1.1 Meaning And Definition Of Auditing

1. Definition of audit

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

2. Auditor to ensure

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.

Questions

Q 1 Explain clearly meaning of Auditing. How would you as an auditor perform the audit (SM)

1.2 Objectives Of Audit

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

1. Obtaining reasonable assurance

To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement; and

2. Reporting

To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor’s findings.

Questions

Q 1 The basis objective of audit does not change with reference to nature, size or form of an entity (SM)

Q 2 State the objectives of Audit according to SA 200 (SM)

1.3 Scope Of Audit

1. Proper planning

The audit should be organized to cover adequately all aspects of the enterprise relevant to the financial statements being audited.

2. Accounting information reliable

The auditor assesses the reliability and sufficiency of the information contained in the underlying accounting records and other source data by:

(a) making a study and evaluation of accounting systems and internal controls and

(b) carrying out such other tests, enquiries and other verification procedures of accounting transactions and account balances as he considers appropriate in the particular circumstances.

3. Proper

The auditor determines whether the relevant information is properly disclosed.
Disclosure in the financial statements by:

a) comparing the financial statements with the underlying accounting records and other source data to see whether they properly summarize the transactions and events recorded therein; and

b) considering the judgments that management has made in preparing the financial statements accordingly, the auditor assess the selection and consistent application of accounting policies, the manner in which the information has been classified, and the adequacy of disclosure.

4. Not to act beyond scope

The auditor is not expected to perform duties which fall outside the scope of his competence. For example, the professional skill required of an auditor does not include that of a technical expert for determining physical condition of certain assets.

5. Restriction on scope

Constraints on the scope of the audit of financial statements that impair the auditor’s ability to express an unqualified opinion on such financial statement should be set out in his report, and a qualified opinion or disclaimer of opinion should be expressed as appropriate.

1.4 Aspects to be covered in Audit

<table>
<thead>
<tr>
<th>1. Examining systems</th>
<th>An examination of the system of accounting and internal control to ascertain whether it is appropriate for the business and helps in properly recording all transactions</th>
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</thead>
<tbody>
<tr>
<td>2. Reviewing systems</td>
<td>Reviewing the system and procedures to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.</td>
</tr>
<tr>
<td>3. Arithmetical accuracy</td>
<td>Checking of the arithmetical accuracy of the books of account by the verification of postings, balances, etc.</td>
</tr>
<tr>
<td>4. Validity of transactions</td>
<td>Verification of the authenticity and validity of transactions entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.</td>
</tr>
<tr>
<td>5. Distinction b/w capital and revenue items</td>
<td>Ascertaining that a proper distinction has been made between items of capital and of revenue nature and that the amounts of various items of income and expenditure adjusted in the accounts corresponding to the accounting period.</td>
</tr>
<tr>
<td>6. P/l and b/s in agreement</td>
<td>Comparison of the balance sheet and profit and loss account or other statements with the underlying record in order to see that they are in accordance therewith.</td>
</tr>
<tr>
<td>7. Verifying assets</td>
<td>Verification of the title, existence and value of the assets appearing in the balance sheet.</td>
</tr>
<tr>
<td>8. Verifying liabilities</td>
<td>Verification of the liabilities stated in the balance sheet.</td>
</tr>
<tr>
<td>9. True and fair view</td>
<td>Checking the result shown by the profit and loss and to see whether the results shown are true and fair.</td>
</tr>
<tr>
<td>10. Complying legal requirements</td>
<td>Where audit is of a corporate body, confirming that the statutory requirements have been complied with.</td>
</tr>
<tr>
<td>11. Reporting</td>
<td>Reporting to the appropriate person/body whether the statements of account examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organisation.</td>
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</tbody>
</table>

1.5 Types Of Audit

1. Audit required under law: The organisations which require audit under law are the following: e.g companies governed by the Companies Act; banking companies; other statutory bodies.
required by their regulators or by specific Act.

2. In the voluntary category

(a) Firms and individual

a) In the voluntary category are the audits of the accounts of proprietary entities, partnership firms, Hindu undivided families, etc. In respect of such accounts, there is no basic legal requirement of audit. Many of such enterprises as a matter of internal rules require audit.
b) Some may be required to get their accounts audited on the directives of Government for various purposes like sanction of grants, loans, etc.
c) But the important motive for getting accounts audited lies in the advantages that follow from an independent professional audit. This is perhaps the reason why large numbers of proprietary and partnership business get their accounts audited.

(b) Ngo's

a) For non-profit making institutions like schools, clubs, hospitals. Most of these have some internal rules to govern their affairs and generally a provision about the requirement of audit is inserted.
b) Activity in the nature of business is not altogether ruled out as a club may sell drinks and eatables to the members and their guests or a school may have endowed agricultural property to yield income.
c) What makes them distinct, is the absence of the question of division of profit: any surplus which may arise can only be used for achieving the objects of the institution.
d) Educational institutions, hospitals, associations, etc., irrespective of any internal rules, get their accounts audited because most of them enjoy government or municipal grants and, generally, for this purpose audited accounts are insisted upon.

(c) trust

a) Trust, however, stands on a slightly different footing; these may be public trusts or private trusts. Trusts can carry on business as well. In the majority of cases trustees are private persons.
b) Trusts generally have two classes of beneficiaries; tenants for life and remainders; persons to whom the accounts are of the supreme importance are often widows and minors, who cannot criticize the accounts in any effective manner.
c) Though audit of trusts, except for public trusts, is not compulsory most of the trust deeds contain a clause for audit of accounts. Private trustees also recognise the advantages of audit in their own interest, since any erroneous treatment in the accounts for which they might be personally liable will be pointed out by the auditor.

1.6 Advantages Of Audit Of Financial Statements

<table>
<thead>
<tr>
<th>1. Financial interest</th>
<th>It safeguards the financial interest of persons who are not associated with the management of the entity, whether they are partners or shareholders, bankers, FI's, public at large etc.</th>
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<tbody>
<tr>
<td>2. Moral check on employee</td>
<td>It acts as a moral check on the employees from committing defalcations or embezzlement</td>
</tr>
<tr>
<td>3. Useful in settling tax liability</td>
<td>Audited statements of account are helpful in settling liability for taxes, negotiating loans and for determining the purchase consideration for a business.</td>
</tr>
<tr>
<td>4. Useful in settling trade dispute</td>
<td>These are also useful for settling trade disputes for higher wages or bonus as well as claims in respect of damage suffered by property, by fire or some other calamity.</td>
</tr>
<tr>
<td>5. Helpful in</td>
<td>An audit can also help in the detection of wastages and losses to show the</td>
</tr>
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</table>
### Detecting wastages and losses
Different ways by which these might be checked, especially those that occur due to the absence or inadequacy of internal checks or internal control measures.

### 6. Proper books maintained or not
Audit ascertains whether the necessary books of account and allied records have been properly kept and helps the client in making good deficiencies or inadequacies in this respect.

### 7. Review of controls
As an appraisal function, audit reviews the existence and operations of various controls in the organisations and reports weaknesses, inadequacies, etc., in them.

### 8. Helpful at admission and retirement
Audited accounts are of great help in the settlement of accounts at the time of admission or death of partner.

### 9. Easy to get license
Government may require audited and certified statement before it gives assistance or issues a license for a particular trade.

### Questions

<table>
<thead>
<tr>
<th>Question</th>
<th>Answer</th>
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<tbody>
<tr>
<td>Q 1</td>
<td>The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. (SM)</td>
</tr>
<tr>
<td>Q 2</td>
<td>The independent audit of an entity’s financial statements is a vital service to investors, trade payables, and participants in economic exchange. “Explain” (SM)</td>
</tr>
</tbody>
</table>

## 1.7 Inherent Limitation of Audit

### 1. The Nature of Financial Reporting
The preparation of financial statements involves judgment by management in applying the requirements of the entity’s applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made.

### 2. The Nature of Audit Procedures
- a) There are practical and legal limitations on the auditor’s ability to obtain audit evidence. For example: There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.
- b) Fraud may involve sophisticated and carefully organised schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
- c) An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

### 3. Timeliness of Financial Reporting and the Balance between Benefit and Cost:
- a) 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.
- b) Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the 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.

### 4. Other Matters that Affect the Limitations of an Audit
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.

**Questions**
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. *(SM)*

## 1.8 RELATIONSHIP OF AUDITING WITH OTHER DISCIPLINES

### 1. Auditing and Accounting

- a) It has been pointed out earlier that both accounting and auditing are closely related with each other as auditing reviews the financial statements which are nothing but a result of the overall accounting process.
- b) It naturally calls on the part of the auditor to have a thorough and sound knowledge of generally accepted principles of accounting before he can review the financial statements.
- c) In fact, auditing as a discipline is also closely related with various other disciplines as there is lot of linkages in the work which is done by an auditor in his day-to-day activities.
- d) To begin with, it may be noted that the discipline of auditing itself is a logical construct and everything done in auditing must be bound by the rules of logic. Ethical precepts are the foundations on which the foundation of the entire accounting profession rests. The knowledge of language is also considered essential in the field of auditing as the auditor shall be required to communicate, both in writing as well as orally, in day-to-day work.

### 2. Auditing and Law

- a) The relationship between auditing and law is very close one.
- b) Auditing involves examination of various transactions from the viewpoint of whether or not these have been properly entered into. It necessitates that an auditor should have a good knowledge of business laws affecting the entity.
- c) He should be familiar with the law of contracts, negotiable instruments, etc.
- d) The knowledge of taxation laws is also inevitable as entity is required to prepare their financial statements taking into account various provisions affected by various tax laws.
- e) In analysing the impact of various transactions particularly from the accounting aspect, an auditor ought to have a good knowledge about the direct as well as indirect tax laws.

### 3. Auditing and Economics

- a) As, it is well known, accounting is concerned with the accumulation and presentation of data relating to economic activity.
- b) Though the concept of income as put forward by economists is different as compared to the accountants concept of income, still, there are lot of similar grounds on which the accounting has flourished.
- c) From the auditing viewpoint, the auditors are more concerned with Micro economics rather than with the Macro economics. The knowledge of Macro economics should include the nature of economic force that affect the firm, relationship of price, productivity and the role of Government and Government regulations.
- d) Auditor is expected to be familiar with the overall economic environment in which his client is operating.

### 4. Auditing and Behavioural Science

- a) The field of auditing as a discipline involves review of various assertions; both in financial as well as in non-financial terms, with a view to prove the veracity of such assertions and expression of opinion by auditor on the same.
- b) Thus, it is quite logical and natural that the function of audit can be performed if
and only if the person also possesses a good knowledge about the fields in respect of which he is conducting such a review.

c) The discipline of behavioural science is closely linked with the subject of auditing. While it may be said that an auditor, particularly the financial auditor, deals basically with the figures contained in the financial statements but he shall be required to interact with a lot of people in the organisation.

d) As against the financial auditor, the internal auditor or a management auditor is expected to deal with human beings rather than financial figures. One of the basic elements in designing the internal control system is personnel.

e) Howsoever, if a sound internal control structure is designed, it cannot work until and unless the people who are working in the organisation are competent and honest.

f) The knowledge of human behaviour is indeed very essential for an auditor so as to effectively discharge his duties.

5. Auditing and Statistics & Mathematics

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<tbody>
<tr>
<td>a)</td>
<td>With the passage of time, test check procedures in auditing have become part of generally accepted auditing procedures.</td>
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<tr>
<td>b)</td>
<td>With the emergence of test check procedure, discipline of statistics has come quite close to auditing as the auditor is also expected to have the knowledge of statistical sampling so as to arrive at meaningful conclusions.</td>
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<tr>
<td>c)</td>
<td>The knowledge of mathematics is also required on the part of auditor particularly at the time of verification of inventories.</td>
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<tr>
<td>d)</td>
<td>The use of data analytics is advancing rapidly in auditing where many organizations are using continuous auditing and continuous monitoring of data to identify risks as part of their system of internal control.</td>
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6. Auditing and Data Processing

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<tr>
<td>a)</td>
<td>Today, organisations are witnessing revolution in the field of data processing of accounts.</td>
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<tr>
<td>b)</td>
<td>Many organisations are carrying out their financial accounting activities with the help of computers which can document, record, collate, allocate and value accounting data and information in very large quantity at very high speed.</td>
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<tr>
<td>c)</td>
<td>The dependence on the accuracy of the programmed instructions given today, the computer is able to carry out each of these activities with complete accuracy.</td>
</tr>
<tr>
<td>d)</td>
<td>With such a phenomenal growth in the field of computer sciences, the auditor should have good knowledge of the components, general capability of the system and the related terms.</td>
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<td>e)</td>
<td>In fact, Computerised Information System auditing in itself is developing as a discipline in itself.</td>
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7. Auditing and Financial Management

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<tbody>
<tr>
<td>a)</td>
<td>Auditing is also closely related with other functional fields of business such as finance, production, marketing, personnel and other general areas of business management.</td>
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<tr>
<td>b)</td>
<td>With the overgrowing field of auditing, the financial services sector occupies a dominant place in our system.</td>
</tr>
<tr>
<td>c)</td>
<td>While in general terms, the auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc.</td>
</tr>
<tr>
<td>d)</td>
<td>The auditor is also expected to have a fair knowledge of the institutions that comprise the market place.</td>
</tr>
<tr>
<td>e)</td>
<td>The knowledge of various institutions and Government activities that influence the operations of the financial market are also required to be understood by an auditor.</td>
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8. Auditing and Production

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<tbody>
<tr>
<td>a)</td>
<td>Regarding production function, it may be stated that a good auditor is one who understands the client and his business.</td>
</tr>
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</table>
| b) | While carrying out the audit activity, the auditor is required to evaluate
transactions from the accounting aspect in relation to the process through which it has passed through as accounting for by-products; joint-products may also require to be done.

c) The knowledge of production process shall become more essential in case of an internal auditor.
d) The auditor shall also require understanding the cost system in operation in the factory and assessing whether the same is adequate for the particular company.
e) The understanding of the terminology of the production shall enable an auditor to communicate with production employees in connection with his work.
f) On the similar pattern the auditor is also expected to have good understanding about the marketing, personnel and other general business management areas.

1.9 Standard Setting Process

| 1. International Federation of Accountants (IFAC) | 1. In 1977, the International Federation of Accountants (IFAC) was set up with a view to bringing harmony in the profession of accountancy on an international scale. In pursuing this mission, the IFAC Board has established the International Auditing and Assurance Standards Board (IAASB) to develop and issue, in the public interest and under its own authority, high quality auditing standards for use around the world.
| | 2. The IFAC Board has determined that designation of the IAASB as the responsible body, under its own authority and within its stated terms of reference, best serves the public interest in achieving this aspect of its mission.
| 2. International auditing and assurance standard board (IAASB) | The IAASB functions as an independent standard-setting body under the auspices of IFAC. The objective of the IAASB is to serve the public interest by setting high quality auditing standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession. The IAASB achieves this objective by:
| | • Establishing high quality auditing standards and guidance for financial statement audits that are generally accepted and recognized by investors, auditors, governments, banking regulators, securities regulators and other key stakeholders across the world;
| | • Establishing high quality standards and guidance for other types of assurance services on both financial and non-financial matters;
| | • Establishing high quality standards and guidance for other related services;
| | • Establishing high quality standards for quality control covering the scope of services addressed by the IAASB; and
| | • Publishing other pronouncements on auditing and assurance matters, thereby advancing public understanding of the roles and responsibility of professional auditors and assurance service providers.

3. Role of Auditing and Assurance Standards Board

| a) The Institute of Chartered Accountants of India is a member of the IFAC and is committed to work towards the implementation of the guidelines issued by the IFAC.
| b) The Institute of Chartered Accountants of India constituted the Auditing Practices Committee (APC) in 1982. The main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute.
| c) While formulating the SAPs in India, the APC gives due consideration to the international auditing guidelines issued by the IAPC and then tries to integrate them to the extent possible in the light of the conditions and practices prevailing in India. While formulating the SAPs, the APC takes into consideration the
applicable laws, customs, usages and business environment in India.

d) In July, 2002, the Auditing Practices Committee has been converted into an Auditing and Assurance Standards Board (AASB) by the Council of the Institute, to be in line with the international trend. A significant step has been taken aimed at bringing in the desired transparency in the working of the Auditing and Assurance Standards Board, through participation of representatives of various segments of the society and interest groups, such as, regulators, industry and academics. The nomenclature of SAPs had also been changed to Auditing and Assurance Standards (AASs).

e) A major development in the field of auditing has been the issuance of revised and/or redrafted International Standards on Auditing pursuant to the Clarity Project of IAASB. The objective of this project is to improve the clarity of International Standards on Auditing (ISAs). The IAASB aims to set high quality international auditing and assurance standards that are understandable, clear and capable of consistent application, thereby serving to enhance the quality and uniformity of practice worldwide. The Auditing and Assurance Standards Board has also laid out a strategy to match step with the IAASB Clarity Project. In the year 2007, the Board issued several revised/new Standards pursuant to the IAASB Clarity Project.

4. Renaming, Re-numbering and Categorisation of Auditing and Assurance Standards:

In terms of the Revised Preface, the Auditing and Assurance Standards are now renamed based on the type of assurance provided by the engagement undertaken by a member.

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### 1.10 Compliance with Documents Issued by the Institute

1. **Statements**

   The Institute has, from time to time, issued ‘Statements’ on a number of matters. The ‘Statements’ have been issued with a view to securing compliance by members on matters which, in the opinion of the Council, are critical for the proper discharge of their functions. ‘Statements’ therefore are mandatory. Accordingly, while discharging their attest function, it will be the duty of the members of the Institute:

   (a) to examine whether ‘Statements’ relating to accounting matters are complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the ‘Statements’, it will be their duty to make **adequate disclosures in their audit reports** so that the users of financial statements may be aware of such deviations; and

   (b) to ensure that the ‘Statements’ relating to auditing matters are followed in the audit of financial information covered by their audit reports. If, for any reason, a member has not been able to perform an audit in accordance with such ‘Statements’, his report should draw attention to the **material departures**, therefrom.

2. **Guidance note**

   The Institute has, from time to time, issued ‘Guidance Notes’ on a number of matters:

   1. **Guidance Notes** : are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may rely in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty.

   2. Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be
necessary to do so. Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

3. There are however a few guidance notes in case of which the Council has specifically stated (discussed in Announcements part reproduced in Handbook on Auditing Pronouncements) that they should be considered as mandatory on members while discharging their attest function.

### 1.11 Qualities of an Auditor

| 1. As per Dicksee | The qualities required, according to Dicksee, are tact, caution, firmness, good temper, integrity, discretion, industry, judgement, patience, clear headedness and reliability. In short, all those personal qualities that go to make a good businessman contribute to the making of a good auditor. |
| 2. Must comply fundamental principles | 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. In fact, Code of ethics mentions integrity, objectivity and independence as one of the fundamental principles of professional ethics. |
| 3. Knowledge of laws | He must have a thorough knowledge of the general principles of law which govern matters with which he is likely to be in intimate contact. The Companies Act need special mention but mercantile law, specially the law relating to contracts, is no less important. Needless to say, where undertakings are governed by a special statute, its knowledge will be imperative; in addition, a sound knowledge of the law and practice of taxation is unavoidable. |
| 4. Good education and training | He must pursue an intensive programme of theoretical education in subjects like financial and management accounting, general management, business and corporate laws, computers and information systems, taxation, economics, etc. Both practical training and theoretical education are equally necessary for the development of professional competence of an auditor for undertaking any kind of audit assignment. |
| 5. Knowledge of business and industry | The auditor should be equipped not only with a sufficient knowledge of the way in which business generally is conducted but also with an understanding of the special features peculiar to a particular business whose accounts are under audit. The auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education. |
| 6. Justice Lindley comments on quality | Lord Justice Lindley in the course of the judgment in the famous London & General Bank case had succinctly summed up the overall view of what an auditor should be as regards the personal qualities. He said, “an auditor must be honest that is, he must not certify what he does not believe to be true and must take reasonable care and skill before he believes that what he certifies is true”. |

### 1.12 Elements of a System of Quality Control

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

(a) Leadership responsibilities for quality within the firm.
(b) Ethical requirements.
(c) Acceptance and continuance of client relationships and specific engagements.
(d) Human resources.
(e) Engagement performance.
1.13 Leadership Responsibilities for Quality on Audits

1. Responsibility for quality control

As per SA 220 “Quality Control for an Audit of Financial Statements”, the engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

2. Engagement partner meaning

Engagement partner refers to the partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor’s report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

3. Duties of engagement partner

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:

(a) The importance to audit quality of:
   (i) Performing work that complies with professional standards and regulatory and legal requirements;
   (ii) Complying with 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; and

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

1.14 Ethical Requirements Relating to an Audit of Financial Statements

1. Fundamental principles of ethics

The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements.

The Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements:

(a) Integrity;
(b) Objectivity;
(c) Professional competence and due care;
(d) Confidentiality; and
(e) Professional behavior

2. Independence of Auditors

2(a) Meaning

1. Professional integrity and independence are considered essential characteristics of all the professions but are more so in the case of accountancy profession. Independence implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him.

2. 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:

   a) “Independence is: (a) Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and

   b) Independence in appearance – the avoidance of facts and circumstances that are so significant that a third party would reasonably conclude an
<table>
<thead>
<tr>
<th>2(b) Purpose of Independence</th>
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<tr>
<td>The auditor’s independence safeguards the auditor’s ability to form an audit opinion without being affected by any influences. Independence enhances the auditor’s ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.</td>
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<table>
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<tr>
<th>2c) Threats to Independence</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats. These are:</td>
</tr>
</tbody>
</table>

1. **Self-interest threats**, which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Examples include (i) direct financial interest or materially significant indirect financial interest in a client, (ii) loan or guarantee to or from the concerned client, (iii) undue dependence on a client’s fees and, hence, concerns about losing the engagement, (iv) close business relationship with an audit client, (v) potential employment with the client, and (vi) contingent fees for the audit engagement.

2. **Self-review threats**, which occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement (Non audit services include any professional services provided to an entity by an auditor, other than audit or review of the financial statements. These include management services, internal audit, investment advisory service, design and implementation of information technology systems etc.), or when a member of the audit team was previously a director or senior employee of the client. Instances where such threats come into play are (i) when an auditor having recently been a director or senior officer of the company, and (ii) when auditors perform services that are themselves subject matters of audit.

3. **Advocacy threats**, which occur when the auditor promotes, or is perceived to promote, a client’s opinion to a point where people may believe that objectivity is getting compromised, e.g. when an auditor deals with shares or securities of the audited company, or becomes the client’s advocate in litigation and third party disputes.

4. **Familiarity threats** are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client’s interests. This can occur in many ways: (i) close relative of the audit team working in a senior position in the client company, (ii) former partner of the audit firm being a director or senior employee of the client, (iii) long association between specific auditors and their specific client counterparts, and (iv) acceptance of significant gifts or hospitality from the client company, its directors or employees.

5. **Intimidation threats**, which occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.

<table>
<thead>
<tr>
<th>2(d) Safeguards to Independence</th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
</tr>
<tr>
<td>The following are the guiding principles in this regard:</td>
</tr>
<tr>
<td>1. For the public to have confidence in the quality of audit, it is essential that auditors should always be and appear to be independent of the entities that...</td>
</tr>
</tbody>
</table>
2. In the case of audit, the key fundamental principles are integrity, objectivity and professional skepticism, which necessarily require the auditor to be independent.

3. Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.

4. When such threats exist, the auditor should either desist from the task or put 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.

### 3. Professional skepticism

#### 3(a) Meaning

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

#### 3(b) Skepticisms should be towards

The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. Professional skepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the SAs.
- Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:
  - Overlooking unusual circumstances.
  - Over generalising when drawing conclusions from audit observations.
  - Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

#### 3(c) Need for skepticism

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

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

#### 3(d) Disregarding past experience

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

### Questions

The code of Ethics for Professional Accountants, prepared by the international federation of Accountants (IFAC) identifies five types of threats. Explain (SM)
### 1.15 Acceptance and Continuance of Client Relationships and Audit Engagements

<table>
<thead>
<tr>
<th>1. Engagement partner to be satisfied</th>
<th>The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed.</th>
</tr>
</thead>
</table>
| 2. Manner to determine whether acceptance and continuance procedure is appropriate | SQC 1 requires the firm to obtain information before accepting an engagement. Information such as the following assists the engagement partner in determining whether the decisions regarding the acceptance and continuance of audit engagements are appropriate:  
- The integrity of the principal owners, key management and those charged with governance of the entity;  
- Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;  
- Whether the firm and the engagement team can comply with relevant ethical requirements; and  
- Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship. |
| 3. Subsequent awareness of any circumstances | If the engagement partner obtains information that would have caused the firm to decline the audit engagement had that information been available earlier, the engagement partner shall communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action. |

### 1.16 Human Resources

<table>
<thead>
<tr>
<th>1. Firm to establish policies</th>
<th>The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.</th>
</tr>
</thead>
</table>
| 2. Matters to covered by policies | Such policies and procedures address the following personnel issues:  
- (a) Recruitment;  
- (b) Performance evaluation;  
- (c) Capabilities;  
- (d) Competence;  
- (e) Career development;  
- (f) Promotion;  
- (g) Compensation; and  
- (h) Estimation of personnel needs. |
| 3. Firm to decide nature and number of personnel required | Addressing these issues enables the firm to ascertain the number and characteristics of the individuals required for the firm’s engagements. The firm’s recruitment processes include procedures that help the firm select individuals of integrity as well as the capacity to develop the capabilities and competence necessary to perform the firm’s work. |

### 1.17 Engagement Performance

| 1. Firm should establish policies for | The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or |
### 1.18 Monitoring

**1. Firm to establish monitoring policies**

The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm’s system of quality control, including a periodic inspection of a selection of completed engagements.

**2. Purpose of monitoring**

The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

- (a) Adherence to professional standards and regulatory and legal requirements;
- (b) Whether the quality control system has been appropriately designed and effectively implemented; and
- (c) Whether the firm’s quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.

**3. Follow up**

Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures.

### 1.19 Terms of Audit engagement

**1. Preconditions for an audit**

As per SA 210 “Agreeing the Terms of Audit Engagements”, preconditions for an audit may be defined as the use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.

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

- (a) Determine whether the financial reporting framework is acceptable; and
- (b) Obtain the agreement of management that it acknowledges and understands its responsibility:
  - (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework;
  - (ii) For the internal control as management considers necessary; and
  - (iii) To provide the auditor with:
    - Access to all information such as records, documentation and other matters;
    - Additional information that the auditor may request from management
for the purpose of the audit; and
- Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

### 2. Agreement on audit engagement terms

1. According to SA 210 “Agreeing the Terms of Audit Engagements”, the auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate.
2. The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:
   - The objective and scope of the audit of the financial statements;
   - The responsibilities of the auditor;
   - The responsibilities of management;
   - Identification of the applicable financial reporting framework for the preparation of the financial statements; and
   - Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.
3. The audit engagement letter is sent by the auditor to his client.
4. If law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities.

### 3. Recurring audits

1. On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.
2. The auditor may decide not to send a new audit engagement letter or other written agreement each period.
3. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:
   a) Any indication that the entity misunderstands the objective and scope of the audit.
   b) Any revised or special terms of the audit engagement.
   c) A recent change of senior management.
   d) A significant change in ownership.
   e) A significant change in nature or size of the entity’s business.
   f) A change in legal or regulatory requirements.
   g) A change in the financial reporting framework adopted in the preparation of the financial statements.
   h) A change in other reporting requirements.

### 4. Limitation on scope prior to audit engagement acceptance

If management or those charged with governance impose a limitation on the scope of the auditor’s work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

### 5. Acceptance of a change in engagement

1. An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.
2. A request from the client for the auditor to change the engagement may result from:
   a) a change in circumstances affecting the need for the service,
   b) a misunderstanding as to the nature of an audit or related service originally requested.
   c) a restriction on the scope of the engagement, whether imposed by
management or caused by circumstances.

d) The **auditor would consider carefully the reason given for the request**, particularly the implications of a restriction on the scope of the engagement, especially any legal or contractual implications.

3. If the auditor concludes that there is **reasonable justification to change the engagement** and if the audit work performed complied with the SAs applicable to the changed engagement, the report issued would be appropriate for the revised terms of engagement. In order to avoid confusion, the report would not include reference to: the original engagement; or any procedures that may have been performed in the original engagement.

4. **The auditor should not agree to a change of engagement where there is no reasonable justification for doing so.**

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

| 6.Unable to change terms of engagement | If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:
| | (a) Withdraw from the audit engagement where possible under applicable law or regulation; and
| | (b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators. |

**Questions**

The audit engagement letter is sent by the client to auditor (SM)
### Chapter -2
Audit Strategy, Audit Planning and Audit Programme

#### 2.1 Audit planning

<table>
<thead>
<tr>
<th>1. Planning essential for effective and efficient audit</th>
<th>“The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner.”</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Planning based on clients business</td>
<td>Plans should be based on knowledge of the client’s business”</td>
</tr>
</tbody>
</table>
| 3. Planning to cover                                    | **Plans should be made to cover, at least:**  
(a) acquiring knowledge of the client’s accounting systems and internal control procedures;  
(b) establishing the expected degree of reliance to be placed on internal control;  
(c) determining and programming the nature, timing, and extent of the audit procedures to be performed; and  
(d) coordinating the work to be performed. |
| 4. Planning to be revised                               | Plans should be further developed and revised as necessary during the course of the audit. |
| 5. Planning not discrete rather iterative phase         | SA-300, “According to it, planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. |
| 6. Firstly strategy than planning                       | 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. |
| Questions                                               | Planning is a discrete phase of an audit (SM) |

#### 2.2 Benefits of Audit Planning

<table>
<thead>
<tr>
<th>1. Devoting proper timing</th>
<th>Helping the auditor to devote appropriate attention to important areas of the audit.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Potential problem identified</td>
<td>Helping the auditor identify and resolve potential problems on a timely basis.</td>
</tr>
<tr>
<td>3. Managing engagement team</td>
<td>Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.</td>
</tr>
<tr>
<td>4. Selecting engagement team</td>
<td>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.</td>
</tr>
<tr>
<td>5. Helpful in directing, supervising and review</td>
<td>Facilitating the direction and supervision of engagement team members and the review of their work.</td>
</tr>
<tr>
<td>6. Helps in coordinating with others</td>
<td>Assisting, where applicable, in coordination of work done by auditors of components and experts.</td>
</tr>
</tbody>
</table>
2.3 Overall Audit Strategy

1. Strategy guide development of 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.

2. Advantages of strategy
   The process of establishing the overall audit strategy assists the auditor to determine, such matters as:
   a) 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;
   b) 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;
   c) When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates; and
   d) 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.

Questions
   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. (SM)

2.4 Establishment of Overall Audit Strategy

In establishing the overall audit strategy, the auditor shall

1. Characteristics of engagement
   Identify the characteristics of the engagement that define its scope;

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

3. Directing engagement team
   Consider the factors that, in the auditor’s professional judgment, are significant in directing the engagement team’s efforts;

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

5. N.T,E of resources required
   Ascertain the nature, timing and extent of resources necessary to perform the engagement

2.5 Development Of Audit Plan

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

1. Risk assessment procedures
   The nature, timing and extent of planned risk assessment procedures, as determined under SA 315

2. Procedures to respond to
   The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330.
2.6 Relationship Between Overall Audit Strategy And Audit Plan

1. Plan vs strategy

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.

2. Deciding strategy and then planning

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.

3. Plan and strategy inter-related

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.

2.7 Knowledge of the Client’s Business

It 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. The auditor shall obtain an understanding of the following:

1. Industry and regulatory

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

2. Nature of entity

The nature of the entity, including:
- its operations;
- its ownership and governance structures;
- the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
- the way that the entity is structured and how it is financed;

to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

3. Entities accounting policies

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.

4. Entities strategies, objectives

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

5. Entities financial performance

The measurement and review of the entity’s financial performance

2.8 Audit Planning – A Continuous Process

1. Planning not a Planning is not a discrete phase of an audit, but rather a continual and iterative
### 2.9 Overall Audit Strategy And The Audit Plan – The Auditor’s Responsibility

#### 1. Planning may be discussed with client

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.

#### 2. Auditor responsibility to plan

Although these discussions often occur, the overall audit strategy and the audit plan remain the auditor’s responsibility.

#### 3. Key Engagement members may be involved in planning

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.

### 2.10 DIRECTION, SUPERVISION AND REVIEW

#### 1. Plan N, T, E of direction and supervision

The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

#### 2. Factors affecting N, T, E

1. 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:
   a) The size and complexity of the entity.
   b) The area of the audit.
   c) The assessed risks of material misstatement

#### Questions

The nature and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors “Explain (SM)"
## 2.11 Changes To Planning Decisions During The Course Of The Audit

| 1. Plan should be updated or revised | The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. |
| 2. Reasons of revision and effect of revision | 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 the performance of substantive procedures may contradict the audit evidence obtained through tests of controls. |

## 2.12 Documentation of audit plan

| 1. overall audit strategy; | 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. |
| 2. audit plan; | 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. |
| 3. any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. | A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit. |

## 2.13 Audit programme

| 1. Definition | An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given company for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on such statements. |
| 2. One programme not suitable for all business | 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. |
| 3. Programme should contain | 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... |
minimum procedure: 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.

4. Programme should be reviewed periodically: 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.

### 2.14 Constructing an Audit Programme

<table>
<thead>
<tr>
<th>1. Scope and objective</th>
<th>Stay within the scope and limitation of the assignment.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Type of evidence available</td>
<td>Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.</td>
</tr>
<tr>
<td>3. Apply relevant procedures</td>
<td>Apply only those steps and procedures which are useful in accomplishing the verification purpose in the specific situation.</td>
</tr>
<tr>
<td>4. Consider error</td>
<td>Consider all possibilities of error.</td>
</tr>
<tr>
<td>5. Coordinate procedures</td>
<td>Co-ordinate the procedures to be applied to related items.</td>
</tr>
</tbody>
</table>

### 2.15 Developing the Audit Programme

<table>
<thead>
<tr>
<th>1. Written Audit Programme</th>
<th>The auditor should prepare a written audit programme setting forth the procedures that are needed to implement the audit plan.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Audit Objective and Instruction to Assistants</td>
<td>The programme may also contain the audit objectives for each area and should have sufficient details to serve as a set of instructions to the assistants involved in the audit and as a means to control the proper execution of the work.</td>
</tr>
<tr>
<td>3. Reliance on Internal Controls</td>
<td>In preparing the audit programme, the auditor, having an understanding of the accounting system and related internal controls, may wish to rely on certain internal controls in determining the nature, timing and extent of required auditing procedures. 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.</td>
</tr>
<tr>
<td>4. Timings of Performance of Audit Procedures</td>
<td>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.</td>
</tr>
</tbody>
</table>
5. Audit Planning
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.

2.16 Advantages of an Audit Programme

<table>
<thead>
<tr>
<th>1. Instruction to assistants</th>
<th>It provides the assistant carrying out the audit with total and clear set of instructions of the work generally to be done.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Idea of total work</td>
<td>It is essential, particularly for major audits, to provide a total perspective of the work to be performed.</td>
</tr>
<tr>
<td>3. Capable Assistant can be selected</td>
<td>Selection of assistants for the jobs on the basis of capability becomes easier when the work is rationally planned, defined and segregated.</td>
</tr>
<tr>
<td>4. Danger of ignoring eliminating</td>
<td>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, the danger is significantly less and the audit can proceed systematically.</td>
</tr>
<tr>
<td>5. Responsibility of assistants fixed</td>
<td>The assistants, by putting their signature on programme, accept the responsibility for the work carried out by them individually and, if necessary, the work may be traced back to the assistant.</td>
</tr>
<tr>
<td>6. Progress of audit can be controlled</td>
<td>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.</td>
</tr>
<tr>
<td>7. Guide for future audit</td>
<td>It serves as a guide for audits to be carried out in the succeeding year.</td>
</tr>
<tr>
<td>8. Serves as evidence</td>
<td>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.</td>
</tr>
</tbody>
</table>

Questions
“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.” (SM)

2.17 Disadvantages of Audit Programmes

| 1. Audit becomes mechanical | 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. |
| 2. Programs may become ineffective | 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. |
| 3. Inefficient assistants may escape | 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. |
| 4. Efficient | A hard and fast audit programme may kill the initiative of efficient and enterprising
<table>
<thead>
<tr>
<th>assistants creativeness is effected</th>
<th>assistants.</th>
</tr>
</thead>
</table>

5. Note- 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.

<table>
<thead>
<tr>
<th>2.18 Quality Control For Audit Work– Delegation And Supervision Of Audit Work</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Audit involves number of persons</td>
</tr>
<tr>
<td>2. Auditor to assure quality before relying on others work</td>
</tr>
</tbody>
</table>
| 3. Objective of quality control | The objective of the auditor is to implement quality control procedures at the engagement level that provides the auditor with reasonable assurance that:  
- The audit complies with professionals standards and regulatory and legal requirements  
- The auditor’s report issued is appropriate in the circumstances. |

<table>
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<tr>
<th>2.19 Materiality</th>
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| 1. Determining materiality for F.S as a whole | When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:  
  a) The elements of the financial statements  
  b) Whether there are items on which the attention of the users of the particular entity’s financial statements tends to be focused  
  c) 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;  
  d) The entity’s ownership structure and the way it is financed and  
  e) The relative volatility of the benchmark.  
Note- 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. |
| 2. Materiality level for a class of transactions, account balance or disclosure | 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. Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures include:  
- The risk of material misstatement  
- The importance of the items to the users of the financial statements  
- The complexity and nature of the transactions  
- The degree of difficulty in auditing the items  
- The potential for fraud or error.  
Note- The auditor should consider the factors that may indicate the existence of material misstatements and the potential for fraud or error in determining the materiality level for the class of transactions, account balances or disclosures. |

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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:

6. Whether law, regulations or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items.

7. The key disclosures in relation to the industry in which the entity operates
   □ Whether attention is focused on a particular aspect of the entity’s business that is separately disclosed in the financial statements.
   □ A newly acquired business.

3. 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.

4. Materiality level may be revised
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.

5. Documenting the Materiality
The audit documentation shall include the following amounts and the factors considered in their determination:
   (a) Materiality for the financial statements as a whole;
   (b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures;
   (c) Performance materiality; and
   (d) Any revision of (a)-(c) as the audit progressed.

Questions
Q 1 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) does not need any revision. (SM)
Q 2 Determining materiality involves the exercise of professional judgment “Discuss starting the factors that may affect the identification of an appropriate benchmark. Also give example. (SM)
### 3.1 Audit Documentation

<table>
<thead>
<tr>
<th>1. Definition</th>
<th>Audit documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. (Terms such as “working papers” or “work papers” are also sometimes used.)</th>
</tr>
</thead>
</table>
| 2. Documentation provides | Audit documentation provides:  
(a) evidence of the auditor’s basis for a conclusion about the achievement of the overall objectives of the auditor; and  
(b) evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements. |
| 3. Purpose | **Purpose of Audit Documentation**  
The following are the purpose of Audit documentation:  
1. Assisting the engagement team to plan and perform the audit.  
2. Assisting members of the engagement team to direct and supervise the audit work, and to discharge their review responsibilities.  
3. Enabling the engagement team to be accountable for its work.  
4. Retaining a record of matters of continuing significance to future audits.  
5. Enabling the conduct of quality control reviews and inspections.  
6. Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements. |
| 4. Form, Content and Extent of Audit Documentation | The form, content and extent of audit documentation depend on factors such as:  
1. The size and complexity of the entity.  
2. The nature of the audit procedures to be performed.  
3. The identified risks of material misstatement.  
4. The significance of the audit evidence obtained.  
5. The nature and extent of exceptions identified.  
6. The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.  
7. The audit methodology and tools used. |
| 5. Audit file | 1) Audit file may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.  
2) The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor’s report. As per SQC-1 An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor’s report.  
3) SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor’s report, or, if later, the date of the group auditor’s report. |
2. Examples of significant judgement  
a) Matters that give rise to significant risks. |
### 2. Related Significant Professional Judgments

b) Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor’s responses to those risks.

c) Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.

3. An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results.

4. Documentation of the professional judgments made, where significant, serves to explain the auditor’s conclusions and to reinforce the quality of the judgment. Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits, when reviewing matters of continuing significance (for example, when performing a retrospective review of accounting estimates).

5. Some examples of circumstances in which it is appropriate to prepare audit documentation relating to the use of professional judgment include, where the matters and judgments are significant:

   a) The rationale for the auditor's conclusion when a requirement provides that the auditor 'shall consider' certain information or factors, and that consideration is significant in the context of the particular engagement.

   b) The basis for the auditor’s conclusion on the reasonableness of areas of subjective judgments (for example, the reasonableness of significant accounting estimates).

   c) The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

### 3. Completion Memorandum or Audit Documentation Summary

1. The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes:

   a) the significant matters identified during the audit and
   b) how they were addressed.

2. Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits.

3. Further, the preparation of such a summary may assist auditor’s consideration of the significant matters. It may also help the auditor to consider whether there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

### 4. Ownership of Audit Documentation

Standard on Quality Control (SQC) 1 provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

### Questions

Q 1 As per SA 230 "Audit Documentation" the working papers are not the property of the auditor(SM)

Q 2 Define audit documentation. Also give some example (SM)

Q 3 "Audit documentation summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits". Explain(SM)
3.2 Audit evidence

1. Definition

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.

2. It includes

- **Information contained in the accounting records:** Accounting records include the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the 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.

- **Other information that authenticates the accounting records and also supports the auditor’s rationale behind the true and fair presentation of the financial statements:** Other information which the auditor may use as audit evidence includes, for example minutes of the meetings, written confirmations from trade receivables and trade payables, manuals containing details of internal control etc. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

3.3 Sufficiency and Appropriateness of Audit Evidence

1. Sufficiency of Audit Evidence

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

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

- **Risk of material misstatement** 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 (a) Inherent risk—The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls. (b) 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.

- **Size of a population** 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.
2. Appropriateness of Audit Evidence:

a) 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.

b) The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

c) In order to obtain reliable audit evidence, information produced by the entity (“IPE”) that is used for performing audit procedures needs to be sufficiently complete and accurate.

Questions

Sufficiency is the measure of the quality of audit evidence. (SM)

3.4 Audit Procedures to Obtain Audit Evidence

1. Types of audit procedures

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) Test 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.

2. Applying procedures in combination

The audit procedures inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry described below may be used as risk assessment procedures, test of controls or substantive procedures, depending on the context in which they are applied by the auditor.

3.5 Risk Assessment Procedures

1. Definition

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.

3.6 Test of controls

1. Definition

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.

2. Purpose

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

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

3. Nature and

1. In designing and performing test of controls, the auditor shall:
### Extent of Test of Controls

- a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:
  1. How the controls were applied at relevant times during the period under audit.
  2. The consistency with which they were applied.
  3. 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.

2. 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.

3. 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.

4. 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:
  a) The frequency of the performance of the control by the entity during the period.
  b) The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
  c) The expected rate of deviation from a control.
  d) The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.
  e) The extent to which audit evidence is obtained from tests of other controls related to the assertion.

### Timing of Test of Controls

- a) 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.
- b) Audit evidence pertaining only to a point in time may be sufficient for the auditor’s purpose, for example, when testing controls over the entity’s physical inventory counting at the period end. If, on the other hand, the auditor intends to rely on a control over a period, tests that are capable of providing audit evidence that the control operated effectively at relevant times during that period are appropriate. Such tests may include tests of the entity’s monitoring of controls.

### Using Audit Evidence Obtained in Previous Audits

In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:
  a) The effectiveness of other elements of internal control, including the control environment, the entity’s monitoring of controls, and the entity’s risk assessment process;
  b) The risks arising from the characteristics of the control, including whether it is manual or automated;
  c) The effectiveness of general IT-controls;
  d) The effectiveness of the control and its application by the entity, including the
nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control;

(e) Whether the lack of a change in a particular control poses a risk due to changing circumstances; and

(f) The risks of material misstatement and the extent of reliance on the control.

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

6. Evaluating the Operating Effectiveness of Controls

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.

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

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

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.

Questions

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. Explain. (SM)

3.7 Substantive Procedures

1. Definition

Substantive procedure may be defined as an audit procedure 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.

2. Designing and Performing Substantive Procedures

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

1. 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.

2. Depending on the circumstances, the auditor may determine that:

   a. 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 test of controls.

   b. Only tests of details are appropriate.
A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

2. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. SA 520, “Analytical Procedures” establishes requirements and provides guidance on the application of analytical procedures during an audit.

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

4. 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.

5. 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.

### 3. External Confirmation as Substantive Procedures

The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures.

1. External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no “side agreement” exists that may be relevant to an entity’s revenue cut-off assertion. Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:
   - (i) Bank balances and other information relevant to banking relationships.
   - (ii) Accounts receivable balances and terms.
   - (iii) Inventories held by third parties at bonded warehouses for processing or on consignment.
   - (iv) Property title deeds held by lawyers or financiers for safe custody or as security.
   - (v) Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.
   - (vi) Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
   - (vii) Accounts payable balances and terms.

2. Although external confirmations may provide relevant audit evidence relating to certain assertions, there are some assertions for which external confirmations provide less relevant audit evidence.

3. Factors that may assist the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include:
   - a. The confirming party’s knowledge of the subject matter – responses may be more reliable if provided by a person at the confirming party who has the requisite knowledge about the information being confirmed.
b. The ability or willingness of the intended confirming party to respond – for example, the confirming party:
   → may not accept responsibility for responding to a confirmation request;
   → may consider responding too costly or time consuming; or
   → may have concerns about the potential legal liability resulting from responding; or
   → may account for transactions in different currencies; or
   → may operate in an environment where responding to confirmation requests is not a significant aspect of day-to-day operations.
   In such situations, confirming parties may not respond, may respond in a casual manner or may attempt to restrict the reliance placed on the response.

c. The objectivity of the intended confirming party – if the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

| 4. Substantive Procedures Related to the Financial Statement Closing Process | The auditor’s substantive procedures shall include the following audit procedures related to the financial statement closing process:
(a) Agreeing or reconciling the financial statements with the underlying accounting records; and
(b) Examining material journal entries and other adjustments made during the course of preparing the financial statements. The nature, and also the extent, of the auditor’s examination of journal entries and other adjustments depends on the nature and complexity of the entity’s financial reporting process and the related risks of material misstatement. |

| 5. Substantive Procedures Responsive to Significant Risks: | When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details. |

### 3.8 Audit Procedures

Audit procedures to obtain audit evidence can include:

| 1. 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. |

| 2. Observation | Observation consists of looking at a process or procedure being performed by others. 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. |

| 3. External Confirmation | An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only. External confirmation procedures also are used to obtain audit evidence about the |
absence of certain conditions.

4. Recalculation

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

5. Re-performance

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

6. 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.

7. 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.

3.9 Assertions

1. Meaning

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.

2. Assertion made by management

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.

3. Types of assertions - 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:

3(a) Assertions about classes of transactions

(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.

### 3(b) Assertions about account balances

(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.

### 3(c) Assertions about presentation and disclosure:

(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.

### 3.10 Types of Audit Evidence

1. **On the basis of source**
   1(a) **Internal evidence**
   Evidence which originates within the organisation being audited is internal evidence.
   1(b) **External evidence**
   evidence that originates outside the client’s organization.

2. **On the basis of nature**
   2(a) **oral evidence**
   Evidences which are obtained in response to inquiry by auditor. Oral evidences can be internal or external.
   2(b) **Written evidences**
   Evidence available to auditor in documentary form example invoices.
   2(c) **Visual evidence**
   evidence available on physical verification by auditor are called visual evidence example condition of inventory.

**Questions**

Purchase invoice is an example of internal evidence. *(SM)*

### 3.11 Relevance and Reliability

1. **Relevance**
   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.

2. **Reliability**
   The reliability of information to be used as audit evidence, and therefore of the audit
3. Generalization on reliability of audit evidence

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

a) The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.

b) 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.

c) 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).

d) 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).

e) Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitised or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

### 3.12 Written Representations

**1. Definitions**

Written representations may be defined as a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

**2. Written Representations as Audit Evidence**

1. Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity’s financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence.

2. Written representations are requested from those responsible for the preparation and presentation of the financial statements.

3. Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management’s responsibilities, or about specific assertions.

**3. The objectives of the auditor regarding written representation**

The objectives of the auditor are:

(a) **To obtain written representations**

   To obtain written representations from management. Also that management believes that it has fulfilled its responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;

(b) **To support other evidence**

   To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations; and

(c) **To respond appropriately**
To respond appropriately to written representations provided by management or if management does not provide the written representations requested by the auditor.

### 4. Management from Whom Written Representations Requested

1. The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.

2. Written representations are requested from those responsible for the preparation and presentation of the financial statements. Those individuals may vary depending on the governance structure of the entity, and relevant law or regulation. However, management (rather than those charged with governance) is often the responsible party.

3. Written representations may therefore be requested from the entity’s chief executive officer and chief financial officer, or other equivalent persons in entities that do not use such titles. In some circumstances, however, other parties, such as those charged with governance, are also responsible for the preparation and presentation of the financial statements.

4. Due to its responsibility for the preparation and presentation of the financial statements, and its responsibilities for the conduct of the entity’s business, management would be expected to have sufficient knowledge of the process followed by the entity in preparing and presenting the financial statements and the assertions therein on which to base the written representations.

5. In some cases, however, management may decide to make inquiries of others who participate in preparing and presenting the financial statements and assertions therein, including individuals who have specialized knowledge relating to the matters about which written representations are requested. Such individuals may include:
   - (a) An actuary responsible for actuarially determined accounting measurements.
   - (b) Staff engineers who may have responsibility for and specialized knowledge about environmental liability measurements.
   - (c) Internal counsel who may provide information essential to provisions for legal claims.

### 5. Written Representations about Management’s Responsibilities

(a) The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements.

(b) Audit evidence obtained during the audit that management has fulfilled the responsibilities is not sufficient without obtaining confirmation from management about the same. This is because the auditor is not able to judge solely on other audit evidence.

### Questions

Although written representation provide necessary audit evidence yet they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Discuss. (SM)

### 3.13 Audit Evidence — Specific Considerations For Inventory

1. **Inventory**

   When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:
   - (a) Attendance at physical inventory counting, unless impracticable, to:
     - (i) Evaluate management’s instructions and procedures for recording and controlling the results of the entity’s physical inventory counting;
     - (ii) Observe the performance of management’s count procedures;
(iii) Inspect the inventory; and
(iv) Perform test counts.

(b) performing audit procedures over the entity’s final inventory records to determine whether they accurately reflect actual inventory count results.

### 2. Attendance at Physical Inventory Counting

(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.

### 3. Matters Relevant in Planning Attendance at Physical Inventory Counting

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.

### 4. Physical Inventory Counting Conducted Other than at the Date of the Financial Statements

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

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

If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.
6. Attendance at Physical Inventory Counting Is Impracticable

If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor shall modify the opinion in the auditor’s report in accordance with SA 705.

In some cases, 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.

8. Inventory under custody of third party

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.

<table>
<thead>
<tr>
<th>3.14 Audit Evidence — Specific Considerations For litigations and claims</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Litigation and Claims</strong></td>
</tr>
<tr>
<td>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:</td>
</tr>
<tr>
<td>(a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;</td>
</tr>
<tr>
<td>(b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and</td>
</tr>
<tr>
<td>(c) Reviewing legal expense accounts.</td>
</tr>
<tr>
<td><strong>2. If the Auditor Assesses a Risk of Material Misstatement regarding Litigation or Claims - Communication with the Entity’s External Legal Counsel</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>The auditor shall do so through a letter of inquiry requesting the entity’s external legal counsel to communicate directly with the auditor.</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>This may be the case, for example, where:</td>
</tr>
<tr>
<td>□ The auditor determines that the matter is a significant risk.</td>
</tr>
<tr>
<td>□ The matter is complex.</td>
</tr>
<tr>
<td>□ 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.</td>
</tr>
</tbody>
</table>
### 3.15 External Confirmation

<table>
<thead>
<tr>
<th><strong>1. Definition</strong></th>
<th>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.</th>
</tr>
</thead>
</table>
| **2. Definition of other Important Terms** | - **Positive confirmation request** – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.  
  - **Negative confirmation request** – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.  
  - **Non-response** – A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.  
  - **Exception** – A response that indicates a difference between information requested to be confirmed, or contained in the entity’s records, and information provided by the confirming party. The exception need to be assessed to the entire population after analyzing the reason for difference. |
| **3. External Confirmation Procedures** | When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:  
  - Determining the information to be confirmed or requested;  
  - Selecting the appropriate confirming party;  
  - Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and  
  - Sending the requests, including follow-up requests when applicable, to the confirming party. |
| **4. 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”. |
| **5. Designing Confirmation Requests** | 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.  
**Factors to consider when designing confirmation requests include:**  
- Specific identified risks of material misstatement, including fraud risks.  
- The layout and presentation of the confirmation request.  
- Prior experience on the audit or similar engagements.  
- The assertions being addressed.  
- The method of communication [for example, in paper form, or by electronic mode (like e-mail) or other medium].  
- 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.  
- The ability of the intended confirming party to confirm or provide the requested information [for example, individual invoice amount versus total balance]. |
| **6. Management’s Refusal to Allow the Auditor to Send a** | 1. 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;  
  - Address any identified risks of material misstatement, including fraud risks.  
  - Consider the layout and presentation of the confirmation request.  
  - Consider prior experience on the audit or similar engagements.  
  - Address the assertions being addressed.  
  - Address the method of communication.  
  - Address 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.  
  - Address the ability of the intended confirming party to confirm or provide the requested information. |
### Confirmation Request

- (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.

2. 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.

3. The auditor also shall determine the implications for the audit and the auditor’s opinion in accordance with SA 705.

### 3.16 Initial Audit Engagement

#### 1. Meaning

An engagement in which either:
- The financial statements for the prior period were not audited; or
- The financial statements for the prior period were audited by a predecessor auditor.

#### 2. Objective of Auditor with respect to Opening Balances – in conducting an Initial Audit Engagement

In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:
- (a) Opening balances contain misstatements that materially affect the current period’s 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.

#### 3. Audit Procedures regarding Opening Balances

1. The auditor shall read the most recent financial statements, if any, and the predecessor auditor’s report thereon, if any, for information relevant to opening balances.

2. 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.

3. 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 in accordance with SA 450.

### 4. Consistency of Accounting Policies relating to opening balances

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.

### 5. Audit Conclusions and Reporting

(a) 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.

(b) 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.

### Questions

Discuss the objective of Auditor with respect to opening balances – in conducting an initial audit engagement (SM).

---

### 3.17 Related party

#### 1. Meaning Of Related Party

A party that is either:

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

Note: 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.

#### 2. Nature of Related Party Relationships and Transactions

Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the 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.

- 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
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.

### 3.18 Responsibilities of the Auditor

<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Accounting requirements for related parties</td>
<td>There are specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and effects on the financial statements.</td>
</tr>
<tr>
<td>2. Auditor responsibility</td>
<td>The auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity’s failure to appropriately account for related party relationships, transactions or balances.</td>
</tr>
</tbody>
</table>
| 3. Understanding entities related parties, their relationships and transactions | 1. The auditor needs to obtain an understanding of the entity’s related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions:
   - (a) Achieve a true and fair presentation; or
   - (b) Are not misleading (for compliance frameworks).
   2. In addition, an understanding of the entity’s related party relationships and transactions is relevant to the auditor’s evaluation of whether fraud risk factors are present as required by SA 240. This is because fraud may be more easily committed through related parties.
   3. Owing to the inherent 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 the SAs. In the context of related parties, the potential effects of inherent limitations on the auditor’s ability to detect material misstatements are greater for such reasons as the following:
   - (a) Management may be unaware of the existence of all related party relationships.
   - (b) Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management. |
| 4. Skepticism for undisclosed related party transactions | Planning and performing the audit with professional skepticism as required by SA 200 is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement associated with related party relationships and transactions, and in designing audit procedures to respond to the assessed risks. |

### 3.19 Concept Of True And Fair

<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Auditor to report on true and fair view</td>
<td>The concept of true and fair is a fundamental concept in auditing. The phrase “true and fair” in the auditor’s report signifies that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit. This requires that the auditor should examine the accounts with a view to verify that all assets, liabilities, income and expenses are stated as amounts which are in accordance with accounting principles and policies which are relevant</td>
</tr>
</tbody>
</table>
and no material amount, item or transaction has been omitted.

2. Things to be checked for true and fair view

What constitutes a ‘true and fair’ view is a matter of an auditor’s judgment in the particular circumstances of a case. In more specific terms, to ensure true and fair view, an auditor has to see:

(i) that the assets are neither undervalued or overvalued, according to the applicable accounting principles,
(ii) no material asset is omitted;
(iii) the charge, if any, on assets are disclosed;
(iv) material liabilities should not be omitted;
(v) the profit and loss account and balance sheet discloses all the matters required to be disclosed;
(vii) accounting policies have been followed consistently; and
(viii) all unusual, exceptional or non-recurring items have been disclosed separately.

3.20 Auditor And The Subsequent Events

1. Meaning of Subsequent Events

Events occurring between the date of the financial statements and the date of the auditor’s report, and facts that become known to the auditor after the date of the auditor’s report.

2. Objectives

The objectives of the auditor are to:

(a) Obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor’s report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements; and

(b) Respond appropriately to facts that become known to the auditor after the date of the auditor’s report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor’s report.

3. Audit Procedure Regarding Events Occurring between the Date of the Financial Statements and the Date of the Auditor’s Report

1. The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor’s report that require adjustment of, or disclosure in, the financial statements have been identified.

2. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

3. The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor’s report, or as near as practicable thereto. The auditor shall take into account the auditor’s risk assessment which shall include the following:

(a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

(b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

(c) Reading minutes, if any, of the meetings, of the entity’s owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

(d) Reading the entity’s latest subsequent interim financial statements, if any.

4. When, as a result of the procedures performed as required above, the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall consider the following:

(a) Whether the events identified are material.

(b) Whether the events identified are of such a nature that they may affect the auditor’s opinion on the financial statements.

(c) Whether the events identified are of such a nature that they may affect the auditor’s qualification of the financial statements.

(d) Whether the events identified are of such a nature that they may affect the auditor’s going concern assumption.

(e) Whether the events identified are of such a nature that they may affect the auditor’s independence.

(f) Whether the events identified are of such a nature that they may affect the auditor’s ability to continue in practice.

(g) Whether the events identified are of such a nature that they may affect the auditor’s fitness to practice.

(h) Whether the events identified are of such a nature that they may affect the auditor’s ability to carry on business.

(i) Whether the events identified are of such a nature that they may affect the auditor’s ability to carry on business.

(j) Whether the events identified are of such a nature that they may affect the auditor’s ability to carry on business.

(k) Whether the events identified are of such a nature that they may affect the auditor’s ability to carry on business.

(l) Whether the events identified are of such a nature that they may affect the auditor’s ability to carry on business.

(m) Whether the events identified are of such a nature that they may affect the auditor’s ability to carry on business.

(n) Whether the events identified are of such a nature that they may affect the auditor’s ability to carry on business.

(o) Whether the events identified are of such a nature that they may affect the auditor’s ability to carry on business.

(p) Whether the events identified are of such a nature that they may affect the auditor’s ability to carry on business.

(q) Whether the events identified are of such a nature that they may affect the auditor’s ability to carry on business.

(r) Whether the events identified are of such a nature that they may affect the auditor’s ability to carry on business.

(s) Whether the events identified are of such a nature that they may affect the auditor’s ability to carry on business.

(t) Whether the events identified are of such a nature that they may affect the auditor’s ability to carry on business.

(u) Whether the events identified are of such a nature that they may affect the auditor’s ability to carry on business.

(v) Whether the events identified are of such a nature that they may affect the auditor’s ability to carry on business.

(w) Whether the events identified are of such a nature that they may affect the auditor’s ability to carry on business.

(x) Whether the events identified are of such a nature that they may affect the auditor’s ability to carry on business.

(y) Whether the events identified are of such a nature that they may affect the auditor’s ability to carry on business.

(z) Whether the events identified are of such a nature that they may affect the auditor’s ability to carry on business.
## 3.21 Auditor And The Going Concern Assumption

### 1. Going Concern Basis of Accounting

Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

### 2. Objectives of the auditor regarding going concern

The objectives of the auditor are:

- **(a)** To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;

- **(b)** To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations, if determined necessary by the auditor or required by other SAs; and

- **(c)** To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.

### 3. Responsibilities of the Auditor

1. The auditor’s responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management’s use of the going concern basis of accounting in the preparation of the financial statements.
and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity’s ability to continue as a going concern.

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

### 3.22 Events or Conditions That May Cast Significant Doubt on the Entity’s Ability to Continue as a Going Concern

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

<table>
<thead>
<tr>
<th>1. Financial</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Net liability or net current liability position.</td>
</tr>
<tr>
<td>b) Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.</td>
</tr>
<tr>
<td>c) Indications of withdrawal of financial support by creditors.</td>
</tr>
<tr>
<td>d) Negative operating cash flows indicated by historical or prospective financial statements.</td>
</tr>
<tr>
<td>e) Adverse key financial ratios.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2. Operating</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Management intentions to liquidate the entity or to cease operations.</td>
</tr>
<tr>
<td>b) Loss of key management without replacement.</td>
</tr>
<tr>
<td>c) Loss of a major market, key customer(s), franchise, license, or principal supplier(s).</td>
</tr>
<tr>
<td>d) Labor difficulties.</td>
</tr>
<tr>
<td>e) Shortages of important supplies.</td>
</tr>
<tr>
<td>f) Emergence of a highly successful competitor.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>3. Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Non-compliance with capital or other statutory or regulatory requirements, such as solvency or liquidity requirements for financial institutions.</td>
</tr>
<tr>
<td>b) Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.</td>
</tr>
<tr>
<td>c) Changes in law or regulation or government policy expected to adversely affect the entity.</td>
</tr>
<tr>
<td>d) Uninsured or underinsured catastrophes when they occur.</td>
</tr>
</tbody>
</table>

### 3.23 Additional Audit Procedures When Events or Conditions Are Identified

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

<table>
<thead>
<tr>
<th>1. Requesting mgt to perform assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Where management has not yet performed an assessment of the entity’s ability to continue as a going concern, requesting management to make its assessment.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2. Verifying mgt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Evaluating management’s plans for future actions in relation to its going concern</td>
</tr>
<tr>
<td>assessment</td>
</tr>
<tr>
<td>---</td>
</tr>
</tbody>
</table>
| 3. Verifying cash flow forecast | Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management’s plans for future actions:  
   (i) Evaluating the reliability of the underlying data generated to prepare the forecast; and  
   (ii) Determining whether there is adequate support for the assumptions underlying the forecast. |
| 4. Additional facts | Considering whether any additional facts or information have become available since the date on which management made its assessment. |
| 5. W.R from mgt | Requesting written representations from management regarding their future action plans and the feasibility of these plans. |
| 6. Other audit procedures | Audit procedures that are relevant to the requirement as stated above may include the following:  
   a) Analyzing and discussing cash flow, profit and other relevant forecasts with management.  
   b) Analyzing and discussing the entity’s latest available interim financial statements.  
   c) Reading the terms of debentures and loan agreements and determining whether any have been breached.  
   d) Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.  
   e) Inquiring of the entity’s legal counsel regarding the existence of litigation and claims and the reasonableness of management’s assessments of their outcome and the estimate of their financial implications.  
   f) Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.  
   g) Evaluating the entity’s plans to deal with unfilled customer orders.  
   h) Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity’s ability to continue as a going concern.  
   i) Confirming the existence, terms and adequacy of borrowing facilities.  
   j) Obtaining and reviewing reports of regulatory actions.  
   k) Determining the adequacy of support for any planned disposals of assets. |
# Chapter-4
## Risk assessment and Internal Control

### 4.1 Audit Risk

<table>
<thead>
<tr>
<th>1. Definition of Audit risk</th>
<th>Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statement are materially misstated. Thus, it is the risk that the auditor may fail to express an appropriate opinion in an audit assignment.</th>
</tr>
</thead>
</table>
| 2. Audit risks is a function of .... | Audit risk is a function of the risks of material misstatement and detection risk.  
**Audit Risk = Risk of Material Misstatement x Detection Risk** |
| 3. Definition of Risk of material mis-statement | **Risk of material misstatement 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:  
4. **Inherent risk**—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.  
5. **Control risk**—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. |
| 4. Definition of mis-statements | **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. |
| 5. Assessment of Risks - Matter of Professional Judgement | 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. |
| 6. What is not included in Audit Risk ? | 6. 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.  
7. Further, 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. |
| 7. Risks of Material Misstatement at Two levels | The risks of material misstatement may exist at two levels:  
8. **The overall financial statement level**- 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.  
9. **The assertion level for classes of transactions, account balances, and disclosures**- 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. |
### Questions

<table>
<thead>
<tr>
<th>Q 1</th>
<th>Risk of material misstatement consists of two components “ Explain clearly defining risk of material misstatement . (SM)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q 2</td>
<td>Define Risk of material misstatement . Explain its components also . (SM)</td>
</tr>
</tbody>
</table>

### 4.2 Inherent risk

<table>
<thead>
<tr>
<th>1. Definition</th>
<th>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.</th>
</tr>
</thead>
</table>
| 2. Factors affecting inherent risks | a) Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others.  
  b) For example, it may be higher for complex calculations.  
  c) External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete.  
  d) Factors in the entity and its environment may also influence the inherent risk related to a specific assertion. For example A lack of sufficient working capital to continue operations or a declining industry characterised by a large number of business failures. |
| 3. Assessment of inherent risks | a) Inherent risk factors are considered while designing tests of controls and substantive procedures.  
  b) Category of auditor’s assessment lower or higher, each category covers a range of degrees of inherent risk.  
  c) 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.  
  d) 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. |

### 4.3 Control risk

<table>
<thead>
<tr>
<th>1. Definition</th>
<th>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.</th>
</tr>
</thead>
</table>
| 2. Factors affecting control risk | a) **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.  
  b) This is because of the inherent limitations of internal control. For example The possibility of human errors or mistakes, or of controls being circumvented by collusion. Accordingly, some control risk will always exist. |
| 3. Control risk assessment | **Auditor assesses control risk as Rely or Not rely on Controls.**  
  When making control risk assessments, consider:  
  a) The control environment’s influence over internal control. A control environment that supports the prevention, and detection and correction, of material misstatements allows greater confidence in the reliability of internal control and audit evidence generated within the entity. However it does not guarantee the |
effectiveness of specific controls. We therefore, test the operating
effectiveness of controls over significant class of transactions (SCOTs) when
we plan to take a controls reliance strategy. Conversely, the control
environment may undermine the effectiveness of specific controls and is a key
factor in our control risk assessments.

b) Evaluations of the related IT processes that support application and IT-
dependent manual controls.

c) Our testing approach over SCOTs and disclosure processes (i.e., controls
reliance or substantive only strategy).

d) The expectation of the operating effectiveness of controls based on the
understanding of entity’s processes.

4.Effect of deficiencies identified on control risk assessment

a) 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.

b) 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.’

c) 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.

Questions

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 were no related
internal controls. (SM)

4.4 Combined Assessment of the Risk of Material Misstatement

1.Risk of material misstatements are entities risks

Inherent risk and control risk are the entity’s risks; they exist independently of the
audit of the financial statements.

2.Combined assessment of risk of material mis-statement

a) 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”.

b) However, the auditor may make separate or combined assessments of inherent
and control risk depending on preferred audit techniques or methodologies and
practical considerations.

c) 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.

Questions

The SAs do not ordinarily refer to inherent risk and control risk separately but rather
to a combined assessment of the “risk of material misstatement”. Explain (SM)
### 4.5 Detection Risk

| Definition | 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. |

### 4.6 Illustration explaining three types of risks

| 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. |
| 1. Inherent Risk | Because items may have been misappropriated by employees, therefore, risk to the auditor is that inventory records would be inaccurate. |
| 2. 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. |
| 3. 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. |

### 4.7 Identifying And Assessing The Risks Of Material Misstatement

| Auditors duty to identify and assess risk | 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. |
| Risk shall be identified and assessed at 2 levels | The auditor shall identify and assess the risks of material misstatement at: the financial statement level; the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures. |
| Auditors strategy on risks | For the purpose of Identifying and assessing the risks of material misstatement, the auditor shall: 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; Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions; 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 Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that
### Auditing and Assurance

<table>
<thead>
<tr>
<th>4. Steps to identify and assess risk</th>
<th>Following two steps should be used to identify and assess risk</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>→ Performing risk assessment procedures</td>
</tr>
<tr>
<td></td>
<td>→ Understanding entity and its environment</td>
</tr>
</tbody>
</table>

### 4.8 Risk Assessment Procedures

<table>
<thead>
<tr>
<th>1. Definition</th>
<th>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.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Information obtained by performing risk assessment procedures</td>
<td>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.</td>
</tr>
<tr>
<td>3. The risks to be assessed include both those due to error and those due to fraud</td>
<td>The risks to be assessed include both those due to error and those due to fraud, and both are covered by this SA.</td>
</tr>
<tr>
<td>4. The risk assessment procedures shall include the following</td>
<td></td>
</tr>
<tr>
<td>4(a) Inquiries</td>
<td>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. 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.</td>
</tr>
</tbody>
</table>
| 4(b) Analytical Procedures | a) 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, the relationship between sales and square footage of selling space or volume of goods sold.  

b) 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.  

c) 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. |
| 4(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:
  a) The entity’s operations.
  b) Documents (such as business plans and strategies), records, and internal control manuals.
  c) Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors’ meetings).
  d) The entity’s premises and plant facilities.

### 4.9 Understanding Of The Entity

#### 1. It is a continuous process

Obtaining an understanding of the entity and its environment, including the entity’s internal control (referred to hereafter as an “understanding of the entity”), is a continuous, dynamic process of gathering, updating and analysing information throughout the audit.

#### 2. Understanding acts as a frame of reference

The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:
  a) Assessing risks of material misstatement of the financial statements;
  b) Determining materiality in accordance with SA 320;
  c) Considering the appropriateness of the selection and application of accounting policies;
  d) 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;
  e) Developing expectations for use when performing analytical procedures;
  f) Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management’s oral and written representations.

#### 3. How to obtain understanding

The auditor shall obtain an understanding of the following:
(a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework.
(b) The nature of the entity, including:
   (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.
(c) The entity’s selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity’s accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.
(d) The entity’s objectives and strategies, and those related business risks that may result in risks of material misstatement.
(e) The measurement and review of the entity’s financial performance.
### 4.10 Internal Control

**1. Definition**

As per SA-315, 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.

**2. Objectives**

*to ensure that*

(i) transactions are executed in accordance with management’s 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.

### 4.11 Limitations of Internal Control

**1. 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.

**2. 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.

**3. 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.

**4. 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.

**5. 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.

**6. 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
## 4.12 Understanding ICS

### 1. Auditor duty

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.

### 2. Understanding the design and implementation of controls

| a) | 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. An improperly designed control may represent a significant deficiency in internal control. |
| b) | 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. |

### 3. 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 designing the nature, timing, and extent of further audit procedures.

### 4. Factors determining whether controls is relevant to audit

| a) | Materiality. |
| b) | The significance of the related risk. |
| c) | The size of the entity. |
| d) | The nature of the entity’s business, including its organisation and ownership characteristics. |
| e) | The diversity and complexity of the entity’s operations. |
| f) | Applicable legal and regulatory requirements. |
| g) | The circumstances and the applicable component of internal control. |
| h) | The nature and complexity of the systems that are part of the entity’s internal control, including the use of service organisations. |
| i) | Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement. |

### 5. Examples of control relevant to audit

| 5(a) Controls over the completeness and accuracy of information | Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures. For example, in auditing revenue by applying standard prices to records of sales volume, the auditor considers the accuracy of the price information and the completeness and accuracy of the sales volume data. Controls relating to operations and compliance objectives may also be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures. |
| 5(b) Internal control over safeguarding of assets | Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor’s consideration 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. |

### Questions

Maintenance of internal control system is the responsibility of the statutory Auditor.
### 4.13 Components of Internal Control

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:

<table>
<thead>
<tr>
<th>5 components</th>
<th></th>
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</thead>
<tbody>
<tr>
<td>(A)</td>
<td>The control environment;</td>
</tr>
<tr>
<td>(B)</td>
<td>The entity’s risk assessment process</td>
</tr>
<tr>
<td>(C)</td>
<td>The information system, including the related business processes, relevant to financial reporting, and communication</td>
</tr>
<tr>
<td>(D)</td>
<td>Control activities</td>
</tr>
<tr>
<td>(E)</td>
<td>Monitoring of controls.</td>
</tr>
</tbody>
</table>

### 4.14 Control Environment

1. **Obtaining understanding**

   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 behavior; and
   - (ii) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

2. **Things 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.

3. **Elements of the Control Environment**

   **3(a) Communication and enforcement of integrity and ethical values**

   These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.

   **3(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.

   **3(c) Participation by those charged with governance**

   Attributes of those charged with governance such as:
   - a) Their independence from management.
   - b) Their experience and stature.
   - c) The extent of their involvement and the information they receive, and the scrutiny of activities.
   - d) The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.

   **3(d) Management’s philosophy and operating style**

   Characteristics such as management’s:
   - a) Approach to taking and managing business risks.
   - b) Attitudes and actions toward financial reporting.
   - c) Attitudes toward information processing and accounting functions and personnel.

   **3(e) Organisation**

   The framework, within which an entity’s activities for achieving its objectives are
<table>
<thead>
<tr>
<th>I structure</th>
<th>planned, executed, controlled, and reviewed.</th>
</tr>
</thead>
<tbody>
<tr>
<td>3(f) Assignment of authority and responsibility</td>
<td>Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.</td>
</tr>
<tr>
<td>3(g) Human resource policies and practices</td>
<td>Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.</td>
</tr>
<tr>
<td>Questions</td>
<td>The auditor shall obtain an understanding of the control environment “Explain stating what is included in control environment.” (SM)</td>
</tr>
</tbody>
</table>

### 4.15 The Entity’s Risk Assessment Process

The auditor shall obtain an understanding of entities risk assessment process

1. Process shall cover
   - Identifying business risks relevant to financial reporting objectives;
   - Estimating the significance of the risks;
   - Assessing the likelihood of their occurrence; and
   - Deciding about actions to address those risks.

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

### 4.16 The Information System

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

1. Other things to be understood
   - (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.

### 4.17 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.

1. Meaning
   - a) Control activities are the policies and procedures that help ensure that management directives are carried out.
   - b) Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels.
   - c) Some examples of control activities can be – authorization, segregation of duties, physical control, performance reviews or information processing.

2. Control
   - Control activities that are relevant to the audit are:
| activities relevant to audit | a) Control activities that relate to **significant risks** and those that relate to risks for which substantive procedures alone do not provide **sufficient appropriate audit evidence**; or
| | b) Those that are considered to be relevant in the judgment of the auditor. |

### 4.18 Significant risks

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.

#### 1. Factors to be considered

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

- **(3)** Whether the risk is a risk of fraud;
- **(4)** Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention;
- **(5)** The complexity of transactions;
- **(6)** Whether the risk involves significant transactions with related parties;
- **(7)** 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
- **(8)** Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

#### 2. Identifying Significant Risks

Significant risks often relate to significant non-routine transactions or judgmental matters.

- **2(a) Non-routine transactions**
  Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. 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.

- **2(b) Judgmental matters**
  Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty. 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.

### 4.19 Monitoring of Controls

#### 1. Definition

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

#### 2. Benefits of monitoring

It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions.

#### 3. Monitoring activities may include

- **a)** 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.
b) 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.

c) Management’s monitoring of control is often accomplished by management’s or the owner-manager’s close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.

d) If the entity has an internal audit function

   If the entity has an internal audit function, the auditor shall obtain an understanding of the following:
   → The internal audit function’s responsibilities and how the internal audit function fits in the entity’s organisational structure; and
   → The activities performed, or to be performed, by the internal audit function.

Questions

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

4.20 Evaluation Of Internal Control By The Auditor

| 1. Auditor should evaluate ICS | 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. |
| 2. Evaluation helps in obtaining reasonable assurance | 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. |
| 3. Auditor should study as well test operation of ICS | The auditor should gain an understanding of the accounting system and related internal controls and should study and evaluate the operations of these internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures. |

4.21 Benefits of Evaluation of Internal Control to the Auditor

The review of internal controls will enable the auditor to know:

1. Probability of errors whether errors and frauds are likely to be located in the ordinary course of operations of the business.
2. Adequate ICS whether an adequate internal control system is in use and operating as planned by the management.
3. Effective internal audit whether an effective internal auditing department is operating;
4. Administrative controls 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.
5. Assets safeguarded whether the controls adequately safeguard the assets.
6. Recording transactions how far and how adequately the management is discharging its function in so far as correct recording of transactions is concerned.
7. Reliability of how reliable the reports, records and the certificates to the management can be.
8. Extent of checking
the extent and the depth of the examination that he needs to carry out in the different areas of accounting.

9. Nature of audit procedures
what would be appropriate audit technique and the audit procedure in the given circumstances.

10. Weak and excessive areas
what are the areas where control is weak and where it is excessive.

11. Suggestion to improve ICS
whether some worthwhile suggestions can be given to improve the control system.

Questions
Test of control are performed to obtain audit evidence about the effectiveness of internal controls systems. (SM)

4.22 Formulate Audit Program after understanding Internal Control

1. Audit programme and ICS
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.

2. Importance of ICS prior to audit programme
2(a) To avoid unnecessary work
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.

2(b) To avoid confusion
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.

2(c) Weakness can be identified as well as reported
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.

2(d) Deciding appropriate procedures
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.

2(e) Extent of checking
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.
4.23 Evaluation of Internal Control– Methods

<table>
<thead>
<tr>
<th>Method</th>
<th>Description</th>
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<tbody>
<tr>
<td><strong>1. The Narrative Record</strong></td>
<td>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.</td>
</tr>
</tbody>
</table>
| **2. A Check List**             | 1. 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. 2. **A few examples of check list instructions are given hereunder:**  
   a) Are tenders called before placing orders?  
   b) Are the purchases made on the basis of a written order?  
   c) Is the purchase order form standardised?  
   d) Are purchase order forms pre-numbered?  
   e) 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?  
   3. The complete check list is studied by the Principal/Manager/Senior to ascertain existence of internal control and evaluate its implementation and efficiency. |
| **3. Internal Control Questionnaire** | 1. 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.  
   2. 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. |
3. 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.

4. Flow Chart

1. 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.

2. 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.

4.24 Testing Of Internal Control

1. After assimilating auditor should start testing

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. Selective testing is being done by application of procedural tests and auditing in depth.

2. Purpose of test of controls

Test of controls are performed to obtain audit evidence about the effectiveness of the-
- Design of ICS
- Operation of internal controls throughout the period

3. Examples of test of controls

a) 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.

b) 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.

c) 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.

d) Testing of internal control operating on specific computerised applications or over the overall information technology function, for example, access or program change controls.

4. Manner of testing

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.
### Results of testing

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.

### 4.25 Internal Control And IT Environment

The characteristics of manual or automated elements relevant to the auditor’s risk assessment and further audit procedures are explained hereunder:

| 1. Controls in Manual and IT System | The use of manual or automated elements in internal control affects the manner in which transactions are initiated, recorded, processed, and reported:  
(iii) 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.  
(iv) 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. |
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<tr>
<td>2. Mix controls</td>
<td>An entity’s mix of manual and automated elements in internal control varies with the nature and complexity of the entity’s use of IT.</td>
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</tbody>
</table>
| 3. Benefits of I.T controls      | Generally, IT benefits an entity’s internal control by enabling an entity to:  
a) Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;  
b) Enhance the timeliness, availability, and accuracy of information;  
c) Facilitate the additional analysis of information;  
d) Enhance the ability to monitor the performance of the entity’s activities and its policies and procedures;  
e) Reduce the risk that controls will be circumvented; and  
f) Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems. |
| 4. Risks arising because of IT controls | 3. IT also poses specific risks to an entity’s internal control, including, for example:  
a) Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.  
b) Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.  
c) The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.  
d) Unauthorised changes to data in master files.  
e) Unauthorised changes to systems or programs.  
f) Failure to make necessary changes to systems or programs. |
Inappropriate manual intervention.
- Potential loss of data or inability to access data as required.

5. Suitability
- Manual elements in internal control may be more suitable where judgment and discretion are required.

6. Reliability
- 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.

7. Nature of Entity’s Information System
- 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.

4.26 Materiality and Audit Risk

1. Applying 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.

2. Auditor overall objective
- In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor’s findings. The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.

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

4. Considering materiality and audit risk together
- Materiality and audit risk are considered throughout the audit, in particular, when:
  1. Identifying and assessing the risks of material misstatement;
  2. Determining the nature, timing and extent of further audit procedures; and
  3. Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor’s report.

Questions
- There is direct relationship between materiality and the degree of audit risk (SM)

4.27 Documenting the Risk

1. Documenting should contain
- The discussion among the engagement team and the significant decisions reached;
- 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;
- The identified and assessed risks of material misstatement at the financial statement level and at the assertion level; and
- The risks identified, and related controls about which the auditor has obtained
4.28 Internal Audit

1. Definition
As defined in the Standards on Internal Audit, **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”.

2. Applicability of Provisions of Internal Audit
As per section 138 of the Companies Act, 2013, the following class of companies (prescribed in rule 13 of Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely:

4. every listed company;
5. every unlisted public company having-
   i. paid up share capital of fifty crore rupees or more during the preceding financial year; or
   ii. turnover of two hundred crore rupees or more during the preceding financial year; or
   iii. outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or
   iv. outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and
(c) every private company having-
   i. turnover of two hundred crore rupees or more during the preceding financial year; or
   ii. outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year:

It is provided that an existing company covered under any of the above criteria shall comply with the requirements within six months of commencement of such section.

3. Who can be appointed as Internal Auditor?
As per section 138, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in practice or not), or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies. The internal auditor may or may not be an employee of the company.

4. Internal audit function
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.

Questions
As per section 138 of the Companies Act, 2013, private companies are not required to appoint internal auditor (SM)

4.29 The objectives and scope of internal audit functions

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:

#### 3(a) 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.

#### 3(b) 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.

#### 3(c) 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.

#### 3(d) 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.

### 4.30 Basics Of Standards On Internal Audit Issued By ICAI

#### 1. Constitution of Committee on Internal Audit

Considering the increasing importance of internal auditing, the Institute of Chartered Accountants of India has constituted a Committee on Internal Audit (CIA) as a non-standing committee on February 5, 2004. The CIA was constituted with the object of formulating Standards and Guidance Notes on Internal Audit now it is known as Internal Audit Standard Board.

#### 2. Issuance of Standards On Internal Audit (SIA)

The Board has, till date, issued eighteen Standards on Internal Audit (SIAs) and the list is given below. The SIAs aim to codify the best practices in the area of internal audit and also serve to provide a benchmark of the performance of the internal audit services. While formulating SIAs, the Board takes into consideration the applicable laws, customs, usages and business environment and generally accepted auditing practices in India.

#### 3. SIAs are Optional in nature

The following SIAs are recommendatory in nature. The Standards shall become mandatory from such date as notified by the council.

#### 4. List of SIAs Notified Till Date

- **SIA 1**: Planning an Internal Audit.
- **SIA 2**: Basic Principles Governing Internal Audit
- **SIA 3**: Documentation.
- **SIA 4**: Reporting.
- **SIA 5**: Sampling.
- **SIA 6**: Analytical Procedures.
- **SIA 7**: Quality Assurance in Audit.
- **SIA 8**: Terms of Internal Audit.
- **SIA 9**: Communication with Management.
- **SIA 10**: Internal Audit Evidence.
- **SIA 11**: Consideration Of Fraud in an Internal Audit.
- **SIA 12**: Internal Control Evaluation.
4.31 Internal Financial Control And Reporting Requirements

1. Definition

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.”

2. Purpose of internal financial control

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.”

3. Reporting on Internal Financial Controls over Financial Reporting

a) Clause (i) of Sub-section 3 of Section 143 of the Act requires the auditors’ report to state whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.
b) It may be noted that auditor’s reporting on internal financial controls is a requirement specified in the Act and, therefore, will apply only in case of reporting on financial statements prepared under the Act and reported under Section 143.
c) Accordingly, reporting on internal financial controls will not be applicable with respect to interim financial statements, such as quarterly or half-yearly financial statements, unless such reporting is required under any other law or regulation.

4. Reporting in board report

a) Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the board report of all companies to state the details in respect of adequacy of internal financial controls with reference to the financial statements.
b) The inclusion of the matters relating to internal financial controls in the directors responsibility statement is in addition to the requirement of the directors stating that they have taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the 2013 Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.

4.32 Internal Financial Control Vs Internal Control Over Financial Reporting

1. Internal Financial Control

Internal Financial Control as per Section 134(5)(e), “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.”

| 2. Internal controls over financial reporting | 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. |
## Fraud and Responsibilities of The auditor

### 5.1 Fraud

<table>
<thead>
<tr>
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<th>The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements” defines the term ‘fraud’ as-</th>
</tr>
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<tbody>
<tr>
<td>1. Definition</td>
<td>→ “an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage”.</td>
</tr>
<tr>
<td></td>
<td>→ Although fraud is a broad legal concept, for the purposes of the SAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements.</td>
</tr>
<tr>
<td>2. Fraud is Intentional</td>
<td>Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.</td>
</tr>
<tr>
<td>3. Two types of intentional misstatements</td>
<td>Two types of intentional misstatements are relevant to the auditor— misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.</td>
</tr>
</tbody>
</table>

### 3 Fraudulent financial reporting

#### 3(a) Manipulation of Accounts:

Detection of manipulation of accounts with a view to presenting a false state of affairs is a task requiring great tact and intelligence because generally management personnel in higher management cadre are associated with this type of fraud and this is perpetrated in methodical way. This type of fraud is generally committed Detection of manipulation of accounts with a view to presenting a false state of affairs is a task requiring great tact and intelligence because generally management personnel in higher management cadre are associated with this type of fraud and this is perpetrated in methodical way. This type of fraud is generally committed

(a) to avoid incidence of income-tax or other taxes;
(b) for declaring a dividend when there are insufficient profits;
(c) to withhold declaration of dividend even when there is adequate profit (this is often done to manipulate the value of shares in stock market to make it possible for selected persons to acquire shares at a lower cost); and
(d) for receiving higher remuneration where managerial remuneration is payable by reference to profits.

There are numerous ways of committing this type of fraud. Some of the methods are given below:

(i) inflating or suppressing purchases and expenses;
(ii) inflating or suppressing sales and other items of income,
(iii) inflating or deflating the value of closing inventory;
(iv) failing to adjust outstanding liabilities or prepaid expenses; and charging items of capital expenditure to revenue or by capitalising revenue expenses

#### 3(b) Misrepresentation

Misrepresentation in or intentional omission from, the financial statements of events, transactions or other significant information.

### Intentional

Intentional misapplication of accounting principles relating to amounts,
<table>
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<th>misapplication of accounting principles</th>
<th>classification, manner of presentation, or disclosure.</th>
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| 4. Fraudulent financial reporting by overriding controls | Fraud can be committed by management overriding controls using such techniques as:  
→ Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.  
→ Inappropriately adjusting assumptions and changing judgments used to estimate account balances.  
→ Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.  
→ Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.  
→ Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.  
→ Altering records and terms related to significant and unusual transactions. |
| 5. Reasons for committing frauds | Following are certain instances which will help to understand these questions:  
→ Financial obligations/ Pressure.  
→ Management’s unrealistic goals.  
→ Dissatisfied Employees or Lack of motivation among employees.  
→ Name game (eg. management using power of authority by asking employees to do something illegal).  
→ Opportunity to commit fraud. |
| 6. Misappropriation of Assets: | It involves the theft of an entity’s assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:  
→ Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).  
→ Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).  
→ Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity’s purchasing agents in return for inflating prices, payments to fictitious employees).  
→ Using an entity’s assets for personal use (for example, using the entity’s assets as collateral for a personal loan or a loan to a related party). |
| 6(a) Misappropriation of Goods | Fraud in the form of misappropriation of goods is still more difficult to detect; for this management has to rely on various measures. Apart from the various requirements of record keeping about the physical quantities and their periodic checks, there must be rules and procedures for allowing persons inside the area where goods are kept. In addition there should be external security arrangements to see that no goods are taken out without proper authority. |
Goods can be anything in the premises; it may be machinery. It may even be the daily necessities of the office like stationery. The goods may be removed by subordinate employees or even by persons quite higher up in the management. Auditors can detect this by undertaking a thorough and strenuous checking of records followed by physical verification process. Also, by resorting to intelligent ratio analysis, auditors may be able to form an idea whether such fraud exists.

6(b) Defalcation of Cash
Defalcation of cash has been found to perpetrate generally in the following ways:

(a) By inflating cash payments:
Examples of inflation of payments:
- Making payments against fictitious vouchers.
- Making payments against vouchers, the amounts whereof have been inflated.
- Manipulating totals of wage rolls either by including therein names of dummy workers or by inflating them in any other manner.
- Casting a larger totals for petty cash expenditure and adjusting the excess in the totals of the detailed columns so that cross totals show agreement.

(b) By suppressing cash receipts:
Few techniques of how receipts are suppressed are:
- Teeming and Lading: Amount received from a customer being misappropriated; also to prevent its detection the money received from another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, moneys received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.
- Adjusting unauthorised or fictitious rebates, allowances, discounts, etc. to customer' accounts and misappropriating amount paid by them.
- Writing off as debts in respect of such balances against which cash has already been received but has been misappropriated.
- Not accounting for cash sales fully.
- Not accounting for miscellaneous receipts, e.g., sale of scrap, quarters allotted to the employees, etc.
- Writing down asset values in entirety, selling them subsequently and misappropriating the proceeds.

(c) By casting wrong totals in the cash book.

Questions
Q 1 Teeming and lading is one of the techniques of inflating cash payments. (SM)
Q 2 Fraud can be termed as intentional error. (SM)
Q 3 Fraudulent financial reporting only involve manipulation, falsification or alteration of accounting records or supporting documents from which financial statements are prepared. (SM)
Q 4 What do you understand by the term ‘fraud’? provide its meaning as given under the standard on Auditing (SA) 240. (SM)
Q 5 There are many ways for cash defalcation, one of which is by suppressing cash receipts. List out few techniques of how the receipts are suppressed. (SM)

5.2 Detection Of Fraud And Error – Duty Of An Auditor

1. Management responsibility

As per SA 240 “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention.

2. Auditor responsibility

An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. As described in SA 200, “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing,” owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.

3. Fraud may be carefully organized

→ The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor.
→ Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false.
→ The auditor’s ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved.
→ While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

4. Management fraud vs employee fraud

Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.

5. Auditor to keep skepticism

When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

Questions

The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. (SM)
# 5.3 Fraud Risk Factors

<table>
<thead>
<tr>
<th>1. Definition</th>
<th>Fraud Risk Factors may be defined as events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.</th>
</tr>
</thead>
</table>
| 2. Classification | **Examples of Fraud Risk Factors:** The fraud risk factors identified here are examples of such factors that may be faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor’s consideration, i.e.,
   - a) fraudulent financial reporting, and
   - b) misappropriation of assets
   For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur:
   - incentives/pressures,
   - opportunities, and
   - attitudes/rationalizations. |

**Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting:** The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting -

| 1. Incentives/Pressures: | Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):
   1. High degree of competition or market saturation, accompanied by declining margins.
   2. High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
   3. Significant declines in customer demand and increasing business failures in either the industry or overall economy.
   4. Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent.
   5. Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.
   6. New accounting, statutory, or regulatory requirements. |
| 2. Opportunities: | The nature of the industry or the entity’s operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:
   8. Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
   9. A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm’s-length transactions.
   10. Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
   11. Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult “substance over form” questions.
   12. Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification. |
| 3. Attitudes/Rationalizations: | Communication, implementation, support, or enforcement of the entity’s values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective.
   10. Known history of violations of securities laws or other laws and regulations.
   11. Excessive interest by management in maintaining or increasing the entity’s inventory price or earnings trend.
   12. Management failing to remedy known significant deficiencies in internal control on a timely basis. |
| 13. | An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons. |
| 14. | The owner-manager makes no distinction between personal and business transactions. |
| 15. | The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:  
   - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.  
   - Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor’s report.  
   - Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.  
   - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor’s work or the selection or continuance of personnel assigned to or consulted on the audit engagement. |

**B. Risk Factors Arising from Misstatements Arising from Misappropriation of Assets:** The following are examples of risk factors related to misstatements arising from misappropriation of assets:

| **1. Incentives/Pressures:** | Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.  
   - Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:  
     - Known or anticipated future employee layoffs.  
     - Recent or anticipated changes to employee compensation or benefit plans.  
     - Promotions, compensation, or other rewards inconsistent with expectations. |
| **2. Opportunities:** | Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:  
   - Large amounts of cash on hand or processed.  
   - Inventory items that are small in size, of high value, or in high demand.  
   - Easily convertible assets, such as bearer bonds, diamonds, or computer chips.  
   - Fixed assets which are small in size, marketable, or lacking observable identification of ownership. |

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. **For example, misappropriation of assets may occur because there is the following:**  
- Inadequate segregation of duties or independent checks.  
- Inadequate oversight of senior management expenditures, such as travel and other reimbursements.  
- Inadequate record keeping with respect to assets.  
- Inadequate system of authorization and approval of transactions (for example, in purchasing).
| 3. Attitudes/Rationalizations: | Disregard for the need for monitoring or reducing risks related to misappropriations of assets.  
→ Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.  
→ Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee.  
→ Changes in behavior or lifestyle that may indicate assets have been misappropriated  
→ Tolerance of petty theft. |
| Questions | Fraud Risk Factor are the events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud. Further, the nature of the industry or the entity’s operations also provides opportunities to engage in fraudulent financial reporting. List out some of the cases from where these opportunities may arise (SM) |

### 5.4 Circumstances Relating to Possibility of Fraud

The following are examples of circumstances that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud:

**A) Discrepancies in the accounting records, including:**
- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.  
- Unsupported or unauthorized balances or transactions.  
- Last-minute adjustments that significantly affect financial results.  
- Evidence of employees’ access to systems and records inconsistent with that necessary to perform their authorized duties.  
- Tips or complaints to the auditor about alleged fraud.

**B) Conflicting or missing evidence, including:**
- Missing documents.  
- Documents that appear to have been altered.  
- Significant unexplained items on reconciliations.  
- Unusual discrepancies between the entity’s records and confirmation replies.  
- Large numbers of credit entries and other adjustments made to accounts receivable records.  
- Missing or non-existent cancelled cheques in circumstances where cancelled cheques are ordinarily returned to the entity with the bank statement.  
- Missing inventory or physical assets of significant magnitude.  
- Unavailable or missing electronic evidence, inconsistent with the entity’s record.
| (d) Problematic or unusual relationships between the auditor and management, including: | → Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.  
→ Undue time pressures imposed by management to resolve complex or contentious issues.  
→ Unusual delays by the entity in providing requested information.  
→ Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.  
→ Denial of access to key IT operations staff and facilities, including security operations, and systems development personnel.  
→ An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable.  
→ An unwillingness to address identified deficiencies in internal control on a timely basis. |
| **(D)Other** | → Unwillingness by management to permit the auditor to meet privately with those charged with governance.  
→ Accounting policies that appear to be at variance with industry norms.  
→ Frequent changes in accounting estimates that do not appear to result from changed circumstances.  
→ Tolerance of violations of the entity’s Code of Conduct. |
| **Questions** | Q 1 Fraud can be committed management overriding controls using techniques as engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity. (SM)  
Q 2 Intelligent Ltd. entered into an agreement with Mr. Intellectual on 15th March 2017, where by it agreed to pay him Rs 2 lakhs per month as retainership fee for consultation in IT department. However, on investigation, no documentary or other evidence of receipt of such service was found. As the auditor of innocent Ltd., what would be your approach? (SM) |

### 5.5 Fraud Reporting

| **1. Reporting to the Central Government** | As per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as statutory auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of `1 crore or above, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government. |
| **2. The manner of reporting the matter to the Central Government is as follows** | (c) the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;  
(d) on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days from the date of receipt of such reply or observations;  
(f) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for
which he has not received any reply or observations the report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;

(g) the report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and

(h) the report shall be in the form of a statement as specified in Form ADT-4.

3. Reporting to the Audit Committee or Board:

Sub-section (12) of section 143 of the Companies Act, 2013 further prescribes that in case of a fraud involving lesser than the specified amount [i.e. less than `1 crore], the auditor shall report the matter to Audit Committee constituted under section 177 or to the Board immediately but not later than 2 days of his knowledge of the fraud and he shall report the matter specifying the following:

(a) Nature of Fraud with description;
(b) Approximate amount involved; and
(c) Parties involved.

4. Disclosure in the Board’s Report:

Sub-section (12) of section 143 of the Companies Act, 2013 furthermore prescribes that the companies, whose auditors have reported frauds to the audit committee or the Board, but not reported to the Central Government, shall disclose the following details about such frauds in the Board’s report during the year:

(b) Nature of Fraud with description;
(c) Approximate Amount involved;
(d) Parties involved, if remedial action not taken; and
(e) Remedial actions taken.

5. Safeguard to auditor

Sub-section (13) of section 143 of the Companies Act, 2013 safeguards the act of fraud reporting by the auditor if it is done in good faith. It states that no duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter above if it is done in good faith.

6. Reporting also applicable on cost auditor as well as secretarial auditor

It is very important to note that these provisions shall also apply, mutatis mutandis, to a cost auditor and a secretarial auditor during the performance of his duties under section 148 and section 204 respectively. If any auditor, cost accountant or company secretary in practice do not comply with the provisions of sub-section (12) of section 143, he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.

7. Reporting on Frauds already detected and reported:

→ The auditor should apply professional skepticism to evaluate/verify that the fraud was indeed identified/detected in all aspects by the management or through the company’s vigil whistleblower mechanism so that distinction can be clearly made with respect to frauds identified/ detected due to matters raised by the auditor vis-à-vis those identified/detected by the company through its internal control mechanism.

→ Since reporting on fraud under section 143(12) is required even by the cost auditor and the secretarial auditor of the company, it is possible that a suspected offence involving fraud may have been reported by them even before the auditor became aware of the fraud. Here too, if a suspected offence of fraud has already been reported under section 143(12) by such other person, and the auditor becomes aware of such suspected offence involving fraud, he need not report the same since he has not per se identified the suspected offence of fraud.


The auditor is also required to report under clause (x) of paragraph 3 of Companies (Auditor’s Report)
Order, 2016, whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

**Audit Procedures and Reporting under CARO:**

| 8(a). Discussion with engagement team | While planning the audit, the auditor should discuss with other members of the audit team, the susceptibility of the company to material misstatements in the financial statements resulting from fraud. While planning, the auditor should also make inquiries of management to determine whether management is aware of any known fraud or suspected fraud that the company is investigating. |
| 8(b). Examining reports of internal auditor | The auditor should examine the reports of the internal auditor with a view to ascertain whether any fraud has been reported or noticed by the management. The auditor should examine the minutes of the audit committee, if available, to ascertain whether any instance of fraud pertaining to the company has been reported and actions taken thereon. |
| 8(c). Enquire from the management | The auditor should enquire from the management about any frauds on the company that it has noticed or that have been reported to it. The auditor should also discuss the matter with other employees including officers of the company. The auditor should also examine the minute book of the board meeting of the company in this regard. |
| 8(d). Written representation from management | The auditor should obtain written representations from management that: it acknowledges its responsibility for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error; it believes the effects of those uncorrected misstatements in financial statements, aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representation; it has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity; and it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud. |
| 8(e). Conclusion | → Where the auditor notices that any fraud by the company or on the company by its officers or employees has been noticed by or reported during the year, the auditor should, apart from reporting the existence of fraud, also required to report, the nature of fraud and amount involved. For reporting under this clause, the auditor may consider the following: → This clause requires all frauds noticed or reported during the year shall be reported indicating the nature and amount involved. As specified the fraud by the company or on the company by its officers or employees are only covered. Of the frauds covered under section 143(12) of the Act, only noticed frauds shall be included here and not the suspected frauds. → While reporting under this clause with regard to the nature and the amount involved of the frauds noticed or reported, the auditor may also consider the principles of materiality outlined in Standards on Auditing. |

**Questions**

Auditor needs to report to central Government in case of fraud involving 20 lakh rupees. (SM)
5.6 Auditor Unable To Continue The Engagement

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

<table>
<thead>
<tr>
<th>1. Determine responsibilities applicable</th>
<th>Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Determine whether withdrawal is permitted</td>
<td>(iii) Consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under applicable law or regulation; and</td>
</tr>
<tr>
<td>3. Responsibility on withdrawal</td>
<td>(iv) If the auditor withdraws: Discuss with the appropriate level of management and those charged with governance the auditor’s withdrawal from the engagement and the reasons for the withdrawal; and Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor’s withdrawal from the engagement and the reasons for the withdrawal.</td>
</tr>
</tbody>
</table>

Questions
You notice a misstatement resulting from suspected fraud during the audit and conclude that it is not possible to continue the performance of audit As a Statutory Auditor, how would you deal? (SM)
Chapter-6
Audit in an Automated Environment

6.1 Automated environment

1. Meaning

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.

2. Key features of an Automated Environment

- Enable faster business operations
- Accuracy in data processing and computation
- Ability to produce large volumes of transaction
- Integration between business operations
- Better security and control
- Less prone to human error
- Provides latest information
- Connectivity and networking capabilities

6.2 Relevance Of ‘IT’ 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:

1. Areas where IT will be relevant

Given below are some situations in which IT will be relevant to an audit,

a) Increased use of Systems and Application software in Business (for example, use of ERPs)

b) Complexity of transactions has increased (multiple systems, network of systems)

c) Hi-tech nature of business (Telecom, e-Commerce).

d) Volume of transactions are high (Insurance, Banking, Railways ticketing).

2. Audit approach

a) In some of the above situations it is likely that carrying out audit using traditional substantive audit procedures may be difficult or even not feasible if the company prepares, records and conducts majority of business activities through IT systems only.

b) On the other hand, many companies may use less complex IT systems including desktop based accounting or spreadsheets. In such situations, the relevance of IT to an audit could be less. However, the auditor is still required to carry out at least an understanding the IT environment of the company and document the same.

c) Another area where IT can be relevant to audit is by using data analytics using computer assisted audit techniques (CAATs). By using data analytics, it is possible to improve the effectiveness and efficiency of an audit. We will learn more about data analytics in the later sections of this chapter.

Conclusion

From the above, we can see how IT is relevant to an audit under different situations viz., audit, non-audit and meeting regulatory compliance requirements. We will learn more about understanding risks, controls and documentation in further
Auditing and Assurance

<table>
<thead>
<tr>
<th>Questions</th>
<th>Briefly mention three reasons why IT should be considered relevant to an audit of financial statements. <em>(SM)</em></th>
</tr>
</thead>
</table>

### 6.3 Understanding and Documenting Automated Environment

#### 1. Understanding 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).

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

#### 3. Understanding Risk due to IT
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.

#### 4. Impact of IT related risks i.e. on Substantive Audit, Controls and Reporting
The above risks, if not mitigated, could have an impact on audit in different ways. Let us understand how:
- First, we may not be able to rely on the data obtained from systems where such risks exist. This means, all forms of data, information or reports that we obtain from systems for the purpose of audit has to be thoroughly tested and corroborated for completeness and accuracy.
- Second, we will not be able to rely on automated controls, calculations, accounting procedures that are built into the applications. Additional audit work may be required in this case.
- Third, due to the regulatory requirement of auditors to report on internal financial controls of a company, the audit report also may have to be modified in some instances.

| Questions | Q 1 All automated environments are complex . *(SM)*  
|           | Q 2 In an audit of financial statements , the auditor should plan response to all IT risks . *(SM)*  
|           | Q 3 Describe how risks in IT systems , if not mitigated could have an impact on audit (SM) |
## 6.4 Controls in an Automated Environment

| 1. Types | General IT Controls  
| | Application Controls  
| | IT-Dependent Controls |

| 2. General IT Controls | General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments. General IT-controls that maintain the integrity of information and security of data commonly include controls over the following  
| | Data center and network operations  
| | Program change  
| | Access security  
| | Application system acquisition, development, and maintenance (Business Applications) |

| 2(a) Data Center and Network Operations | **Objective:** To ensure that production systems are processed to meet financial reporting objectives.  
| **Activities:**  
| | Overall Management of Computer Operations Activities  
| | Batch jobs – preparing, scheduling and executing  
| | Backups – monitoring, storage & retention  
| | Performance Monitoring – operating system, database and networks  
| | Recovery from Failures – BCP, DRP  
| | Help Desk Functions – recording, monitoring & tracking  
| | Service Level Agreements – monitoring & compliance  
| | Documentation – operations manuals, service reports |

| 2(b) 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 |

| 2(c) Access Security | **Objective:** To ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives.  
| **Activities:**  
| | Security Organization & Management  
| | Security Policies & Procedures  
| | Application Security  
| | Data Security  
| | Operating System Security  
| | Network Security – internal network, perimeter network  
| | Physical Security – access controls, environment controls |
Auditing and Assurance

→ System Administration & Privileged Accounts – Sysadmins, DBAs, Super users

2(d) Application system acquisition, development, and maintenance

**Objective:** To ensure that systems are developed, configured and implemented to meet financial reporting objectives

**Activities:**
- Overall Mgmt. of Development Activities
- Project Initiation
- Analysis & Design
- Construction
- Testing & Quality Assurance
- Data Conversion
- Go-Live Decision
- Documentation & Training

3. 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.

3(a) 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.

3(b) General IT Controls vs. Application Controls

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

Questions

General IT controls support the functioning of Application controls. (SM)

6.5 Testing Methods

There are basically four types of audit tests that should be used. They are inquiry, observation, inspection and re-performance.

1. Inquiry

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.

2. Reperformance

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.

3. Methods should be applied in combination

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 as required by SA 230.

4. Methods of testing in automated environment

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.
- Inspect the system logs to determine any changes made since last audit testing.
- Inspect technical manual / user manual of systems and applications.
- Carry out a test check (negative testing) and observe the error message displayed by the application.
- Conduct reperformance using raw source data and independently applying formulae, business rules or validations on the source data using CAATs.

Questions

Q 1 Inquiry is often the most efficient audit testing method, but least effective. (SM)
Q 2 What are the different testing methods used when auditing in an automated environment which is the most effective and efficient method of testing (SM)

6.6 Internal Financial Controls As Per Regulatory Requirements

1. Meaning

The term Internal Financial Controls (IFC) basically refers to the policies and procedures put in place by companies for ensuring:
- reliability of financial reporting
- effectiveness and efficiency of operations
- compliance with applicable laws and regulations
- safeguarding of assets
- prevention and detection of frauds

2. Reference in companies act

- Sec 134(5)(e) - board report
- Sec 143(3) (i) - duties of auditors
- Sec 149(8) and Schedule IV - directors
- Sec 177 - audit committee
- Rule 8 (5) of Companies (Accounts) Rules 2014

3. Responsibility

- 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.

6.7 Data Analytics For Audit

- 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. A famous businessman recently said, “Data is the new Oil”.
- 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.
- Re performance of mathematical calculations – depreciation, bank interest calculation.
- Analysis of journal entries as required by SA 240.
- Fraud investigation.
- Evaluating impact of control deficiencies.

Questions

Specialised audit tools like IDEA, ACL are required to perform data analytics.

---

6.8 Assess And Report Audit Findings

1. Conclusion of audit

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.

2. Point to be considered

> 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.
### 7.1 Audit Sampling

| Meaning | → Audit sampling‖, ‗audit sampling' refers to 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. |
| Questions | Q 1 Sample need not be representative(SM)  
Q 2 What is the meaning of Sampling ?Also discuss the methods of sampling . Explain in the light of SA 530 “ Audit sampling “(SM)  
Q 3 With reference to standard on Auditing 530 , state the requirements relating to audit sampling , sample design , sample size and selection of items for testing . (SM)  
Q 4 While planning the audit of S Ltd . you want to apply sampling techniques. What are the risk factors you should keep in mind ? (SM) |

### 7.2 Population

| 1.Meaning | Population refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions |
| 2.Characteristics of Population |  |
| 2(a) Appropriateness | The auditor will need to determine that the population from which the sample is drawn is appropriate for the specific audit objective. 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 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. |
| 2(b) 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 operated effectively during the financial reporting period, the population needs to include all relevant items from throughout the entire period. |
| 2(c) 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. |
| Questions | Universe refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions . (SM) |

### 7.3 Approaches To Sampling

| 1.Two approaches | → 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. → A sampling approach that does not have above characteristics is considered |
Auditing and Assurance

| 2. Statistical sampling | non-statistical sampling.  
| The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.  
| 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. |
| 2. Statistical sampling | 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.  
| 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. 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.  
| 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. |
| 5. Advantages of statistical sampling | 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), using 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. |
| Questions | Q 1 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 . (SM)  
| Q 2 Write short notes on the following :  
| (a) Advantages of statistical sampling in Auditing . (SM) |

7.4 Appropriateness of Sampling Approaches

<p>| 1. Comparisons between | In statistical sampling, the sample results are measurable as to the adequacy and |</p>
<table>
<thead>
<tr>
<th>2. Advantages of statistical sampling</th>
<th>The advantages of statistical sampling may be summarized as follows -</th>
</tr>
</thead>
<tbody>
<tr>
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</tr>
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</tr>
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</tr>
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<td>d)</td>
<td>It provides a means for deriving a “calculated risk” and corresponding precision (sampling error) <em>i.e.</em> the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.</td>
</tr>
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<td>e)</td>
<td>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.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Conclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>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. The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor’s judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.</td>
</tr>
</tbody>
</table>

### 7.5 Sample Design

→ When designing an audit sample, 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. 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. 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.

→ 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. 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.

→ 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.

7.6 Stratification and Value-Weighted Selection

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection technique is appropriate. SA 530 provides guidance to the auditor on the use of stratification and value-weighted sampling techniques.

1. 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.

→ 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.

→ If a class of transactions or account balance has been divided into strata, the misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.

2. 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.
## 7.7 Sample size

### 1. Sample Size

- 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.

### 2. Examples of Factors Influencing Sample Size for Tests of Controls

- 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.
- 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.
- When there is an increase in the expected rate of deviation of the population to be tested then sample size will increase, as higher 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.
- 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.
- 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.

### 3. Examples of Factors Influencing Sample Size for Tests of Details

- The higher the auditor’s assessment of the risk of material misstatement, the larger the sample size needs to be.
- 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.
- 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.
- An increase in tolerable misstatement will decrease the sample size as lower the tolerable misstatement, the larger the sample size needs to be.
- 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.
- 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.
### 7.8 Sample Selection Methods

<table>
<thead>
<tr>
<th>Method</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Random Sampling</strong></td>
<td>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.</td>
</tr>
<tr>
<td><strong>2. Simple Random Sampling</strong></td>
<td>Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected. The mechanics of selection of items may be by choosing numbers from table of random numbers by computers or picking up numbers randomly from a drum. It is considered that random number tables are simple and easy to use and also provide assurance that the bias does not affect the selection. This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range.</td>
</tr>
<tr>
<td><strong>3. Stratified Sampling</strong></td>
<td>→ 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. → 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. → Therefore, we can say that random selection method is applied through random number generators, for example, random number tables).</td>
</tr>
<tr>
<td><strong>4. Interval or Systematic Sampling</strong></td>
<td>→ 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. → 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.</td>
</tr>
<tr>
<td><strong>5. Monetary Unit Sampling</strong></td>
<td>It is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.</td>
</tr>
<tr>
<td><strong>6. Haphazard sampling</strong></td>
<td>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.</td>
</tr>
</tbody>
</table>
**7. 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.

**Questions**

Q 1  The method which involves dividing the population into group of items is known as block sampling (SM)

Q 2  The objective of stratification is to increase the variability of items with each stratum and therefore allow sample size to be reduced without increasing sampling risk. (SM)

Q 3  Stratified sampling (SM)

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**7.9 Selection of Items for Testing**

- 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.

---

**7.10 Sampling and Non-Sampling Risk**

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

2. **Non-Sampling Risk.** The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. Examples of non-sampling risk include use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognize a misstatement or deviation. Non sampling risk can never be mathematically measured.
## 7.11 Performing Audit Procedures

<table>
<thead>
<tr>
<th>1. Applying audit procedures</th>
<th>The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Unable to apply on a selected item</td>
<td>If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item.</td>
</tr>
<tr>
<td>3. No audit procedure applicable on a item</td>
<td>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.</td>
</tr>
</tbody>
</table>

## 7.12 Nature and cause of deviations and misstatements

<table>
<thead>
<tr>
<th>1. Examining deviation or misstatements having common feature</th>
<th>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. 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.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Considering Effect on purpose of the audit procedure and on other areas of the audit.</td>
<td>In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud. 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.</td>
</tr>
<tr>
<td>3. Considering a misstatement or deviation discovered in a sample to be an anomaly</td>
<td>In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population. The auditor shall obtain 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.</td>
</tr>
</tbody>
</table>

## 7.13 Projecting Misstatements

<table>
<thead>
<tr>
<th>1. Projecting misstatements</th>
<th>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.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Excluding anomaly while projecting</td>
<td>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.</td>
</tr>
<tr>
<td>3. Projecting not necessary in case of test of controls</td>
<td>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.</td>
</tr>
</tbody>
</table>

## 7.14 Evaluating Results Of Audit Sampling

<table>
<thead>
<tr>
<th>1. Auditor to evaluate</th>
<th>The auditor shall evaluate- (a) The results of the sample; and</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2. Test of controls</strong></td>
<td>For tests of controls, an unexpectedly high sample deviation rate may lead to an increase in the assessed risk of material misstatement, unless further audit evidence substantiating the initial assessment is obtained.</td>
</tr>
<tr>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td><strong>3. Test of details</strong></td>
<td>For tests of details, an unexpectedly high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no material misstatement exists.</td>
</tr>
</tbody>
</table>
| **4. Compare projected misstatement plus anomalous misstatement with tolerable rate of misstatement** | → In the case of tests of details, the projected misstatement plus anomalous misstatement, if any, is the auditor’s best estimate of misstatement in the population.  
→ When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested.  
→ The closer the projected misstatement plus anomalous misstatement is to tolerable misstatement, the more likely that actual misstatement in the population may exceed tolerable misstatement.  
→ Also if the projected misstatement is greater than the auditor’s expectations of misstatement used to determine the sample size, the auditor may conclude that there is an unacceptable sampling risk that the actual misstatement in the population exceeds the tolerable misstatement.  
→ Considering the results of other audit procedures helps the auditor to assess the risk that actual misstatement in the population exceeds tolerable misstatement, and the risk may be reduced if additional audit evidence is obtained. |
| **5. Sampling results not reasonable** | → In case the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested,  
→ the auditor may request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or  
→ tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures. |
8.1 Meaning of Analytical Procedures

1. Origin
   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 trend and ratio analysis in addition to reasonable tests. Hence analytical procedures were introduced.

2. Meaning
   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.

3. Examples
   Examples of Analytical Procedures having consideration of comparisons of the entity’s financial information with are:
   - Comparable information for prior periods.
   - Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
   - Similar industry information, such as a comparison of the entity’s ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

4. Examples
   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.

Questions
Q 1 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” (SM)
Q 2 Auditor can depend on routine checks to disclose all the mistakes or manipulation that may exist in accounts. (SM)
Q 3 Define Analytical procedures. (SM)

8.2 Purpose And Timing Of Analytical Procedures

1. Purpose
   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.

2. Timing
   Analytical Procedures are required in the planning phase and it is often done during...
### Analytical Procedures

3. 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.

### Questions

Q 1 Analytical procedures are required in the planning phase only. (SM)

Q 2 Only purpose of analytical procedures is to obtain relevant and reliable audit evidence when using substantive analytical procedures. (SM)

### 8.3 Factors to be considered for Substantive Audit Procedures

<table>
<thead>
<tr>
<th>1. Availability of Data</th>
<th>The availability of reliable and relevant data will facilitate effective procedures.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Disaggregation</td>
<td>The degree of disaggregation in available data can directly affect the degree of its usefulness in detecting misstatements.</td>
</tr>
<tr>
<td>3. Account Type</td>
<td>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.</td>
</tr>
<tr>
<td>4. Source</td>
<td>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 are often subject to management judgment and therefore more difficult to predict.</td>
</tr>
<tr>
<td>5. Predictability</td>
<td>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.</td>
</tr>
<tr>
<td>6. Nature of Assertion</td>
<td>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.</td>
</tr>
<tr>
<td>7. Inherent Risk or “What Can Go Wrong”</td>
<td>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.</td>
</tr>
</tbody>
</table>

### Questions

What are the factors that determine the extent of reliance that the auditor places on result of analytical procedures? Explain with reference to SA – 520 “Analytical procedures. (SM)
8.4 Techniques Available as Substantive Analytical Procedures

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:

1. **Trend analysis**
   - A commonly used technique 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.

2. **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.

3. **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.

4. **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**

While carrying out the statutory audit of a large entity, what are the substantive procedures to be performed to assess the risk of material misstatement? (SM)

8.5 Analytical Procedures used as Substantive Tests

When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330, the auditor shall:

1. **Determining suitability**
   - 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;

2. **Evaluating reliability**
   - 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;

3. **Developing expectation**
   - Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and

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

**Questions**

Substantive analytical procedures are generally less applicable to large volumes of transactions that tend to be predictable over time. (SM)

8.6 Suitability Of Particular Analytical Procedures For Given Assertions

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

1. **Relationship**
   - 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.

2. Effectiveness of analytical procedures

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.

3. Specific Situation

In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For 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.

4. Different types provide different assurance

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.

5. Nature of assertion as well as risk

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.

6. Test of details already performed

Particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion.

### 8.7 Extent Of Reliance On Analytical Procedures

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

1. Source

Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity.

2. Comparability

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.

3. Nature and relevance

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

4. Controls

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.
8.8 Risk Of Material Misstatements

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.

8.9 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:

| 1. Inquiry | 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. |
| 2. Other procedures | 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. |

8.10 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.

8.11 Considerations Specific To Public Sector Entities

- The relationships between individual financial statements items traditionally considered in the audit of business entities may not always be relevant in
the audit of governments or other non-business public sector entities; for example, in many public sector entities there may be little direct relationship between revenue and expenditure.

→ In addition, because expenditure on the acquisition of assets may not be capitalized, there may be no relationship between expenditures on, for example, inventories and fixed assets and the amount of those assets reported in the financial statements.

→ Also, industry data or statistics for comparative purposes may not be available in the public sector.

→ However, other relationships may be relevant, for example, variations in the cost per kilometer of road construction or the number of vehicles acquired compared with vehicles retired.