b*) Uncalled liability on shares and other investments partly paid;<br>(*c*) Other commitments (specify nature).<br>In terms of AS 29, "Provisions, Contingent Liabilities and Contingent Assets", ensure whether following disclosures have been made: |

| | |
|---|---|
| | ❑ For each class of provision, an enterprise shall disclose:<br>❍ the carrying amount at the beginning and end of the period;<br>❍ additional provisions made in the period, including increases to existing provisions;<br>❍ amounts used (i.e. incurred and charged against the provision) during the period;<br>❍ unused amounts reversed during the period.<br>❑ An enterprise shall disclose the following for each class of provision:<br>❍ a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;<br>❍ 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<br>❍ the amount of any expected reimbursement, stating the amount of any asset that has been recognized for that expected reimbursement.<br>❑ 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:<br>❍ an estimate of its financial effect<br>❍ an indication of the uncertainties relating to any outflow; and<br>❍ The possibility of any reimbursement. |

Where any of the information required by above paragraph is not disclosed because it is not practicable to do so, that fact should be stated.

Other information as per requirement of Part I, Schedule III, to be disclosed as Additional Regulatory Information

**(1) 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.

**(2) 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) | | |

**(3) 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.

## QUESTIONS

### Theory Questions

**19.** Proceedings have been initiated against False Limited for holding benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and the rules made thereunder, but such property is not recorded in books of accounts. As a consultant to the company, what will you advice to the company as far as disclosure requirements are concerned in relation to said proceedings?

**Ans.** Disclosure in case of Benami Properties held by the Company:

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 not in the books, then the fact shall be stated with reasons,

(*e*) Where there are proceedings against the company under this law as an a better of the transaction or as the transferor, then the details shall be provided,

(*f*) Nature of proceedings, status of same and company's view on same.

***Notes to Add***

## *Notes to Add*

## STATEMENT OF PROFIT AND LOSS-CAPTIONS

**Sale of Products and Services**

(1) Understanding of
- → Organisation
- → Revenue Centres
- → I.C.

(2) ToC → Accordingly → Reduce Substantive Testing

(3) Select → Random Selection of Sample

(4) Perform → SAP

**Occurrence**

(1) Revenue → Not overstated

- (*i*) Single Invoice → Recorded Twice
  Cancelled Invoice → Recorded
- (*ii*) Test Check → Few Invoice → Entries
- (*iii*) External Confirmation
- (*iv*) Fictitious
  - → Customer
  - → Sale
- (*v*) Uncertainty → Collectability
- (*vi*) Customer's Obligation → Contingent

(2) Sequence of Journal Entries

(3) Entries for unusual transactions

(4) Sales Return to Sales Ratio

**Completeness**

(1) Verify → Credit Notes

(2) Trace → Shipping Docs

(3) Reconciliation → $\frac{\text{Total Sales}}{\text{Goods Dispatched}}$

(4) GST →
- → Tax
- → Returns

**Measurement**

(1) Trace few transaction

↓

Inception to Completion

(2) Export Sales → AS 11

(3) Understanding
- → Client Operation
- → GAAP

Disclosure

↓

Schedule III (Part II) of The companies Act, 2013.

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. Sales is one of the most important item in the financial statements 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.

As part of the year-end audit of an entity's financial statements, 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.

**Revenue Cycle**


**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).

1. 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 andrewards are transferred to the customer, how the sales have been recognised in the system.

2. 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.

   **Example:** Common internal controls over the sales cycle include pre -numbered sales invoices, proper authority for approval of orders, execution of sales order, customer purchase order authorization over a certain limit and authorization over receivables write-offs.

3. The auditor selects a random sample of transactions and examines the related customer purchase orders, invoices and customer statements to ensure that the control being tested is a numbered sales invoice. This will enable the auditor to determine the nature, timing and extent of his substantive procedures to be applied.

**Example:** The auditor ensures that all numbers in a section are accounted for and that none are missing.

4. 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. The auditor will need to know the sales prices of the products or services over the year, monthly average sales price per product or service, discount policy.

   **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.

The below table summarises the audit procedures generally required to be undertaken while auditing sales:

| Brief description | Audit procedures |
|---|---|
| Recorded sales represent goods shipped/ services performed during the period **(OCCURRENCE)** | ❑ Ensure revenue is not overstated by performing following audit procedures:<br>○ Check whether a single sales invoice is recorded twice or a cancelled sales invoice could also be recorded.<br>○ Test check few invoices with their relevant entries in sales journal.<br>○ Obtain confirmation from few customers to ensure genuineness of sales transaction<br>○ Whether any fictitious customers and<br>○ Sales have been recorded.<br>○ Whether any shipments were done without the consent and agreement of the customer, especially at the year end to inflate the sales figure<br>○ Whether unearned revenue recorded as earned.<br>○ Whether any substantial uncertainty exists about collectability.<br>○ Whether customer obligations are contingent on other actions (financing, resale, etc.).<br>❑ Review sequence of sales invoices<br>❑ Review journal entries for unusual transactions<br>❑ Calculate the ratio of sales return to sales and compare it with previous year and enquire for the reasons for increase/ decrease.<br>❑ Check the sales return with sales invoice, challan, credit note, stock register, etc. |

| | |
|---|---|
| All sales made during the period were recorded and there is no understatement or overstatement. **(COMPLETENESS)** | - Perform cut-off procedures to ensure that revenues are recognised in the current accounting period and sales were not tampered towards the period end.<br>- 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. In order to perform a robust sales cut-off test, auditors need to understand and consider the specific cut-off error risk of each engagement. |
| | - Auditors should also 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.<br>- Trace from the shipping documents to the sales journal.<br>- Check whether quantity is appearing in sales register or not and check reconciliation of total sales/goods dispatched as per stock records and financial records and statutory records like GST.<br>- Review GST tax and GST returns and ensure that the same are reconciled with revenue reported in the profit and loss account. Verify reasonability say 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)** | - Trace a few transactions from inception to completion. (Examination in depth)<br>**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.<br>- if the client is engaged in export sales, then compliance with AS 11 shall be ensured.<br>- Auditor must understand client's operations and related GAAP issues e.g. point of sale revenue recognition vs. percentage of completion, wherever applicable.<br>- 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:<br>(A) In respect of a company other than a finance company revenue from operations shall disclose separately in the notes revenue from—<br>(*a*) Sale of products;<br>(*b*) Sale of services;<br>(*ba*) Grants or donations received (relevant in case of section 8 companies only),<br>(*c*) Other operating revenues; Less:<br>(*d*) Excise duty.<br>(B) In respect of a finance company, revenue from operations shall include revenue from—<br>(*a*) Interest; and<br>(*b*) Other financial services.<br>Revenue under each of the above heads shall be disclosed separately by way of notes to accounts to the extent applicable.<br>❑ Whether brokerage and discount on sales other than usual trade discount has been disclosed.<br>❑ Whether the transactions with related parties are appropriately disclosed in notes to accounts. |

***Notes to Add***

## *Notes to Add*

## ■ OTHER INCOME COMPRISING INTEREST INCOME, DIVIDEND INCOME, GAIN/ LOSS ON SALE OF INVESTMENTS ETC.

**Interest Income on FD**

Occurrence + Completeness + Measurement

(1) Obtain → List of FD + App. Interest Rates + No. of Days
(2) Arithmetical Accuracy
(3) Deposits O/S as at pd. end
(4) Confirmation of Interest Income → from Bank
(5) Copy of Form 26 AS

**Dividends**

(1) Recognized in → P/L
Only when Right To Receive → established
(2) Verify → Gain / (Loss) → Recorded as → Other Income
(3) Obtain → Mutual Fund st.
Disclosure
↓
Schedule III (Part II) of The companies Act, 2013

**Additional Info.**

**(1) Undisclosed Income**

**Co.**
↓
**Give Details → Any transactions**
↓
**NOT Recorded as Income**
**Surrendered** | **Disclosed**
**Tax Assessment**
↓
**Unless Immunity → Any Scheme**

**State → whether**
↓
**Previously**
**Unrecorded income** | **Related assets**
**Properly Recorded**
↓
**During the year**

***Notes to Add***

Any form of income earned by an entity which is not linked to the entity's core business operations is generally classified as other income. Examples – interest on excess funds parked in fixed deposits with banks (the entity not being a bank or financial institution), interest on loans given to third parties/ within the group, return on mutual fund investment etc.

- **Interest income** on fixed deposits is recognized on a time proportion basis taking into account the amount outstanding and the applicable interest rate.
- **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** 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.

| Brief description | Audit procedures |
|---|---|
| Recorded other income was earned during the Period **(OCCURRENCE)**<br><br>Other income earned during the period was appropriately recorded and there in no understatement or overstatement. **(COMPLETENESS)**<br><br>Other income has been measured appropriately as per the applicable accounting standards **(MEASUREMENT)** | ❑ For verifying interest income on fixed deposits:<br>○ 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.<br>○ 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.<br>❑ For deposits still outstanding as at the period- end, trace the same to the direct confirmations obtained from the respective bank/ financial institution.<br>❑ 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.<br>❑ Also, 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.<br>❑ For Dividends, verify that the same are recognised in the statement of profit and loss only when the entity's right to receive payment of the dividend is established.<br>❑ Verify that Gain/(loss) on sale of investment in mutual funds is recorded as other income only on<br>○ transfer of title from the entity AND<br>○ is determined as the difference between the redemption price and carrying value of the investments.<br><br>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. |

| | |
|---|---|
| Required **DISCLOSURE** for other income have been appropriately made | Ensure whether the following disclosures as required under Schedule III (Part II) to Companies Act, 2013 have been made:<br>Other income<br>Other income shall be classified as:<br>(a) Interest Income (in case of a company other than a finance company);<br>(b) Dividend Income;<br>(c) Net gain/loss on sale of investments;<br>(d) Other non-operating income (net of expenses directly attributable to such income). |

## NOTES

**To be disclosed as Additional Information**

**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.

# QUESTIONS

### Correct/Incorrect

**State with reasons (in short) whether the following statements are correct or incorrect:**

**20.** Dividends are recognised in the statement of profit and loss only when the entity's right to receive payment of the dividend is established.

**Ans. Incorrect:** 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.

**21.** Dividends are recommended by the Board, and declared by the Shareholders.

**Ans. Correct:** The dividends are recommended by the Board of Directors by passing a resolution at the board meeting.

The Shareholders declare the dividends at the AGM by passing an ordinary resolution. Declaration of dividend is an item of ordinary business. However, the shareholders can decrease the amount of dividends recommended by the board but cannot increase it.

***Notes to Add***

## PURCHASES

(1) Understanding of → Organisation
→ **Production** Centres
→ I.C.

(2) Identify → Controls → Over Purchase

(3) ToC → Purchase Cycle → Determine → Control → Effective
→ Not

(4) Random Selection → Transactions

(5) Performing → SAP

**Occurrence**

(1) Purchase → Not → Under ← Stated
→ Over ← Stated

(*i*) Fictitious Vendors

(*ii*) Entry → Security Gate → Inward Register

(*iii*) Quality Inspection

(*iv*) GRN → Prepared
→ Signed

(2) Original Purchase Invoice

(3) Invoice → Booked → Only Once
↓

(4) Name of the Entity

(5) Input Tax

(6) Related Party Transactions

**Completeness + Measurement**

(1) Cutoff Test → Correct A/c. pd.

(2) Check → Last 5 transaction

(3) Correct → A/c. Treatment

(4) Obtain → W.R.

(5) Perform → Analytical Procedure

Consumption | Stock Composition | Ratio

Analysis

Disclosure
↓
Schedule III (Pat II) of the Companies Act, 2013.

Purchases is another significant process of an entity. Similar to sales as discussed above, 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. As part of the year-end audit of an entity's financial statements, 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.

Auditor needs to obtain a clear understanding about the organisation and its production centres e.g. 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.

**(1)** An auditor needs to identify the control points over purchases e.g. 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.

**(2)** 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. Common internal controls over the purchase cycle include inviting competitive quotations for shortlisting the vendors, numbered purchase orders, purchase order authorization over a certain limit, generation of GRN on receipt of goods, quality inspection of goods, 2 way/ 3-way match, authorization of purchase invoices, appropriate authority to recognise the purchases in the system.

**(3)** 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.

**(4)** Performing substantive audit procedures is 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. 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.

The below table summarises the audit procedures generally required to be undertaken while auditing purchases:

| Brief description | Audit procedures |
|---|---|
| Recorded purchases represent goods actually received/ services availed during the period **(OCCURRENCE)** | Ensure purchases are not understated/ overstated by performing following audit procedures:<br>❑ 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.<br>❑ Whether the goods were received at the factory gate and whether there exists an entry in the security gate inward register<br>❑ Whether quality inspection of goods was done.<br>❑ Whether a goods receipt note was prepared and signed by an appropriate client personnel. |
| | ❑ Whether the purchase invoice was approved as per delegation of authority and whether a 3 or 2-way match (as discussed above) was done.<br>❑ Whether stock record has been updated by the stores personnel.<br>**Special considerations during audit of purchases**<br>❑ 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.<br>❑ Purchase invoice should have been booked only once risk and reward incidental to ownership has been transferred to the entity. Specific consideration for cases where the terms of delivery as agreed with vendor are F.O.B., C.I.F. etc.<br>❑ Purchase invoice should be in the name of entity. However, in case of different branches, it should be addressed to the appropriate branch.<br>❑ 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.<br>❑ 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.<br>❑ The auditor should review whether purchases should be capitalized or expensed off in Statement of Profit and loss according to his professional judgement.<br>❑ Review journal entries for unusual transactions. |

| | |
|---|---|
| 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:<br>❑ Perform cut-off test to ensure that purchases are recognized 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.<br>❑ 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. |
| | ❑ Obtain written representation from the management that all the purchases that took place during the year have been properly recorded in the books.<br>❑ Perform analytical procedures to obtain audit evidence as to overall reasonableness of purchase quantity and price which may include:<br>❍ **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.<br>❍ **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.<br>❍ **Ratios:** Auditor should compare the creditors turnover ratios and stock turnover ratios of the current year with previous years.<br>❍ 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 II) to Companies Act, 2013 have been made:<br>❑ Whether purchases of stock-in-trade have been specifically disclosed.<br>❑ Whether changes in inventories of finished goods, stock–in-trade and work-in-progress have been specifically disclosed.<br>❑ Whether the transactions with related parties are appropriately disclosed in notes to accounts. |

## EMPLOYEE BENEFITS EXPENSES

(1) Understanding of → Organisation
→ Hiring
→ Appraisal

Process → Hiring, Appraisal

(2) ToC → Payment Process → Determine → Controls → Effective / Not

(3) Random Selection → Transactions

(4) Performing → SAP

**Occurrence + Completeness + Measurements**

(1) Process of capturing attendance

(2) Fictitious Employees

(3) Sample of Employees → Bank Details / ID Proofs

(4) List of Employees

| New Hires | Continuous | Leavers |
|---|---|---|
| ↓ | ↓ | ↓ |
| Appointment Letters | PF / ESI | Full & Final Computation |

(5) Perform → Analytical Procedure

Disclosure

↓

Schedule III (Part II) of The Companies Act, 2013

***Notes to Add***

Employee benefits expenses or commonly called as payroll expenses represent the aggregate sum an entity pays as a consideration to its employees for their labour/ efforts along with associated expenses such as perquisites/ benefits, post- employment benefits like gratuity, superannuation, leave encashment, provident fund contribution etc. as well as towards their hiring, their welfare and training. In many industries, employee benefits expense is the biggest expense category and hence it is critical for businesses to manage this expenditure shrewdly and for the auditors to verify and ensure that such expenditure is appropriate and has been accounted as per applicable accounting standards and generally accepted accounting principles.

Auditor needs to obtain a clear understanding about the organisation and its hiring, appraisal and retirement process in the following manner:

1. An auditor tests the controls the entity has set around 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.
2. The auditor selects a random sample of transactions and examines the related appointment letters, appraisal letters, attendance records, HR policies, employee master etc.
3. Performing substantive audit procedures is must. Substantive analytical procedure will consist of monthly expense reasonability, comparison with previous accounting period, any analysis is auditor may find relevant and most important of all setting an expectation in relation to the expense incurred during the period under audit and compare that with the client's business operations and overall trend in the industry.

The below table summarises the audit procedures generally required to be undertaken while auditing employee benefits expenses:

| Brief description | Audit procedures |
|---|---|
| Recorded employee benefit expenses were actually incurred during the period **(OCCURRENCE)**<br><br>Employee benefit expenses pertaining to the period have been recorded appropriately **(COMPLETENESS)** | ❑ Obtain an understanding of 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.<br>❑ Obtain a list of employees as at the period- end along with a monthly movement split between new hires, leavers and continuing employees.<br>❑ For a sample (selected randomly) 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. |

| | |
|---|---|
| Employee benefit expenses have been measured appropriately. There in no understatement or overstatement. **(MEASUREMENT)** | - For a sample (selected randomly) 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 acknowle-dgement on final computation has been obtained.<br>- Obtain the monthly salary registers for all 12 months. Compile a monthly payroll reasonability by calculating the average salary per employee per month and compare with the previous year 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.<br>- Verify if accrual/ provision has been made for all employee benefits and obligations like bonus, gratuity, leave encashment, etc.<br>- 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 defined timelines.<br>- Perform analytical procedures to obtain audit evidence as to overall reasonableness of employee benefit expenses which may include production per employee analysis. 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 the following disclosures as required under Schedule III (Part II) to Companies Act, 2013 have been made:<br>(a) Employee Benefits Expense [showing separately<br>(*i*) salaries and wages,<br>(*ii*) contribution to provident and other funds,<br>(*iii*) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP),<br>(*iv*) staff welfare expenses. |

## QUESTIONS

**Correct/Incorrect**

**State with reasons (in short) whether the following statements are correct or incorrect:**

**22.** Employee benefits expenses represent the sum an entity pays to its employees for their labour/ efforts only.

**Ans. Incorrect:** Employee benefits expenses, commonly called payroll expenses, represent the aggregate sum an entity pays to its employees for their labour/efforts, as well as associated expenses such as perquisites/benefits, postemployment benefits like gratuity, superannuation, leave encashment, provident fund contribution etc. as well as towards their hiring, their welfare and training.

***Notes to Add***

## DEPRECIATION AND AMORTIZATION

(1) Entity's → A/c. Policy → Depreciation / → Amortisation

↓

(2) As per → The Companies Act, 2013 / → AS

(3) Policy → Applied Consistently / → Δ → Adequately Disclosed

(4) Depreciation / Amortization → Charges

- Valid
- Accurately Calculated
- Appro. Pd.

(5) Obtain → F.A.R.

(6) Perform → Analytical Procedure

Combined Question

Expenditure

- C.Y
- Revenue ↓ Not Capital
- Supporting Docs
- Correct head
- Authorised
- Relation to Entity

***Notes to Add***